HOW TO AVOID LEVERAGE RISKS IN SMALL CAPS

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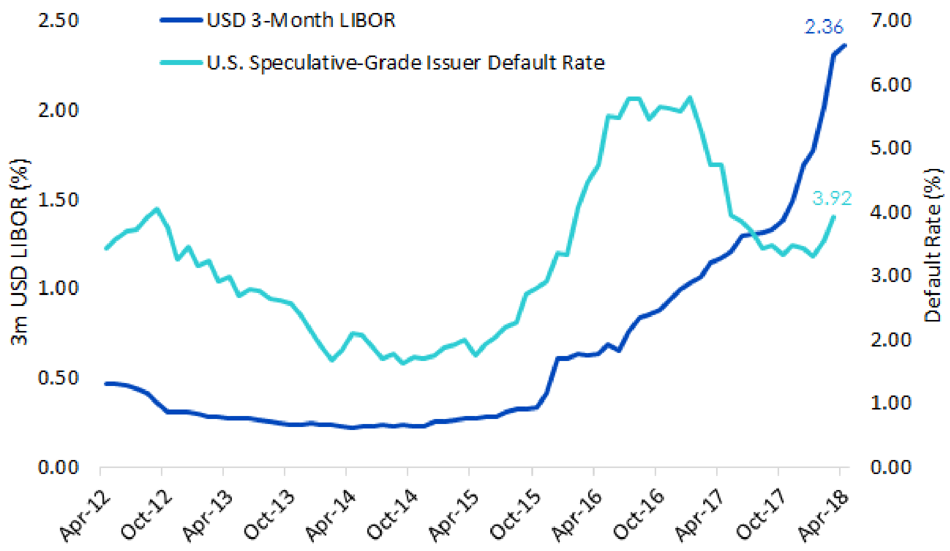
A relative bright spot amid a challenging start to 2018 for U.S. equities has been the performance of small caps: The Russell 2000 Index's 4.65% return is an advantage of more than 180 basis points (bps) over the 2.82% return of the S&P 500 Index.[1] As analyzed in my colleague's recent blog post, small caps often outperform during rising rate environments. A unique feature of this rising rate environment is the unprecedented era of monetary easing from which we are emerging that has coincided with increased levels of debt financing. Different small-cap indexes provide significantly different exposures to potential pockets of excessive leverage risks, and now is as necessary a time as any for a review.

Rate Rises Picking Up Momentum

The Federal Reserve's gradual and well-telegraphed rate hikes over the past several years have been widely lauded for not pulling the rug out from under the financial system. However, for a variety of reasons, both technical and structural, the main benchmark floating rate (USD 3-month LIBOR) has increased by more than 100 bps over the past year.[2] While this rate matters for the interest expense of large caps, it matters even more for small caps. Of the constituents of the Russell 2000, 48% of their debt is linked to floating rates, as opposed to just 9% for the S&P 500.[3] As this rate has risen, the default rates for speculative-grade issuers have also begun to tick up, albeit from low levels compared to the past two years. The signal is clear: Rates are rising, and speculative, unprofitable firms may have a difficult time refinancing at higher rates.

Rising Rates Coinciding with Speculative-Grade Defaults



Sources: WisdomTree, Bloomberg, Moody's. LIBOR rates from 4/30/12 to 4/30/18. Past performance is not indicative of future results. U.S. Speculative-Grade Issuer Default Rate from 4/30/12 to 3/30/18.

Earnings Weighted vs. Market Cap Weighted

When explaining why WisdomTree decided to create an earnings-weighted family, we often discuss the merits of a disciplined annual rebalance that raises earnings yields and lowers price-to-earnings (P/E) ratios. The WisdomTree U.S. SmallCap Earnings Index selects only profitable companies for inclusion at each December rebalance, and then weights companies by their contribution to total core earnings over the prior annual cycle. This value-sensitive rebalance has gained greater investor intrigue at today's elevated valuations for market cap-weighted indexes. The current trailing P/E ratio of the WisdomTree U.S. SmallCap Earnings Index is a somewhat modest 14x, which compares to the near 40x for the Russell 2000, an index with 22% weight in unprofitable companies.[4]

	Leverage Ratios		Valuation Ratios	
Index	Interest Coverage	Assets/Equity	P/E	Fwd P/E
WisdomTree U.S. SmallCap Earnings	4.1	4.5	14.2	13.5
Russell 2000	2.7	4.3	39.7	25.3

