
WHY “PASSIVE” DOESN’T ALWAYS MEAN “AVERAGE”

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In February 2007, WisdomTree launched the [WisdomTree U.S. MidCap Earnings Index](#), and the [WisdomTree U.S. MidCap Earnings Fund \(EZM\)](#) to track it. With an almost 11-year live track record for reflection, we review why WisdomTree chose to weight this Index by earnings and how this decision has helped the exchange-traded fund (ETF) achieve returns among the top of its Morningstar Category of active and passive peers.

How Valuation Has Been Important

Over a variety of long-term periods, work by Professor Jeremy Siegel in his book *The Future for Investors* has indicated that the after-[inflation](#) returns of equities have held a very close relationship to their [earnings yield](#)—the reciprocal of the [price-to-earnings \(P/E\) ratio](#). In short:

- Higher earnings yields (or lower P/E ratios) have been associated with stronger real returns.
- Lower earnings yields (or higher P/E ratios) have been associated with weaker real returns.

If, for instance, we’re looking at the [S&P MidCap 400 Index](#) with a trailing 12-month P/E ratio of 26.1x as of January 31, 2018, that is associated with a 3.8% earnings yield, and it becomes more challenging to see *real* after-inflation returns to U.S. equities that are too different from this 3.8% level—at least if history is any guide.¹

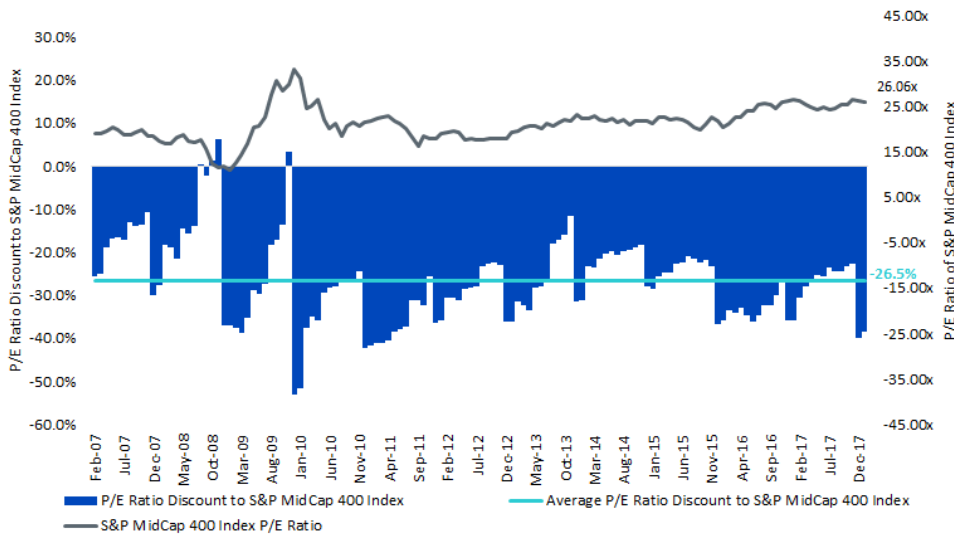
Where WisdomTree’s U.S. MidCap Earnings Strategy Can Help

The WisdomTree U.S. MidCap Earnings Index follows two big-picture steps at its [annual rebalance](#), screened on November 30 of each year:

- Include only profitable companies
- Weight companies by their [core earnings](#)

This process has tended to raise earnings yields (same thing said a different way: lower P/E ratios) compared with [market capitalization-weighted](#) universes of similar stocks. Below, we focus on the WisdomTree U.S. MidCap Earnings Index P/E relative to the S&P MidCap 400 Index historically.

The WisdomTree U.S. MidCap Earnings Index Has Had a 26.5% Average P/E Ratio Discount Compared with the S&P MidCap 400 Index over Its Live History



Sources: WisdomTree, FactSet, with data from 2/1/07, the inception date of the WisdomTree U.S. MidCap Earnings Index, to 1/31/18. Past performance is not indicative of future results. You cannot invest directly in an index. 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. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

The Benefits of a Multi-Factor Rebalance

Factor-based investing is taking on greater importance in portfolio construction. So how does the WisdomTree U.S. MidCap Earnings Index tap into multiple factors that have been associated with long-term outperformance?

