THE ACTIVE VS. PASSIVE DEBATE IN MID CAP EQUITIES

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I recently had a conversation with Craig Lazzara, Head of Index Investment Strategy at S&P Dow Jones Indices, about his research on dispersion—a factor he believes is very important in explaining the opportunities for active managers. According to Craig, current dispersion readings are quite low, which implies there are fewer opportunities for active managers than usual. Craig finds there is greater dispersion in mid-cap stocks than large-cap stocks, so the question is: Does this lead to more outperformance for active managers—or just more dispersion between the best and worst managers in the mid-cap category? As a follow-up to that discussion, I thought it would be interesting to see how active managers had performed against broad indexes over the past decade. I recently looked at small-cap equities, which you can read here, but now I'd like to expand the analysis to mid-cap equities. **There Are Many Ways to Invest** There are numerous ways to invest, but the decision usually starts with whether to invest in either active mutual funds or passive exchange-traded funds (ETFs). Some argue that active managers are best suited to outperform, especially in mid-capitalization stocks, because they think this area tends to be less efficient. Recently, as a result of the broad market rally, these same proponents of active managers have insisted that today's environment is ripe for active managers to outperform, so I want to take a hard look at the numbers. In the table below, I compare how some mid-cap indexes have performed against U.S. ETFs and open-end mutual funds in Morningstar's Mid-Cap Blend category.

Mid-Cap Study (12/31/03–12/31/13)

	Average Annual Return			Calendar Year Return									
Index	3 years	5 years	10 years	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
WisdomTree MidCap Earnings	19.06%	26.22%	N/A	40.40%	18.19%	1.69%	26.10%	50.54%	-35.69%	N/A	N/A	N/A	N/A
S&P MidCap 400	15.64%	21.89%	10.36%	33.50%	17.88%	-1.73%	26.64%	37.38%	-36.23%	7.98%	10.32%	12.56%	16.48%
Russell Midcap	15.88%	22.36%	10.22%	34.76%	17.28%	-1.55%	25.48%	40.48%	-41.46%	5.60%	15.26%	12.65%	20.22%
Did Managers Outperform the Specified Index?													
WisdomTree MidCap Earnings	No	No	N/A	No	No	No	No	No	No	N/A	N/A	N/A	N/A
S&P MidCap 400	No	No	No	Yes	No	No	No	No	No	No	Yes	No	Yes
Russell Midcap	No	No	No	No	No	No	No	No	Yes	No	No	No	No
Percentage of Managers Beaten by the Specified Index													
	3 years	5 years	10 years	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
WisdomTree MidCap Earnings	96.2%	98.1%	N/A	88.5%	72.5%	90.5%	79.5%	87.2%	76.1%	N/A	N/A	N/A	N/A
S&P MidCap 400	63.2%	71.5%	87.4%	44.9%	69.0%	73.4%	86.1%	66.1%	71.8%	75.0%	25.7%	79.1%	41.8%
Russell Midcap	66.2%	76.0%	81.7%	52.8%	59.5%	76.3%	70.2%	75.7%	30.1%	55.4%	68.7%	79.5%	73.3%
	399	354	276	437	447	443	424	396	386	369	338	308	299

Sources: WisdomTree, Zephyr StyleADVISOR, Morningstar, 12/31/2003–12/31/2013. Past performance is not indicative of future results. You cannot invest directly in an index.

• **Majority of Active Managers Underperform** – Over the most recent 10-year period the Russell Midcap Index and the S&P MidCap 400 Index outperformed 81.7% and 87.4%, respectively, of funds in the Morningstar Mid-Cap Blend category. The Russell Midcap also outperformed more than 50% of the Morningstar category in 9 out of the past 10 calendar years, and the S&P MidCap 400 outperformed more than 50% of the category in 7 out of the past 10 calendar years. • **WisdomTree MidCap Earnings Index** – WTMEI has outperformed close to 99% of the Morningstar category since its inception.[1] I find it impressive that the Index was able to outperform over 75% of the category during the worst calendar year for the category (2008) as well as during the best one (2009). **Why Indexes?** Like all investors, active managers are susceptible to behavioral biases that can negatively affect their investment decisions. This is illustrated through the table above, which shows that the majority of active managers actually underperformed their respective benchmarks over the most recent 10-year period and over the majority of calendar years. For believers of active management, I think these results are even more alarming given the fact that the Russell and S&P indexes are market cap-weighted. Market cap-weighted indexes typically give the greatest weight to the stocks with the highest prices, without regard to any measure of fundamental value. As a result, the market capitalization-weighted index may tend to over-weight more expensive equities and under-weight those that may be relatively less expensive. **Why Smart Beta?** Although I do not feel active management is necessary to provide compelling long-term returns, I do think it is important to invest with a disciplined focus on valuations. WisdomTree uses a rules-based methodology to weight the companies in its Indexes by their underlying fundamentals, such as dividends or earnings, because at WisdomTree we believe that stock markets are not always efficient. Furthermore, WisdomTree rebalances its Indexes annually to adjust for relative value. As I referenced above, although dispersion levels can't predict active manager performance, the current low dispersion levels imply that there are potentially fewer opportunities for active managers than usual. Given this reading and the historical underperformance of active managers against traditional indexes, I do not think it is time for active management in mid-cap equities. [1]Sources: Zephyr StyleADVISOR, Morningstar; Index inception: 02/01/2007.

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DEFINITIONS

Dispersion : A measure of the statistical distribution of portfolio returns.

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

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.

Actively managed mutual funds : Investment strategies that are not designed to track the performance of an underlying index.

Passive exchange-traded funds : Exchange-traded funds that track the performance of an index.

Open-End Mutual Funds : Type of mutual fund that does not have restrictions on the amount of shares the fund will issue, so if demand is high enough the fund will continue to issue shares. These funds buy back shares when investors wish to sell.

Russell Midcap Index : The Russell Midcap Index measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.

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.

WisdomTree MidCap Earnings Index : Fundamentally-weighted index that measures the performance of the top 75% of the market capitalization of the WisdomTree Earnings Index after the 500 largest companies have been removed.

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.

Fundamental value : The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.

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

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

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.

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.

Relative value : The relationship between a particular attribute, e.g., a dividend, and the firm’s share price compared to that of another firm.