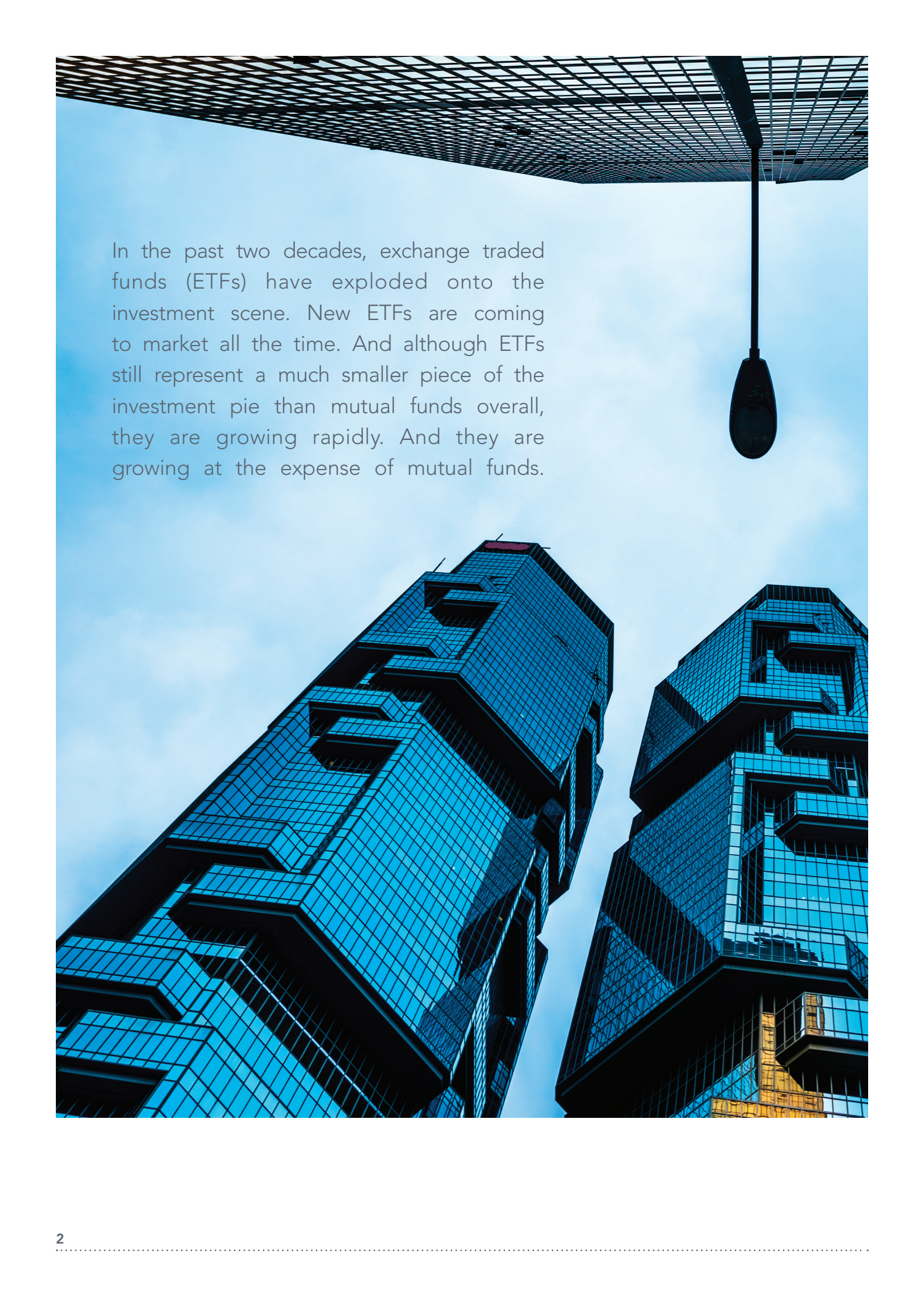


WisdomTree

SMART BETA





In the past two decades, exchange traded funds (ETFs) have exploded onto the investment scene. New ETFs are coming to market all the time. And although ETFs still represent a much smaller piece of the investment pie than mutual funds overall, they are growing rapidly. And they are growing at the expense of mutual funds.

