Why “Passive” Doesn’t Always Mean “Average”

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In February 2007, WisdomTree launched the WisdomTree U.S. MidCap Earnings Index, and the WisdomTree U.S. MidCap Earnings Fund (EZM) to track it. With an almost 11-year live track record for reflection, we review why WisdomTree chose to weight this Index by earnings and how this decision has helped the exchange-traded fund (ETF) achieve returns among the top of its Morningstar Category of active and passive peers.

How Valuation Has Been Important

Over a variety of long-term periods, work by Professor Jeremy Siegel in his book *The Future for Investors* has indicated that the after-inflation returns of equities have held a very close relationship to their earnings yield—the reciprocal of the price-to-earnings (P/E) ratio. In short:

- Higher earnings yields (or lower P/E ratios) have been associated with stronger real returns.
- Lower earnings yields (or higher P/E ratios) have been associated with weaker real returns.

If, for instance, we’re looking at the S&P MidCap 400 Index with a trailing 12-month P/E ratio of 26.1x as of January 31, 2018, that is associated with a 3.8% earnings yield, and it becomes more challenging to see *real* after-inflation returns to U.S. equities that are too different from this 3.8% level—at least if history is any guide.1

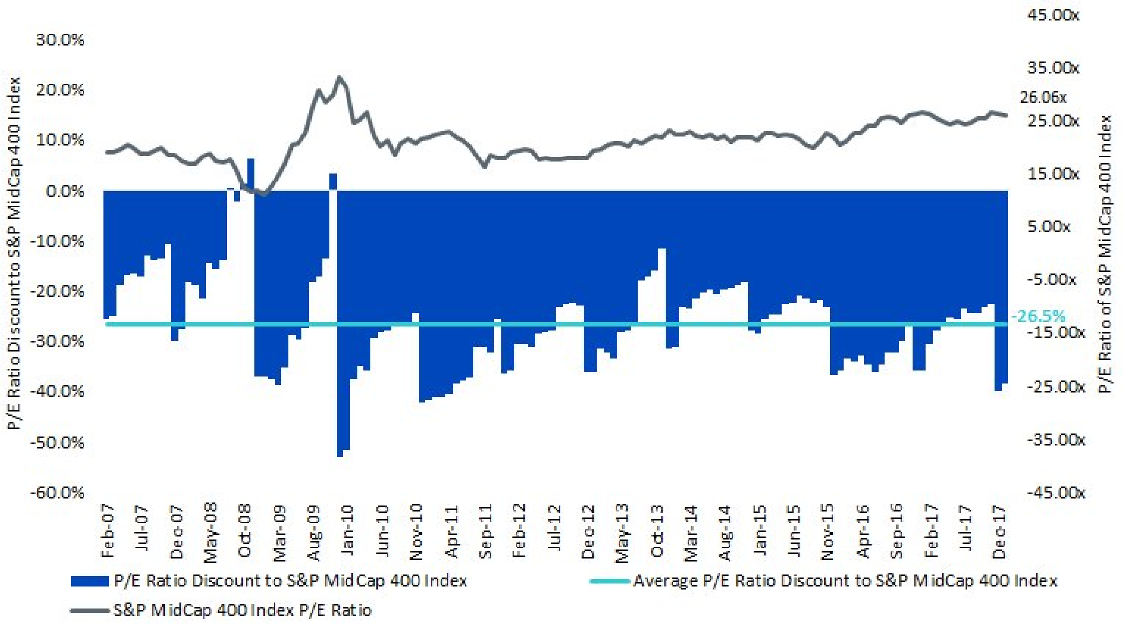
Where WisdomTree’s U.S. MidCap Earnings Strategy Can Help

The WisdomTree U.S. MidCap Earnings Index follows two big-picture steps at its annual rebalance, screened on November 30 of each year:

- Include only profitable companies
- Weight companies by their core earnings

This process has tended to raise earnings yields (same thing said a different way: lower P/E ratios) compared with market capitalization-weighted universes of similar stocks. Below, we focus on the WisdomTree U.S. MidCap Earnings Index P/E relative to the S&P MidCap 400 Index historically.

