USING ARITHMETIC TO CRUSH CLOSET INDEXERS AND FEE SCALPERS

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What is the profile of a fund that has the odds stacked against it?

For starters, "beta" index trackers that cover market capitalization-weighted indexes such as the S&P 500 may often lag their underlying index because of their fees, even though most of their expense ratios are tiny. Nevertheless, such funds may offer a better prospect than many active managers, who can't get out of the way of their operating costs.

Another fund manager who is against the wall is the "closet indexer"—the career risk manager. These strategists claim to be coming up with great investments, but when you look under the hood, their holdings look just like their competitors' funds. Then there is the manager who actually has a lot of unique holdings but high fees.

There is a fourth kind of manager who is not a market capitalization-weighted index strategist, a closet indexer or an expensive active manager. They have truly different holdings at digestible fees. We think WisdomTree's quality dividend growth ETF suite is in this group.

For example, three of the six WisdomTree Funds that we highlight here that screen for quality, earnings growth and dividends have at least 89%"active share," the proportion of their holdings that are different from their respective MSCI benchmarks. And since this is WisdomTree, they come with what we call Modern Alpha™ fee schedules.

For an idea of just how bold such active share is, a cap-weighted strategy would target a figure of 0% because it is trying to be exactly like the S&P 500, MSCI EAFE or some other major index. A closet indexing strategy may clock in at 30% or 40%. One that is totally different, with no holdings in common with its asset class, would have 100% active share.

A fund such as the WisdomTree International Quality Dividend Growth Fund (IQDG), which tracks the WisdomTree International Quality Dividend Growth Index, is 89% different from MSCI EAFE. Think about that. It's the kind of fund designed to identify factors we think work—and then actually do something about it, rather than just quiver in the corner in fear of a bad year with some cap-weighted index.

Now, put active share in the context of fees: Using simple arithmetic, we can calculate the "hurdle rate"—popularized by Martijn Cremers at Notre Dame—which quantifies how well the active selections need to perform to cover their expense ratios. This really matters in picking a fund or ETF.

Path 1 is the worst. Sadly, trillions still sit in closet index funds that have **low active share** and **high fees**. Avoid these: Their existence is only justified if they somehow get past **High** hurdle rates.

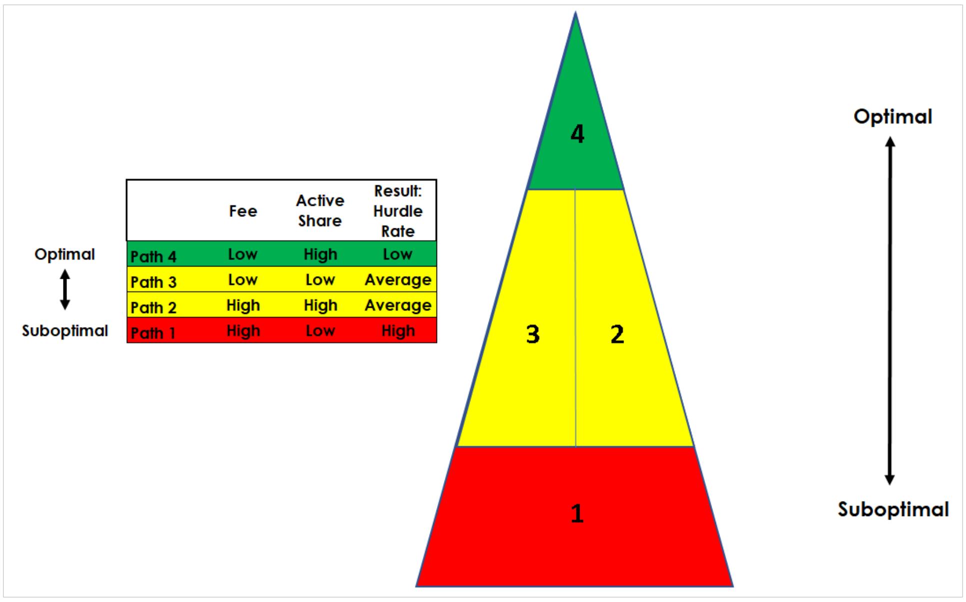
Path 2 isn't much better. These money managers at least have **high active share**, so they have the courage of their convictions, but they trip over their **high fees**. Their hurdle rates are **Average**.

