IMPORTANCE OF REFRESHING THE QUALITY FACTOR

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We tend to write a lot about the annual rebalance of the WisdomTree U.S. Earnings Indexes because—simply put—this is the single most important difference that they bring to any U.S. equity discussion. The success of the nearly 11-year live track record can be traced back to this process, repeated each year based on data screened on the last trading day of November.

Modern Alpha Generation Must Have a Foundation within Risk Premiums

Even as academics continue to research and debate the presence (or lack thereof) of different risk premiums, consensus has seemed to accept the presence of five primary factors upon which excess returns over and above what could be explained by taking excess risk have tended to be based:

1. Value
2. Quality
3. Size
4. Momentum
5. Low volatility

As the terminology has shifted from fundamentally weighted to smart beta to now modern alpha, the building blocks—these factors—have remained constant. We wrote recently ("11 Consecutive Years of Lowering P/E Ratios … and Counting!") about how one can think of our U.S. Earnings Index rebalance "refreshing" exposure to the value factor. Now, we turn our focus to quality.

Profitability within Small Caps and Mid-Caps Has Been Associated with Stronger Returns

Market Capitalization Size Segment	Operating Profitability: Lowest	Low	Mid	High	Highest
Smallest	8.53%	14.90%	13.90%	15.05%	12.87%
Small	9.20%	12.89%	13.81%	12.74%	15.10%
Mid	8.88%	13.11%	12.82%	12.68%	14.55%
Large	9.66%	12.13%	11.74%	12.31%	13.66%
Largest	7.51%	8.56%	9.82%	10.20%	11.02%

Sources: WisdomTree, Kenneth French Data Library, with data for the period 6/30/1963–10/31/17.

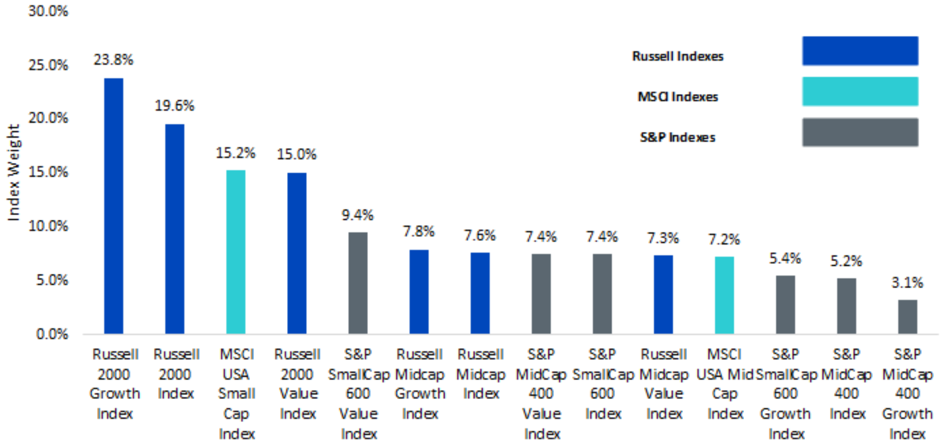
As we search for the darkest shades of green—the strongest returns—we tend to see them on the small- to mid-cap end of the size spectrum and on the higher end of the operating profitability spectrum. We see the darkest shades of red (lowest returns) clustered along the lowest operating profitability quintile. Simple, long-run data, therefore, suggests that the first hurdle to clear could very well be avoiding those firms with the lowest operating profitability, while the second could be emphasizing stronger profitability within the mid-cap and small-cap size segment.

Market Capitalization-Weighted Indexes Won't Avoid Unprofitable Firms

Simply utilizing a broad-based, market capitalization-weighted benchmark of mid-caps or small caps will not actually avoid exposure to unprofitable firms. We never cease to be surprised by 1) the amount of exposure to unprofitable firms present, particularly in certain small-cap benchmarks, and 2) the variation in exposure to unprofitable firms across different index providers.

Importantly, exposure to unprofitable firms—particularly those with negative trailing 12-month earnings per share—is a fairly insignificant matter on the large-cap end of the size spectrum, which is why we don't discuss it here.

Exposure to Unprofitable Companies in Mid-Cap and Small-Cap Benchmarks



Sources: WisdomTree, Bloomberg, with data as of 11/30/17. You cannot invest directly within an Index.