The WisdomTree U.S. MidCap Earnings Index Has Had a 26.5% Average P/E Ratio Discount Compared with the S&P MidCap 400 Index over Its Live History



Sources: WisdomTree, FactSet, with data from 2/1/07, the inception date of the WisdomTree U.S. MidCap Earnings Index, to 1/31/18. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

The Benefits of a Multi-Factor Rebalance

Factor-based investing is taking on greater importance in portfolio construction. So how does the WisdomTree U.S. MidCap Earnings Index tap into multiple factors that have been associated with long-term outperformance?

Value: This factor was touched on above—a systematic P/E discount to the market cap-weighted benchmark Index has been the result of the annual rebalance.

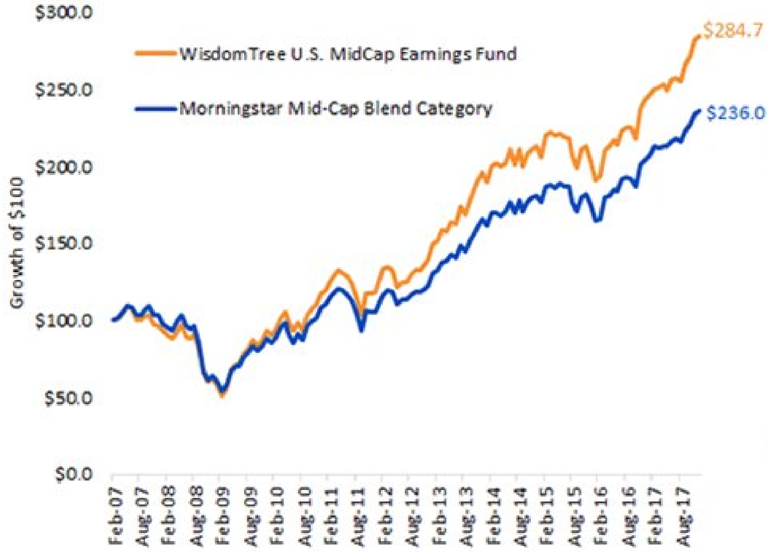
Quality: We also find that weighting profitable companies by earnings tends to tilt the Index toward stocks with higher measures of return on equity and return on assets, commonly used measures of the quality (or profitability) factor.

Size: Providing purer exposure to the mid-cap segment of the market can also help improve returns over time. As of December 31, 2017, the WisdomTree U.S. MidCap Earnings Index held 100% of its weight in stocks between the $2 billion and $10 billion market cap range in an efficient targeting of the size-factor exposure.

The Result: 100% Outperformance over Trailing 10 Years

The overarching goal of the WisdomTree Index has been the same all along: to unshackle the investor from needing to invest at whatever the market's earnings yield is by rebalancing annually with a process aimed at actually raising the earnings yield compared to a similar market cap-weighted index.

Just as the higher earnings yields of the WisdomTree Index have indicated, over longer periods of time, the investment result for the fund tracking this Index has been outperforming 100% of its Morningstar peer category over the past 10 years, and 98% since its inception.



				Average Annual Total Returns as of 12/31/17									
	Fund Information			NAV Returns (%)					Market Price Returns (%)				
Fund/Index/Category	Ticker	Exp. Ratio	Inception Date	1-Year	3-Year	5-Year	10-Year	Common Period	1-Year	3-Year	5-Year	10-Year	Common Period
WisdomTree U.S. MidCap Earnings Fund	EZM	0.38%	2/23/2007	17.2%	10.2%	15.3%	11.4%	10.1%	17.4%	10.2%	15.3%	11.4%	10.1%
S&P MidCap 400 Index				16.2%	11.1%	15.0%	10.0%	9.1%	16.2%	11.1%	15.0%	10.0%	9.1%
Morningstar Mid-Cap Blend Category				15.9%	9.3%	14.0%	8.6%	8.2%	15.9%	9.3%	14.0%	8.6%	8.2%

Sources: WisdomTree, Morningstar, as of 12/31/17. EZM has outperformed 65% of its Morningstar peer category over the past year. Number of peers (both mutual funds and ETFs) in each category: Mid-Cap Blend: 446 (1-Year), 362 (3-Year), 327 (5-Year), 221 (10-Year), 198 (Since Inception). "Common Period" refers to 2/28/07–12/31/17 due to the availability of Morningstar Category performance data. The Percent of Peers Beaten is the fund's total-return percentile rank compared to all funds in the same Morningstar Category and is subject to change each month.

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1Sources: WisdomTree, FactSet.

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