Exchange traded funds, including ETFs in Europe, had nearly \$52bn in inflows in 2016, which represented 14% growth in AUM for the European ETF industry.¹ Furthermore, European ETFs have seen positive inflows in nine successive years since 2008 and ETFs continue to take market share from mutual funds globally. By the end of November 2016, ETF assets under management increased to nearly 18% of mutual funds globally, while in 2000, this ratio was under 2%.²

There are more than 2,230 ETFs/ETPs with more than 7,000 listings, from 57 providers across 25 exchanges in Europe.³ They target a wide array of regions, sectors, commodities, bonds, futures and other asset classes and their numerous benefits—including easy diversification,⁴ low cost,⁵ tax efficiency and the convenience of exchange trading flexibility—have helped this newer investment vehicle to flourish. And there are many other drivers that will likely help this industry continue to grow over the coming years.

One of these drivers is the continued growth and acceptance of what has come to be known as “smart beta” ETFs.

So, what is smart beta anyway?

¹ Source: Morningstar Direct, 31 December 2016

² Source: Deutsche Bank, ICI, Bloomberg Finance LP, 2000-November 2016

³ Source: ETFGI, as of January 2017

⁴ Diversification does not eliminate the risk of experiencing investment losses

⁵ Ordinary brokerage commissions apply

BETA AND THE “EFFICIENT MARKET”

The very first ETFs—and the majority of those that followed—were based on market capitalisation-weighted indices. Why? Consider that the measurement of the volatility of an investment compared to the market is known as “beta.” These ETFs mirror these indices in an effort to help provide investors with a portfolio that seeks to deliver the same risk and moves in the same way as the market; thus the term “beta” has become synonymous with broad market representation.

But if you want to understand why these indices are market capitalisation-weighted, we need to go a bit further. Market capitalisation-weighted indices, the bulk of indices in existence today, weight individual components by their stock market capitalisation (price per share times shares outstanding). 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 (that is, 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 capitalisation-weighted indices 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 regardless of an investor’s risk tolerance. So, if the Efficient Market Hypothesis holds, any portfolio that does not weight individual stocks by market capitalisation will not be mean variance efficient and therefore will not offer these desirable risk/return characteristics.

But what if markets are not always efficient?

Beta: A measure of the volatility of an index or investment relative to a benchmark. A reading of 1.00 indicates that the investment has moved in lockstep with the benchmark; a reading of -1.00 indicates that the investment has moved in the exact opposite direction of the benchmark.
Volatility: A measure of the dispersion of actual returns around a particular average level.

WHO IS WisdomTree?

WisdomTree launched its first ETFs in the United States in June of 2006 and in Europe in October of 2014. A smart beta innovator, WisdomTree pioneered the concepts of fundamentally-weighted indices and active ETFs—and is currently an industry leader in both categories. WisdomTree strategies span asset classes and countries around the world.

In Europe, in addition to UCITS ETFs, WisdomTree sponsors a family of ETPs under the Boost brand.

THE NOISY MARKET HYPOTHESIS

While the Efficient Market Hypothesis has had tremendous influence in the finance profession, it is just one of several theories that seek to explain broad movements in stock prices. As with all theories, it is subject to challenge. There is persuasive evidence that markets are not always efficient and that stock prices can deviate from their fundamental values for many reasons. WisdomTree believes that stock price movements are better explained by a different hypothesis—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.

Conventional wisdom has long recognised that prices of speculative assets, such as equities, experience periods of irrational bubbles and frenzies—as evidenced by the Information Technology sector in the United States during the late 1990s—that can cause their prices to deviate widely from their fair value. Consider that, if traders such as momentum traders⁶ speculate on the basis of past price movements or are motivated by “noise” such as rumours or incomplete or inaccurate information, the prices of individual stocks will not always be efficient. Furthermore, investors and institutions often buy or sell shares for reasons unrelated to the valuation of the firm, sometimes for liquidity, fiduciary, tax—or even emotional—reasons. Consequently, the prices realised on these trades are often not representative of the best, unbiased estimate of the fundamental value of the shares.

