

SMART BETA—THE PROOF IS IN THE PERFORMANCE

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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.

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DEFINITIONS

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

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.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Market capitalization-weighting : 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.

Efficient Market Hypothesis : Current share prices correctly reflect all available information about publicly traded firms and continually incorporate the emergence of new information on a nearly instantaneous basis; there are no bubbles, and firms are neither expensive nor inexpensive.

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.

Fair value : Also known as "eNAV." It is essentially an indicative value (IV) that is made in real time by calculating the basket value on every underlying tick and by adjustments that account for updated market new.

Momentum traders : Individuals whose buy and sell decisions are influenced more heavily by recent price performance than any other factors; they typically buy after upward movements and sell after downward moves.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Fiduciary : An individual in whom another has placed trust and confidence to manage and protect property or money.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.