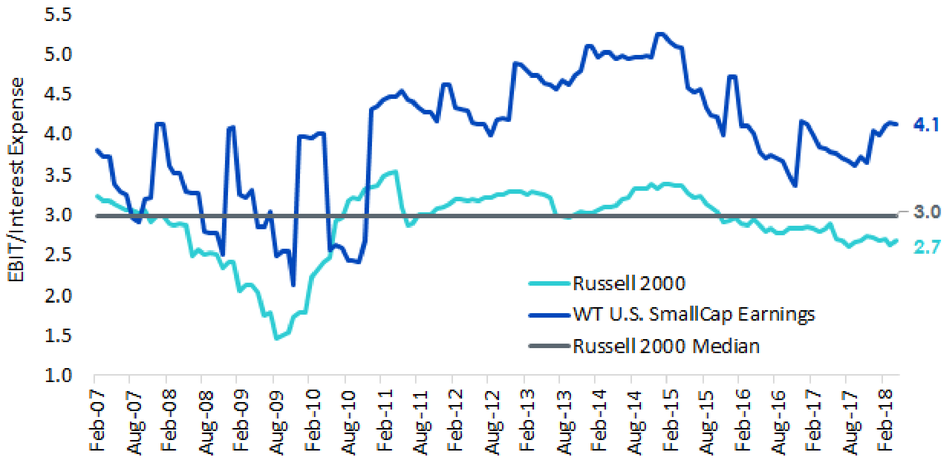
Sources: WisdomTree, FactSet. Data as of 4/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

In addition to the benefits of a value exposure, an equally important byproduct to this fundamentally focused rebalance is greater exposure to quality companies. By selecting only profitable companies and then weighting by those companies, WisdomTree avoids those parts of the market that may have the greatest difficulty meeting debt obligations. When looking at leverage ratios in isolation, leverage of the WisdomTree Index and the Russell 2000 are actually at similar levels of 4.5 and 4.3, respectively, based on assets/equity.

On the other hand, analyzing the historical changes in interest coverage ratios, measured as EBIT/interest expense, provides a meaningfully different picture. The interest coverage ratio indicates sustainable costs of debt compared to earnings, and the trend for the Russell 2000 since 2015 has been a clear increase in interest expense as a share of earnings. At the current level of 2.7 for the Russell 2000, it is below its median of 3.0 since 2007 and, prior to 2017, at levels last touched in 2010. While the trend for the WisdomTree U.S. SmallCap Earnings Index is in the same direction, because of the profitability focused tilt to the Index, there is a more than 50% improvement in the ratio of earnings to interest costs.

Interest Coverage Ratios

2/28/2007–4/30/2018



Sources: WisdomTree, FactSet. Data as of 4/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion: An Annual Rebalance to Quality at a Discount

Fed tightening alone does not seem to pose dire consequences for U.S. equities broadly. Rates are still at low levels historically, and as the path of hikes continues to be data dependent on economic growth, we favor small caps to outperform. However, as we are in the later stages of this bull market, a focus on holding onto quality companies with sustainable levels of debt seems to make increasing sense over a market cap-weighted approach that is trading at extreme P/E premiums. The market cap-weighted Index has been steadily trending toward lower interest coverage over the past three years. During this timeframe, WisdomTree's Index has undergone three December rebalances that have increased that ratio by assigning greater weight to higher earners.

[1]Source: Bloomberg, 12/29/17–5/14/18.

[2]Source: Bloomberg, 5/2/17–5/2/18.

[3]Source: Jessica Binder Graham, Deep Mehta, Ronny Scardino and Tarun Lalwani, "Small Cap Opportunities: More Near-Term Pluses than Minuses," Goldman Sachs, 3/29/18.

[4]Sources: WisdomTree, FactSet. Data as of 4/30/18.

For the top 10 holdings of EES please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/equity/ees

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You cannot invest directly in an index.

DEFINITIONS

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

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.

Basis point : 1/100th of 1 percent.

S&P 500 Index : Market capitalization-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.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

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.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

London Interbank Offered Rate (LIBOR) : the average rate that major banks offer to lend to each other for short-term unsecured funds in a particular currency for a particular maturity in the wholesale money market in London. It can range from overnight to one year and is utilized as a benchmark for various loans and in the capital markets.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Earnings-weighted : Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

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.

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.

Earnings yield : The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

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.

Earnings before interest and taxes (EBIT) : A measure of a firm's profit that includes all expenses except interest and income tax expenses.

Fed tightening : Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

Bullish : a position that benefits when asset prices rise.