Performance is now bearing out the idea that market capitalisation weighting may not be the best method of indexing. According to Cass Consulting, a research-led consultancy service provided by Cass Business School, returns of traditional, market capitalisation-weighted indices lagged various fundamentally-weighted—or smart beta—indices by as much as 2% per year from 1969–2011.⁷ So, although the majority of ETF assets in the market today track cap-weighted indices, it may not be surprising that alternative methods are growing in popularity.

⁶ 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

⁷ Andrew Clare, et. al., *An Evaluation of Alternative Equity Indices Part 2: Fundamental Weighting Schemes*, Cass Business School, March 2013

SMART BETA DEFINED

Some define smart beta as simply any type of index that is not market capitalisation-weighted. In our opinion, the smart beta approaches that are attracting the greatest attention in the world of equity indexing today are as follows:

Fundamentally-Weighted Indices	Components are selected to provide broad exposure to a market based on market capitalisation, but companies are weighted by a fundamental factor such as aggregate dividends or earnings.
Equal Weight Indices	Components are often selected from established indices like the S&P 500, ⁸ but are equally weighted so that all components have identical weights when rebalanced.
Factor-Based Indices	Components are selected based on one or more fundamental factors and are weighted based on one or more fundamental factors. Factor-based indices can also be modified equal weighted, where stocks are first divided into tiers based on certain factors, and then equal weighted within the tiers.
Low Volatility Indices	Components are selected because they have exhibited lower volatility than the overall stock market and/or are weighted based on their historic volatility.

ETFs tracking such rules-based, passive indices have attracted tens of billions of dollars in assets in recent years, helping to legitimise the category of smart beta as a viable alternative to traditional cap-weighted indices.

⁸ S&P 500 Index: A market capitalisation-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



THE INTRODUCTION OF SMART BETA



Put simply, the difference between beta and smart beta may be the idea that smart beta seeks to provide an exposure with the potential to outperform the market—or generate better risk-adjusted returns than the market—rather than merely measure the performance of all investable stocks in an equity market.

Though many investors may only now be hearing about smart beta indices and ETFs, they have been around for some time. In fact, WisdomTree was an early pioneer in this category, inventing the concept of dividend-weighted equity products. And, in 2006, we launched one of the first families of alternatively-weighted ETFs, calling them “fundamentally-weighted.” From there we applied the same methodology to the earnings generating segments of the market to expand our offering. We weighted these first ETFs by dividends or earnings because we believe these fundamentals offer a more objective measure of a company’s health, value and profitability than stock price alone. Today, WisdomTree offers investors smart beta ETFs in all major equity markets around the world.

For these families, we use proprietary weighting methodologies designed to magnify the effect fundamentals—such as dividends or earnings—have on risk and return characteristics. And the proof is in the performance.

WISDOMTREE SMART BETA HAS HISTORICALLY OUTPERFORMED ACTIVE MANAGERS

Since their respective inceptions, the majority of our dividend and earnings-weighted ETFs that provide exposure to the US market have outperformed the majority of active managers in their respective peer groups. Since their respective inceptions, all four of WisdomTree’s core US earnings-weighted ETFs have outperformed their comparable capitalisation-weighted benchmarks. Four of WisdomTree’s five US dividend-weighted ETFs—all of which are categorised as “value” by Morningstar—outperformed the major cap-weighted “value” benchmark in their asset class since their respective inceptions. How did they do this? By using a rules-based process to select and weight stocks.

