ACCESS ETF
STRUCTURE MATTERS

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Interview series: How “Structure Matters” in investing in ETFs

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WisdomTree and its Director of Research, Jeremy Schwartz are very much at the center of the structural question about what modern indexing or smart beta means. WisdomTree which was founded in 2004 has an AUM of approx. $34 billion. Readers of this interview, will gain insights into (1) Why they might want to diversify their index strategies; (2) How WisdomTree came to the conclusion that some investors would benefit by hedging currency exposure; and (3) What the Bank of Japan is doing buying up ETFs.

DAN WEISKOPF: Thank you Jeremy for joining us today. As WisdomTree's Director of Research could you provide some background and include how you work with Jeremy Siegel.

JEREMY SCHWARTZ: Before joining Wisdom Tree in 2004, I started working with Professor Jeremy Siegel down at UPenn some 13 years ago; I was one of his undergraduate students. I started with him in the summer of 2001. I worked with him on the third edition of *Stocks for the Long Run*, which came out in 2002 and then I helped him write *The Future for Investors* . Professor Siegel joined WisdomTree as its Senior Investment Strategy Advisor and consults the firm, and I still do some work with him at Wharton.

DAN WEISKOPF: You recently released a paper called "Looking Under the Hood of Smart Beta." What are the key takeaways from that paper?

JEREMY SCHWARTZ: The question we tried to address in that paper: What is smart beta and what are the exposures you have? A lot of the academics use a four factor-based model, the standard Eugene Fama/Ken French model, to try to figure out what factors can explain returns of a specific investment approach. From our perspective, the difference between “beta” and “smart beta” may be the idea that smart beta seeks to provide an exposure with the potential to outperform the market, isolate or accentuate a certain characteristic of the market, or generate better risk-adjusted returns than the market, rather than merely measure the performance of all investable stocks in an equity market.

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One of the discussion points we highlight is whether smart beta is just a small cap-biased portfolio. We agree that some equal weight strategies have a small cap tilt, but when you look at WisdomTree's core dividend weighted indexes, or earnings weighted indexes, especially in our large caps, they actually have a bigger large cap bias.

A second point the paper addresses is the value tilt inherent to our dividend and earnings indexes. Dividends are more value-tilted than earnings, for sure, but we showed that while our dividend family has a value bias, dividend indexes were certainly more than just a value index as they out performed value indexes during the past 7-8 years. Moreover, earnings weighted indexes outperformed traditional core cap-weighted indexes since their inception, mid and small caps significantly, despite growth beating value over that same period.

DAN WEISKOPF: How do you feel about the characterization that WisdomTree is a leader in the smart beta category? And specifically, what that label means. Should we be looking at a different labels, non-market weighting, or modern indexing?

JEREMY SCHWARTZ: We believe WisdomTree is a pioneer in the fundamentally-weighted indexing – or smart beta – space. We think it's beneficial for investors to start asking themselves: Should I be in just one investment strategy at the core of my portfolio?

When we launched WisdomTree back in 2006, 95% or more of ETFs were market cap weighted. While some market cap-weighted strategies have served investors very well, they do have drawbacks such as a lack of valuation discipline, and running into bubbles. For example, Japan in 1989 was 60% of the MSCI EAFE index and dragged down the index return for 25 years as Japan entered their bear market. We believe investors should look at a multi-disciplined investment approach to their core equity allocations.

DAN WEISKOPF: Your firm is unusual in its ability to self-index. There have been multiple times where you've recalibrated some of your indexes – 2011 and 2012. Can you speak a little bit about how decisions to recalibrate have been made?

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JEREMY SCHWARTZ: Absolutely. We were the first ETF firm to 'self-index' and had to get special exemptive relief to do so. These changes took time, diligence and required deep analysis. We are committed to our strategies, but we do monitor them and have the flexibility to make changes we believe to benefit the strategy and fund shareholders.

Mechanically I should point out that there is a firewall between my indexing group and the portfolio management group. There's a 60-days announcement time before any change we make to an index gets implemented. It has to get announced publicly (on our website) before the index change or before we can discuss with the fund operations group.

DAN WEISKOPF: Can you speak a little about DXJ and how that decision came about?

JEREMY SCHWARTZ: Back in 2008, the euro was around 1.60 and thematically we had the idea that the euro may not go up forever versus the dollar, but that should not remove motivation to invest in European equities, which could do well if U.S. economy doing well.

Similarly we felt the strength in the Yen was self-destructive. There was a period of time between 2008- 2009 where every day the Yen was rallying and it was clear that this strength was creating competitive hurdles for key exporting companies like Toyota, Sony and Fujitsu, whose stock prices would move opposite the direction of the yen on a daily and long-term basis there.

We launched our first broad-based currency hedge ETF at the end of 2009 and then added a currency hedge to DXJ in early 2010 after many deliberations about how to make DXJ more unique. The idea was the yen could move 15-20% a year and we could really differentiate the Fund by adding the currency hedge element. This made DXJ the first ETF of its kind to offer that type of exposure.

DXJ started gaining traction over next few years, even though the yen kept strengthening longer term. We received feedback from a number of clients that if the yen were to eventually weaken, this could especially benefit export tilted companies. We added an export tilt to DXJ in November 2012. (Note this was announced over 60-days prior to that implementation given our disclosure requirement.)

After the new administration won the Japan election, our timing proved pristine and we were able to share with investors research about how 'Abenomics' might work to weaken the yen and support the equity markets. We put a lot

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of work behind the various pieces of research, provided on our website, offering thought leadership for our investment themes and index strategies. Given the increasing investor interest in this area, Japan has been a particularly prominent research category on our site.

DAN WEISKOPF: What things are you looking for out of the Bank of Japan, from a research standpoint, that would provide evidence that what's going on in Japan is sticking?