Path 3 is a different breed, but just as bad as Path 2. These managers have **low fees** because they got the memo that the jig is up on huge expense ratios. But they are still closet indexing, hoping investors won't notice their **low active share**. Their hurdle rates are **Average**.

Path 4 is hard to find. These are strategies that have both **high active share** and **low fees**. Their hurdle rates are **Low**—the sweet spot. Chances are good that a Path 4 fund is an ETF.

I put this in visual form in figure 1.

Figure 1: Visualizing the Four Paths



Find the Low Hurdle

Figure 2 puts numbers to this concept, with hypothetical Path 1, 2 and 3 managers.

Start with the Path 1 closet indexer. It has 35% active share, meaning the other 65% of its holdings are found in the cap-weighted benchmark. It charges 0.80%, so the unique holdings need to outperform by 229 basis points (bps) to match the market's performance. That figure is found by dividing the expense ratio by the active share. It's a big hurdle rate.

The process repeats for Path 2 managers. A fund with 70% active share has the courage of its convictions, but this one is charging 1.00%. Its actively different picks must outperform by 143 bps for the fund's return to match the market's. Then we have the Path 3 closet indexer. Its hurdle rate is 100 bps despite its low fee.

Figure 2: Hurdle Rates, Closet Indexers and Conviction Managers

Ticker	Name	Active Share	Exp. Ratio	Hurdle Rate vs. Benchmark	Description
Path 1	High Fee, Low Active Share	35%	0.80%	2.29%	High Fee Closet Indexer
Path 2	High Fee, High Active Share	70%	1.00%	1.43%	High Fee Conviction Manager
Path 3	Low Fee, Low Active Share	20%	0.20%	1.00%	Cost-Conscious Closet Indexer

Source: WisdomTree. Funds are hypothetical.

We think our quality dividend growth suite is the ideal Path 4. The ETFs have serious active share and small hurdle rates. If factor investing makes logical sense—and we think it does—the way to operate an ETF business is to have conviction and reasonable fees. That's Path 4, and WisdomTree is in that business.

Figure 3: A Half Dozen of WisdomTree's Quality Dividend Growth ETFs

Path 4: Cost-Conscious, High Active Share					
Ticker	Name	Active Share	Exp. Ratio	Hurdle Rate vs. Benchmark	Market Capitalization-Weighted Comparable
DGRS	WisdomTree U.S. SmallCap Quality Dividend Growth Fund	91%	0.38%	0.42%	MSCI USA Small Cap Index
IQDG	WisdomTree International Quality Dividend Growth Fund	89%	0.38%	0.42%	MSCI EAFE Index
DGRE	WisdomTree Emerging Markets Quality Dividend Growth Fund	71%	0.32%	0.45%	MSCI Emerging Markets Index
DGRW	WisdomTree U.S. Quality Dividend Growth Fund	60%	0.28%	0.47%	MSCI USA Index
DNL	WisdomTree Global ex-U.S. Quality Dividend Growth Fund	95%	0.58%	0.61%	MSCI World ex USA Index
EUDG	WisdomTree Europe Quality Dividend Growth Fund	83%	0.58%	0.70%	MSCI European Monetary Union (EMU) Index

Sources: Bloomberg, WisdomTree. Active shares and hurdle rates vs. respective MSCI indexes, as of 2/6/2019. Past performance is not indicative of future results. You cannot invest directly in an index.

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DEFINITIONS

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

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.

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.

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

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Basis point : 1/100th of 1 percent.