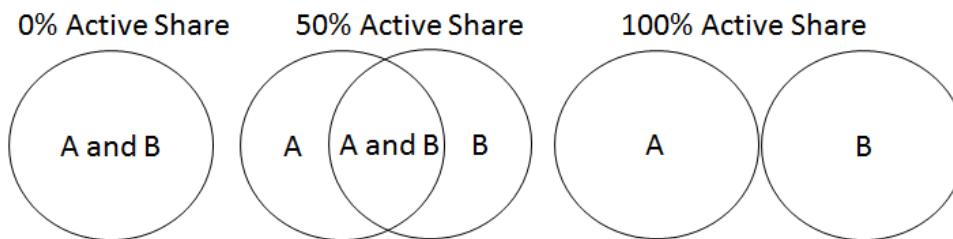


# ACTIVE SHARE: MEASURE STOCK PICKING AMONG YOUR STRATEGIES

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Active share is a seldom-used statistic, but don't be mistaken—it's an important one. For equity funds, it measures how "alike" a strategy is to its benchmark based on the stocks selected and the weights assigned to them. Thus, 0% active share means stocks and weights are identical, while 100% active share means there is nothing in common between the strategy and its benchmark.



Source: WisdomTree.

Generally used in the mutual fund world, active share informs an investor how much active stock picking a manager is making versus a benchmark. When evaluating how "active" an active manager actually is, the fees and corresponding hurdle rate are important considerations:

1)**Fees:** For their services, active managers tend to charge relatively higher fees compared to index-based exposures, so not only do investors rely on their decision-making ability to beat beta benchmarks but investors are also implicitly betting that active managers are making enough decisions to give themselves a chance to outperform, given their fees.

2)**Hurdle Rate:**<sup>1</sup> The hurdle rate considers the relatively higher fees charged by active managers and the lower fees that would be charged for the comparable beta exposure, and then calculates what level of outperformance the active managers would need to achieve (with their active share component) to at least match the benchmark.

Below, we frame fees, active share and the hurdle rate to better understand how they impact expectations.

Domestic Equity Funds	Hypothetical Hurdle Rate Calculations*			Annual Hurdle Rate
	Expense Ratio	Cost of S&P 500 Exposure	Active Share	
Example Fund A	1.05%	0.04%	15%	6.73%
Example Fund B	1.05%	0.04%	75%	1.35%
Example Fund C	0.28%	0.04%	75%	0.32%

Sources: WisdomTree, Martijn Cremers, ("Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity," Financial Analysts Journal, forthcoming). \*Hurdle Rate Calculation: (Expense Ratio-Cost of S&P 500 Exposure)/Active Share. Past performance is not indicative of future results.

- Example Fund A is expensive at 1.05% per year and also carries a low active share of only 15%. This means 85% of the fund is the same as the [S&P 500 Index](#) and won't contribute to outperformance, leaving only 15% room to beat beta. Because the high fees of Example Fund A act as a headwind, it must outperform the S&P 500 by 6.73% a year with its 15% active share in order to break even with the market. That's a high hurdle.
- Example Fund B charges the same expense ratio as Example Fund A, but it has a much larger active share of 75%. This lowers its hurdle rate considerably as the manager now has more room to impact the fund's final returns relative to the S&P 500. Example Fund B's active manager has to beat the S&P 500 by 1.35% with 75% active share. A smaller hurdle than Example Fund A, but a formidable hurdle nonetheless.
- Example Fund C has a lower expense ratio and a higher active share. This makes the hurdle rate a meager 32 [basis points \(bps\)](#). In other words, by lowering the fees and increasing active share, Example Fund C removes its handicap as much as possible. This allows its stock picking, if successful, to impact the fund in a more meaningful way.

With Example Fund C, you are betting that the portion of the fund that the active manager can affect will account for at least 32 bps of outperformance per year. This may seem a reasonable hurdle for an active manager to clear, but the fee of .28% is somewhat unrealistic. In fact, WisdomTree found that the Morningstar mutual fund large-blend category has a median expense ratio of .95%; and that is including the index mutual funds that don't rely on active decision making. Were we to remove those low-fee, index-tracking mutual funds, that number may easily gravitate north of 1.00%. Fees are one reason why 88%, 90% and 97% of [large-cap](#), [mid-cap](#) and [small-cap](#) active managers underperformed the S&P 500, S&P MidCap 400 and S&P SmallCap 600 indexes, respectively, over the last five years.<sup>2</sup>

To be clear, higher active share does increase a fund's ability to underperform beta and to have potentially higher [tracking error](#). But those on the quest for [alpha](#) should have at least some active share in order to attain it. The more important question is: "How does one find intelligent high active share for a low cost?" Our answer: a passive multifactor approach.

**[WisdomTree U.S. Multifactor Fund \(USMF\)](#)**

In the case of the WisdomTree U.S. Multifactor Fund, by eliminating the active manager and using a [passive](#), rules-based approach, one is able to lower the expense ratio to .28%, considerably less than the median fees of active management. As of July 31, 2017, the fund's active share was 75% versus the S&P 500, resulting in its fees and active share being the same as Example Fund C from earlier, implying a hurdle rate of only 32 bps.

This high active share component comes from selecting 200 stocks that exhibit the highest composite attributes of [value](#), [quality](#), [low correlation](#) and [momentum](#), which are all factors associated with generating excess returns versus the market over long-term holding periods. This is all done while remaining sector neutral to the market, making your potential alpha not a sector bet but a focused multifactor selection and weighting bet.

Although the WisdomTree U.S. Multifactor Fund’s inception date was just a month ago, we have already begun to see outperformance. We are excited by the potential of a multifactor approach with such a low hurdle rate and look forward to following it in the coming years.

Fund/Index	Ticker	Expense Ratio	USMF Inception Date	As of 7/31/17		
				Active Share vs S&P 500	Since WT Inception Total Return (NAV)	Since WT Inception Total Return (Mkt)
WisdomTree U.S. Multifactor Fund	USMF	0.28%	6/29/2017	75%	2.34%	2.30%
S&P 500 Equal Weight Index				45%	1.90%	1.90%
S&P 500 Index				0%	2.22%	2.22%

Sources: WisdomTree, FactSet, Bloomberg, as of 7/31/17.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at [www.wisdomtree.com](http://www.wisdomtree.com).

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

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.

[Click here for USMF standardized performance.](#)

<sup>1</sup>Martijn Cremers, “Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity,” 12/28/16. Will appear in a forthcoming issue of Financial Analysts Journal. Available at SSRN: <https://ssrn.com/abstract=2860356> or <http://dx.doi.org/10.2139/ssrn.2860356>

<sup>2</sup>SPIVA Year-End U.S. Scorecard, as of 12/30/16.

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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.

For more investing insights, check out our [Economic & Market Outlook](#)

view the online version of this article [here](#).

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**U.S. investors only:** Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

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## DEFINITIONS

**Active**: Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

**Active manager**: Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

**Hurdle rate**: Rate at which the currency needs to depreciate in order to compensate for the high carry of the currency.

**Beta benchmark**: Characterized by measuring the performance of a particular universe of equities without attempting to utilize selection and weighting to generate differences in performance relative to this universe.

**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.

**Basis point**: 1/100th of 1 percent.

**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.

**Mid-Cap**: Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

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

**Tracking Error**: Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

**Alpha**: Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

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

**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 time.

**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 time.

**Low Correlation**: Characterized by assets that have a relatively lower correlation vs the market over time. This term is also associated with the Low Correlation Factor which

associates these stock characteristics with excess returns vs the market over time.

**Momentum Factor**: 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.