JEREMY SCHWARTZ: I think the current valuation case in Japan is one of the more interesting, from a global markets perspective. Last year in the U.S., there were strong gains; 32% S&P 500, but most of it was multiple expansion. In Japan, despite a huge rally, you had multiple compression as earnings went up faster than stock prices.

Today, DXJ - on an estimated earnings basis - is trading around a 30-year low multiple at 13 times earnings versus the S&P at about 16 times, and even cheaper compared to Europe. Only the emerging markets are truly cheaper, but recently many have been fearful about the emerging markets. Japan's headed in the right direction on the earnings front.

Now, I think when you look at what Abe is doing, a lot of it is actually working. He has his three-arrow policy of aggressive central bank easing. There's been no question the central bank was a dead bull's eye in their approach. They completely changed the dynamic about a year ago when they implemented -- shock-and-awe quantitative easing.

Moreover, they're not just buying bonds, they're buying ETFs. The Bank of Japan owns 40% of the entire ETF market in Japan. So talk about a bold statement about ETFs; if Janet Yellen came out saying, "I am going to buy the S&P 500," that's essentially what the Bank of Japan is doing.

I continue to see Abe as being very pro-business and market supportive. Culturally they need to move very methodically to preserve the integrity of the policy.

Japan just announced a new consumption tax hike, from 5% to 8% that people are concerned about. Abe has talked about how he wants to target a 25% corporate tax rate. They want to shift the tax burden away from the corporates. They want to make Japan a haven for investment over Hong Kong and Singapore. They know they've got high debt-to-GDP, so they've got to balance this out. They have no choice but to get inflation going in a positive direction.

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They were successful in the first year by getting inflation to a 1.5% level which helps to grow tax revenue. Amazingly they've kept the Japanese bond yields at 60 basis points. It's bad if you're a holder of JGBs; you're suffering a negative real return. However, it's great for the government because it buys them some time. What they're doing is going in the right direction. They're going to try to make the corporates more profitable. If they're going to affect corporate tax revenues, that'll hopefully fuel a broader economic growth – and keep them out of the deflationary cycle.

Bottom line – the program seems to be on track and will continue to be a strong region for profit growth at the most reasonable valuations. There is still an apparent negatively correlated currency-equity market. The case for Japan starts with the yen is staying flat to weakening.

That is not to say the yen and equities could not go in the same direction at some point in time in the future and currency hedging would be less important. But not from current levels. If the yen was 120 or above, maybe the yen could go up and the stocks and currency go in the same direction; But not from 100 where you are currently. I think the current situation still argues for currency hedging.

DAN WEISKOPF: There's also been a lot of anticipation about the $1.3 trillion Japanese pension fund allocating more to local equities. Has the pension program really moved materially?

JEREMY SCHWARTZ: Ironic to our earlier smart beta discussion is the fact that the Pension has allocated to the S&P GIVI index rather than a traditional market weighted index, the new JPX-400 Index, and they are taking money away from traditional beta and active managers. The fact is that the culture is changing. They launched this new index in Japan; it's called the JPX 400. This is one step they've taken to try and improve corporate governance.

DAN WEISKOPF: Everybody seems to be talking about Europe. Let's change the subject for a second. Or at least geography. You've got two very successful products – HEDJ and DFE. Can you also speak to how you came to the conclusion to change the methodology on HEDJ and why those two products have been so successful.

JEREMY SCHWARTZ: It gets back to that same question as Japan. I believe currency hedging is one of the most important things happening in ETFs today, and HEDJ helps illustrate this. In this case, we added a 50% export tilt to HEDJ (before we added the export screen to DXJ) in order to change its focus from a broad-based currency hedged strategy to a fund focused on dividend-paying exporters from the Euro zone with the single euro currency hedge.

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Those using HEDJ tend to be tactical managers who say, “I want exposure to Europe, but I don't necessarily have a strong opinion on the euro.”

I still think that strategic question for core broad-based international portfolios-- is actually a really important question. So long-term, what people need to question is why as an investor do I want the euro/yen/pound when I'm buying foreign equities? Traditional indexes start with this baseline, but it does not necessarily have to be the natural conclusion in this new global investment world. The cost to hedge the developed world currencies is minimal.

DAN WEISKOPF: Structure matters as far as when to buy an ETF; especially since the Japanese markets are closed usually when the US markets are open. Are we supposed to look at, from a pricing standpoint, where the futures are? Or do they generally lead off of where it closed?

JEREMY SCHWARTZ: It's a great question. There is a lot of confusion on this issue. The Japan stock market opens at 8 p.m., U.S. time, and they're closed at 2 a.m., U.S. time. So when U.S. investors are buying Japanese ETFs, the Japanese markets are closed. Japan ETF trading in the US trades really provides an

indication for how Japan’s markets are going to open the next day, based on what's happening in the yen, what's happening in Europe, what's happening in the US markets. They're taking their cues off of the sentiment. Often we have seen articles about “ETFs trading at a 5% premium or discount to yesterday’s market close,” but this idea is misguided. ETFs serve as price discovery tools in anticipation of the next day’s move.

DAN WEISKOPF: When do you think the next catalyst is for Japan?

JEREMY SCHWARTZ: The short-term catalyst is when does the Bank of Japan do more quantitative easing. Abe's chief advisor said, the next set of programs could entail more ETF purchases from the Bank of Japan, an area that may have considerable room for expansion.

They have directly stated they're trying to lower the risk premium to buy in the market, another way the BOJ is signaling support. We also will see more from Abe in his growth strategy this June. So that too can be a catalyst.

DAN WEISKOPF: Jeremy, thank you for sharing your insights and research. I look forward to more ETF innovation and reading your research and white papers.

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