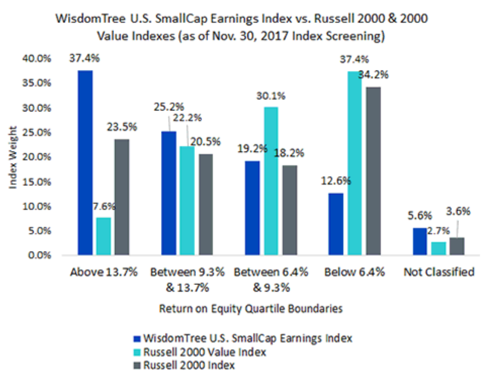
- **Russell 2000 Index Variants:** Three of the top four exposures to unprofitable firms were the Russell 2000 Index, Russell 2000 Value Index and Russell 2000 Growth Index. This methodology, true, is the broadest-based of the indexes shown, but we'd encourage people to remember that a consequence of being the broadest-based is including firms with strong, average and weak fundamentals.
- **The S&P Index Difference:** The S&P indexes shown are not as broad as the Russell indexes, and one reason for this is that every constituent must prove positive generally accepted accounting principles (GAAP) net income over four quarters prior to initial inclusion.[1] This biases the S&P indexes to tend toward less exposure to unprofitable firms than the Russell indexes.

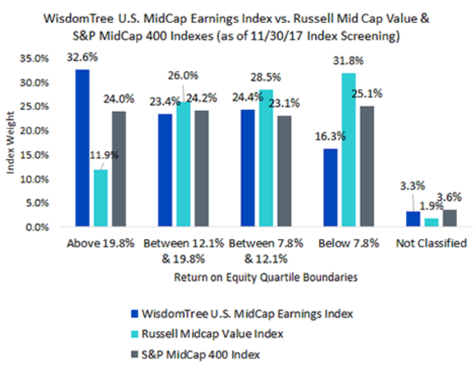
Eliminating Unprofitable Firm Exposure on an Annual Basis

WisdomTree's U.S. Earnings Indexes require firms to prove, annually, that they need to generate cumulative profits on an annual basis. Over 11 years, we've seen this have the largest impact in the mid-cap and small-cap size segments because of what we showed earlier—without any screening at all, the mid-cap and small-cap markets in the U.S. have significant components that are unprofitable and of a more speculative nature.

An interesting way that this tilt toward higher quality tends to show up is in a quartile distribution of Index weight based on the return on equity (ROE) of underlying constituents.

What a "Quality Tilt" Looks Like in Mid- & Small-Cap Equity Indexes





Sources: WisdomTree, FactSet, with data as of 11/30/17 Index screening. You cannot invest directly within an index. "Not Classified" refers to firms that, operationally, tend to have very large liabilities relative to their assets and for the accounting identity (Assets = Liabilities + Shareholder's Equity) to hold need a negative value for shareholder's equity.

- Traditional value indexes (the Russell 2000 Value and Russell Midcap Value) actually showcased the opposite—more weight in constituents with lower ROE. We mentioned earlier that, even though the WisdomTree U.S. Earnings approach doesn't access the value premiums in precisely the same fashion as these indexes, the annual rebalance has lowered the price-to-earnings (P/E) ratio on both the WisdomTree U.S. MidCap and U.S. SmallCap Earnings Indexes over all 11 live rebalances.

If one is looking to the "value" style and one approach tilts greater exposure to firms with higher return on equity than another, this is certainly an interesting distinction.

In the Face of Changing Corporate Tax Rates, Prefer Profits to Losses

To conclude, we recognize that over the past year, not a day seemed to go by without mention of Congress and the potential changes to U.S. tax policy, both at the individual and corporate levels. We've written about how smaller and midsized firms are better positioned to benefit, as they export less and have less opportunity to leave profits overseas, thereby avoiding U.S. taxes. Both the WisdomTree U.S. SmallCap and MidCap Earnings Indexes have effective tax rates around 30% to 32% on an aggregate basis,[2] making the reduction in the statutory rate from 35% to 21% particularly attractive."

[1]Source: "S&P U.S. Indices Methodology," S&P Dow Jones Indices, August 2017.

[2]Sources: WisdomTree, FactSet.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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You cannot invest directly in an index.

DEFINITIONS

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Modern Alpha : Modern Alpha® combines the outperformance potential of active with the benefits of passive—to offer investor strategies that are built for performance.

Risk premium : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

Excess Returns : refers to investment returns on a securities above that of a benchmark or index exhibiting similar risk characteristics.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Low Volatility : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

Fundamental weighting : A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

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.

Russell 2000 Value Index : measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Russell 2000 Growth Index : Measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

Generally Accepted Accounting Principles (GAAP) : Principles of accounting utilized in the U.S. that deal with different aspects and assumptions that are deemed acceptable in calculating the earnings of a firm.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.