

Smart Beta—the Proof Is in the Performance

Published April 4, 2014

Though you may only recently have heard about smart beta indexes and exchange-traded funds (ETFs), they have actually been around for some time. In fact, in 2006, we launched one of the first families of alternatively weighted ETFs, weighting by dividends and calling them “fundamentally weighted.” From there, we applied the same methodology to the earnings-generating segments of the market to expand our offering. Today, WisdomTree offers investors smart beta ETFs in all major equity markets around the world. You may wonder why our first ETFs were weighted by dividends or earnings. The short answer is because we believe these fundamentals offer a more objective measure of a company’s health, value and profitability than stock price alone. For the longer answer, we’ll have to talk a little about finance theory and history. Market capitalization-weighted indexes, the bulk of indexes in existence today, weight individual components by their stock market capitalization. This approach is supported by what is known as the Efficient Market Hypothesis, a widely accepted theory that claims the market price of any security is always the best unbiased estimate of a firm’s true underlying value (i.e., its “fundamental value”) and that no other information that can be easily obtained will give a better estimate of the stock’s fundamental value. Taken a step further, this theory implies that capitalization-weighted indexes deliver the highest expected returns given any level of risk and the lowest possible risk for any given return—making them “mean variance efficient,” which would mean that they offer the optimal risk/return ratio for any desired level of risk tolerance.

But Markets Are not Always Efficient At WisdomTree, we believe that stock price movements are better explained by the Noisy Market Hypothesis—a term coined by Professor Jeremy Siegel, Senior Investment Strategy Advisor to WisdomTree and Russell E. Palmer Professor of Finance at The Wharton School of the University of Pennsylvania. Why do we believe this theory? To name just a few reasons:

- Conventional wisdom has long recognized that prices of speculative assets, such as equities, experience periods of frenzy and irrational bubbles that can cause their prices to deviate widely from their fair value.
- When momentum traders speculate on the basis of past price movements or are motivated by “noise,” such as rumors or incomplete or inaccurate information, the prices of individual stocks will not always be efficient—or, in other words, offer the highest possible return for the desired level of risk.
- Investors and institutions often buy or sell shares for reasons unrelated to the valuation of the firm, but for liquidity, fiduciary, tax—or even emotional—reasons.

Consequently, the prices realized on these trades are often not representative of the best, unbiased estimates of the fundamental value of the shares. And today, performance demonstrates that market capitalization weighting may not be the best method of indexing. In fact, according to Cass Consulting, a research-led consultancy service provided by Cass Business School, returns of traditional, market capitalization-weighted indexes are lagging behind alternative—or smart beta—indexes by as much as

2% per year from 1969 to 2011¹. So, although the majority of ETFs on the market today adhere to their passive “indexing” heritage, it may not be surprising that alternative methods are growing in popularity (read more [here](#)). If you can accept that price may not always be the best indicator of value—as history has shown time and again—you can appreciate the potential value of smart beta approaches such as WisdomTree’s, which rebalance and weight entire equity markets based on income. WisdomTree’s family of smart beta ETFs has proven itself for more than seven years—which included an unprecedented market event².

We believe smart beta approaches like ours may help advisors and investors to:

- Enhance portfolio returns
- Reduce portfolio risk
- Increase dividend income
- Benefit from more complete diversification
- And much more

To learn more about smart beta, read our full paper [here](#).

¹Source: Andrew Clare et al., “An Evaluation of Alternative Equity Indices; Part 2: Fundamental Weighting Schemes,” Cass Business School, March 2013.

²Referring to the 2008–09 global financial crisis, during which many asset classes globally faced significant pressure.

Important Risks Related to this Article

Diversification does not eliminate the risk of experiencing investment losses.