GROWTH OF SMART BETA WILL BE THE GROWTH OF ETFs

While some industry insiders may worry that smart beta is a fad, investors do not seem to agree. Consider that European domiciled smart beta ETFs gathered \$8.1 billion inflows in 2016—an increase of 33% in 2016, compared to the 12% growth in assets under management for regular or non-smart beta ETFs.⁹ And, according to a survey conducted among financial advisers and wealth respondents, 71% of current smart beta ETF users would increase their allocation over time.¹⁰ We believe this could make smart beta the largest category of ETFs and the primary driver of ETF growth going forward, perhaps helping to match equity mutual fund assets under management (currently €13.8 trillion) in less than the one decade we previously mentioned. And when you consider that European ETFs have grown at almost double the rate of mutual funds since January 2012, with asset growth of 104% and 65%, respectively, this expectation seems attainable.¹¹

With growth expectations like this, we believe investors should seek asset managers and investments that use smarter investment methods.

OUR EUROPEAN DOMESTIC FAMILY OF DIVIDEND-WEIGHTED INDICES

- Includes only dividend-paying companies
- Weights stocks by their contribution to the *Dividend Stream*[®]
- Rebalances to relative value on an annual basis

The WisdomTree Dividend Indices typically weight each stock eligible for inclusion by its share of the *Dividend Stream*[®], defined as the sum of regular cash dividends paid by all the companies in the respective Index.

10 Largest Companies in the WisdomTree Europe Equity Income Fund

Ranked by Cash Dividends, as of 31 May 2016*

Rank in Index	Company Name	2015 Indicated Dividend per Share	Shares Outstanding	Company Dividend Stream	Percentage of Dividend Stream
1	BP	\$0.40	20.0 billion	\$8.00 billion	4.3%
2	Royal Dutch Shell PLC	\$1.78	4.20 billion	\$7.51 billion	4.0%
3	TOTAL SA	\$2.71	2.43 billion	\$6.60 billion	3.8%
4	GlaxoSmithKline	\$1.16	5.35 billion	\$6.23 billion	3.4%
5	HSBC Holdings Plc	\$0.51	19.5 billion	\$9.95 billion	3.1%
6	Vodafone Group	\$0.17	28.8 billion	\$4.80 billion	2.6%
7	Sanofi-Aventis	\$3.26	1.30 billion	\$4.25 billion	2.5%
8	British American Tobacco Plc	\$2.24	2.02 billion	\$4.54 billion	2.4%
9	Telefonica SA	\$0.83	4.97 billion	\$4.11 billion	2.4%
10	Daimler AG	\$3.62	1.06 billion	\$3.87 billion	2.2%
Top 10 Companies, Total Contributions				\$59.89 billion	30.7%

Sources: WisdomTree, Bloomberg

Holdings subject to change

Dividend Stream[®] = Cash Dividends per Share x Shares Outstanding

Percent of *Dividend Stream*[®] = Company Dividend Stream/Total Stream of All Companies

*The annual screening date for the WisdomTree Domestic Earnings and Dividend Indices is at the end of May

⁹ Morningstar Direct, as of 31 December 2016

¹⁰ Invesco, Smart Beta – a tool for precision and control, European Investor Research 2016

¹¹ Deutsche Bank, ETF Annual Review & Outlook, 31 January 2017

WHEN IT COMES TO IDENTIFYING SMART BETA, WE THINK INVESTORS SHOULD LOOK FOR:

- 01 A rules-based, repeatable methodology that offers broad, representative exposure to an asset class
- 02 Alternative weighting methods that allow for ample investment capacity
- 03 High correlations to established benchmarks
- 04 A proven track record on a total return and risk-adjusted basis
- 05 Regular rebalancing back to a measure of relative value

CONCLUSION

Investment managers and investors alike are always seeking better ways to invest. Indexing can be highly efficient, and ETFs have a number of benefits that make them a wise way to invest which has led to their quick adoption and impressive industry growth.

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 indices such as WisdomTree’s, which rebalance and weight equity markets based on *Dividend Stream*®. WisdomTree’s family of smart beta ETFs has proven itself since 2006—which included an unprecedented market event, the global financial crisis of 2008 and 2009. 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

ABOUT US

At WisdomTree, we do things differently. Our ETFs are built with proprietary methodologies, smart structures or uncommon access to provide investors with the potential for income, performance, diversification and more. **For more information on WisdomTree ETFs, visit www.wisdomtree.com.**

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For Investors in France

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