Value: This factor was touched on above—a systematic P/E discount to the market cap-weighted benchmark Index has been the result of the annual rebalance.

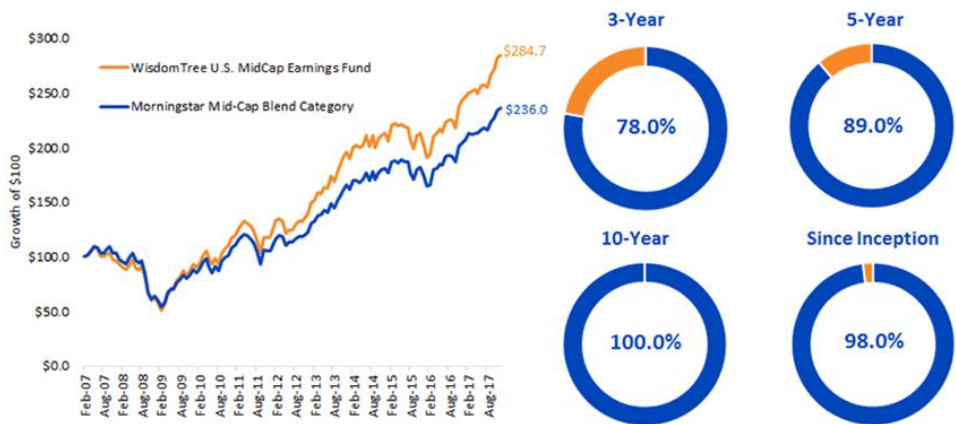
Quality: We also find that weighting profitable companies by earnings tends to tilt the Index toward stocks with higher measures of [return on equity](#) and [return on assets](#), commonly used measures of the quality (or profitability) factor.

Size: Providing purer exposure to the mid-cap segment of the market can also help improve returns over time. As of December 31, 2017, the wisdomTree U.S. MidCap Earnings Index held 100% of its weight in stocks between the \$2 billion and \$10 billion market cap range in an efficient targeting of the size-factor exposure.

The Result: 100% Outperformance over Trailing 10 Years

The overarching goal of the wisdomTree Index has been the same all along: to unshackle the investor from needing to invest at whatever the market’s earnings yield is by rebalancing annually with a process aimed at actually raising the earnings yield compared to a similar market cap-weighted index.

Just as the higher earnings yields of the wisdomTree Index have indicated, over longer periods of time, the investment result for the fund tracking this Index has been outperforming 100% of its Morningstar peer category over the past 10 years, and 98% since its inception.



Fund/Index/Category	Average Annual Total Returns as of 12/31/17													
	Fund Information			NAV Returns (%)					Market Price Returns (%)					
	Ticker	Exp. Ratio	Inception Date	1-Year	3-Year	5-Year	10-Year	Common Period	1-Year	3-Year	5-Year	10-Year	Common Period	
WisdomTree U.S. MidCap Earnings Fund	EZM	0.38%	2/23/2007	17.2%	10.2%	15.3%	11.4%	10.1%	17.4%	10.2%	15.3%	11.4%	10.1%	
S&P MidCap 400 Index				16.2%	11.1%	15.0%	10.0%	9.1%	16.2%	11.1%	15.0%	10.0%	9.1%	
Morningstar Mid-Cap Blend Category				15.9%	9.3%	14.0%	8.6%	8.2%	15.9%	9.3%	14.0%	8.6%	8.2%	

Sources: WisdomTree, Morningstar, as of 12/31/17. EZM has outperformed 65% of its Morningstar peer category over the past year. Number of peers (both mutual funds and ETFs) in each category: Mid-Cap Blend: 446 (1-Year), 362 (3-Year), 327 (5-Year), 221 (10-Year), 198 (Since Inception). "Common Period" refers to 2/28/07–12/31/17 due to the availability of Morningstar Category performance data. The Percent of Peers Beaten is the fund's total-return percentile rank compared to all funds in the same Morningstar Category and is subject to change each month.

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.

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.

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¹Sources: WisdomTree, FactSet.

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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](#)

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DEFINITIONS

Inflation: Characterized by rising price levels.

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.

S&P MidCap 400 Index: provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

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.

Core Earnings: Income generated by the company's daily operations rather than one-time events or market fluctuations.

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.

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

Return on assets (ROA): Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.