POSITIONING FOR A POTENTIAL RECOVERY WITH SMALL CAP STOCKS

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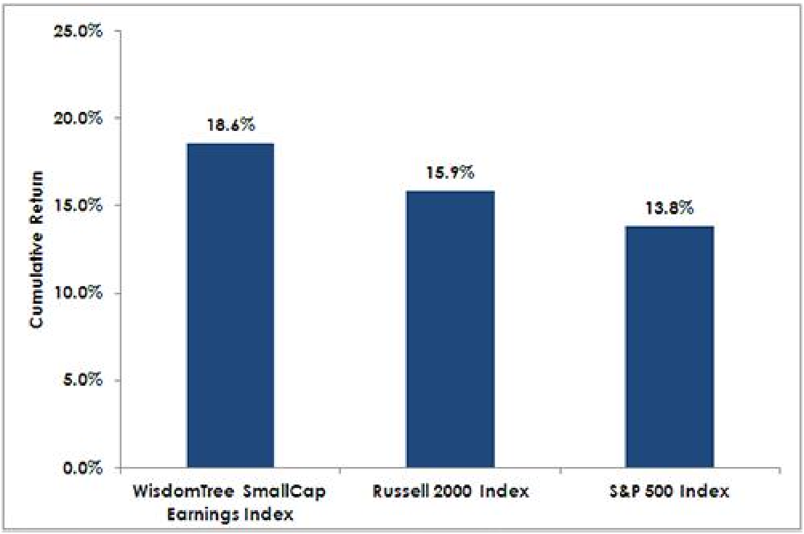
After the S&P 500 Index hit record highs during the first half of 2013, many now believe that the U.S. economy is heading toward a point of inflection. One of the single largest market-moving influences of late has been the different tone coming out of the U.S. Federal Reserve. Since the 2008–09 global financial crisis, U.S. equity markets have enjoyed an environment of accommodative monetary policy. If this should change, a crucial question regards how equity markets might respond. **WisdomTree SmallCap Earnings Index (WTSEI): Outperformance (12/31/2012–6/30/2013)**



Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

Average Annual Returns (as of 6/30/2013)

	WT Index Inception Date	1-Year	3-Year	5-Year	Since WT Index Inception	10-Year
WisdomTree SmallCap Earnings Index	2/1/2007	27.19%	19.95%	14.72%	6.58%	N/A
Russell 2000 Index		24.21%	18.67%	8.77%	4.62%	9.53%
S&P 500 Index		20.60%	18.45%	7.01%	3.98%	7.30%

Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

• **WTSEI Performed Strongly**: Whether one looks at a year-to-date, one-year, three-year, five-year or even since-inception return, WTSEI has done well compared to the Russell 2000 Index and the S&P 500 Index, possibly the most widely followed measure of U.S. equity market performance. • **Consumer Discretionary**: The changing tone coming out of the U.S. Federal Reserve could signal an improving U.S. economic picture. If this is indeed the case, U.S. consumers may ultimately pick up their consumption. Compared to the Russell 2000 Index, WTSEI had an approximate 5% over-weight (approx. 19% vs. 14%) in this sector during the first half of 2013. The S&P 500 Index had about 12% weight in this sector. Performance for Consumer Discretionary stocks within each index for the period was approximately 39% for WTSEI, 32% for the Russell 2000 and 20% for the S&P 500. This coincides with a broader measure of exposure to the more defensive sectors—sectors that may underperform if the U.S. economy continues to improve. As of June 30, 2013, defensive sector exposure was at approx. 13% for WTSEI, 20% for the Russell 2000 and 30% for the S&P 500. **Navigating the Inflection Point** Small-cap stocks—and WTSEI in particular—offer an interesting means through which to navigate the changing

U.S. economic landscape. We see three crucial distinguishing factors that lead us to this conclusion: 1. Exposure to U.S.-generated revenues 2. Lower leverage and lower long-term debt to equity 3. Attentiveness to relative valuation **Exposure to U.S.-Generated Revenues** In essence, if the Fed deems the economy to be stable enough to handle less accommodative policy, growth must be relatively strong compared to even a few short years ago. As a result, some might be looking at the equity markets from the perspective of which types of companies may be more exposed to U.S.-generated revenues—thereby being in a prime position to benefit from an improving U.S. economic picture. As of June 30, 2013, whether one looks at the weighted average revenues of the top 10 U.S. constituents of WTSEI or the Russell 2000 Index, the figure is over 80%. This compares to less than 50% for the S&P 500 Index, a commonly used measure of U.S. large caps. Therefore, if sensitivity to U.S. economic strength is desired, this is one argument for thinking about small-cap stocks. **Lower Leverage and Lower Long-Term Debt to Equity** If the Fed is to actually follow through on its plan to abandon its monetary purchases, a potential side effect of this policy could be rising interest rates. **Long-Term Debt to Equity & Leverage as of June 30, 2013**

Index	Long-Term Debt to Equity	Leverage
WisdomTree SmallCap Earnings Index	61.5%	2.0x
Russell 2000 Index	78.1%	2.1x
S&P 500 Index	71.5%	2.5x

Source: Bloomberg.
Past performance is not indicative of future results.
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Long-term debt to equity and leverage are two measures that can be used to gauge potential sensitivity to rising interest rates. How is this? Well, both of these metrics indicate the propensity of index constituents to employ borrowed money, and firms with higher borrowing needs may be faced with a more difficult situation if interest rates rise, as their costs could increase. Generally speaking, the small-cap stock indexes shown (WTSEI and the Russell 2000) have lower leverage than the S&P 500. While true that it may be easier for larger firms to employ greater leverage at a lower cost, we believe it is still worth pointing out this important difference. On the other hand, the long-term debt to equity picture does not offer as clearly stratified an illustration across the capitalization spectrum. WTSEI is on the lower end of the three indexes shown. **Attentiveness to Relative Valuation** In this piece, the first thing we discussed was the strong relative performance of WTSEI. One of the most important considerations after a period of such outperformance regards valuation. Have the stocks themselves started to become expensive? WTSEI is weighted by the *Earnings Stream* as opposed to market capitalization like the Russell 2000 Index. What this means is that to garner a greater share of WTSEI's weight, a firm must generate not only positive earnings (firms with negative earnings are not eligible at the Index screening date) but more positive earnings than other firms. What that tends to do is lower the price-to-earnings (P/E) ratio compared to market capitalization-weighted indexes of similar universes of stocks. As of June 30, 2013, WTSEI had a P/E ratio of 15.8x, whereas the Russell 2000 Index had a P/E ratio of 22.5x. **Conclusion** WTSEI performed strongly during the first half of 2013, and we believe a foundation is in place upon which the Index could remain well-positioned for changing U.S. monetary policy. It is interesting to us that the Index's largest over-weights compared to the Russell 2000 Index as of June 30, 2013, are in Consumer Discretionary and Industrials. If in fact the U.S. economy is improving, those sectors have the potential to benefit from a stronger U.S. consumer and an increased demand for products. **Unless otherwise stated, data source is Bloomberg.**

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DEFINITIONS

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Long-term debt to equity : Ratio of long-term debt, typically over one year in maturity, to the level of equity. Higher numbers indicate a greater reliance on borrowing to finance firm activity.

Relative value : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.

Earnings Stream® : Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.