BARRON'S ONLINE

Monday, January 1, 2007

FUND OF INFORMATION

WisdomTree Thinks It Has a Better Idea

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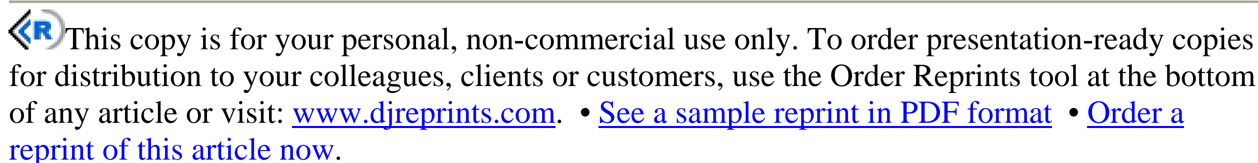
U.S. EXCHANGE-TRADED FUNDS HAVE CLOSE TO $400 billion in assets. So the $1.5 billion that WisdomTree, a fledgling venture launched in 2006, has under management in 30 funds is a mere drop in the bucket.

But WisdomTree, based in New York, has more firepower and marketing muscle than most start-up firms. It has launched an aggressive advertising and public-relations campaign, and its management roster features some big names, who are featured prominently in those advertisements.

Its chairman is Michael Steinhardt, a pioneering and extremely successful hedge-fund manager. Its senior investment strategy adviser is Jeremy Siegel, the Wharton professor whose books include Stocks for the Long Run.

Beyond all of that, WisdomTree is trying to position itself as the ETF player with the better mousetrap -- namely using fundamentals, rather than stock-market value, to construct indexes.

DOW JONES REPRINTS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WisdomTree has set its sights on the indexing world. "Our goal is to pull money out of cap-weighted products," says Bruce Lavine, the firm's president and chief operating officer.

Until recently, exchange-traded funds tracked indexes, such as the S&P 500, that are weighted by companies' stock-market values. Under that methodology, the stocks with the largest market capitalizations have the biggest weight in an index. WisdomTree, however, has built its indexes

on fundamentals, mainly dividends. (It also plans to roll out six funds with weightings based on earnings, a measure that fits with its fundamental approach.)

Siegel says that, for many years, he was a fan of cap-weighted indexing. But that was before the stock market meltdown from 2000 through early 2003. Thereafter, he decided that companies that "return profits to shareholders as a group do well." He cites two main reasons for using dividends as a foundation for an index. First, he says, dividends are "objective;" it's hard for a company's management to manipulate them. Second, he contends, the stocks of dividend-paying companies, on average, slide less in downturns, providing a cushion.

Siegel says that "cap-weighting is not going to disappear." But he disputes the argument that it's the best solution for investors. "That just does not hold water," he says. Since so much of the indexing world, including the influential Vanguard Group, remains committed to the traditional indexing approach, WisdomTree is going against the grain. "You're always battling inertia," says Lavine. "You're always battling being the new kid on the block. But this has gone extremely well, so far."

The company's domestic funds include **WisdomTree Total Dividend** (ticker: DTD), **WisdomTree High-Yielding Equity** (DHS), **WisdomTree MidCap Dividend** (DON) and **WisdomTree SmallCap Dividend** (DES). Its suite of international funds includes **WisdomTree Japan Total Dividend** (DXJ) and **WisdomTree Europe SmallCap Dividend** (DFE).

It's still too early to meaningfully evaluate these funds' performance, given their recent launch.

Sonya Morris, who follows exchange-traded funds for Morningstar, says these funds are likely to appeal to "income-hungry investors." As the boomers approach or reach retirement, that will be attractive.

Still, she cautions, "the jury is still out on what is the right way to index." The WisdomTree funds, she says, "need more time in the real world to prove themselves."

ACTIVELY MANAGED exchange-traded funds are still only on the drawing board. But an academic paper concludes that they would free up managers to pick stocks, instead of managing inflows and outflows.

One of the authors, Scott Gibson, an associate professor of finance at the Mason School of Business at the College of William & Mary in Williamsburg, Va., cites two factors that can hurt a mutual fund's returns. One is maintaining a cash position, presumably for meeting redemptions when investors sell their shares. The other, Gibson says, is "having to engage in portfolio rebalancing to meet liquidity needs."

Sometimes a fund manager has to make "liquidity trades," owing to inflows or outflows. And, frequently it seems, these trades must be made at inopportune times. For example, when cash pours into a fund in a rising market, the manager can increase its cash position only to a certain extent. Then, he must buy stocks, even if he isn't convinced that it's the right moment to do so. Indeed, the paper asserts, "fund managers were unable to beat the market when compelled to invest excess cash from investor inflows."

Pouring In: As equities roared higher in the year's last days, investors stormed back into stock funds, buying a net $235 million after having withdrawn money. Muni funds drew a net $521 million; taxable bond funds, $2.6 billion; money funds, $15.4 billion.

The paper, whose other authors are Gordon Alexander of the Carlson School of Management at the University of Minnesota and Gjergji Cici of William & Mary, asserts that there are essentially two kinds of transactions for a fund manager. Besides liquidity trades, there are "valuation trades," in which the manager decides to buy or sell a security based on its fundamentals.

Studying domestic stock funds from 1980 to 2003, the authors separated liquidity trades from valuation trades. Their conclusion: When managers made valuation trades, they beat the market, on average. "These guys know what they are doing," says Gibson. "This liquidity trading acts as a

drag on performance. You want to free the manager from having to deal with making these liquidity trades."

An actively managed exchange-traded fund would be the ideal vehicle to do that, he says.

The authors found that the performance of funds was especially good when managers bought large amounts of a security while a fund had heavy outflows. In those cases, the funds outpaced the market by nearly three percentage points.

FOR INVESTORS IN international ETFs, the fourth quarter was generally very rewarding. Among the top performers were **iShares MSCI South Africa Index** (EZA), up 26.83%; **iShares MSCI Singapore Index** (EWS), up 20.27%; **iShares MSCI Brazil Index** (EWZ), up 20.49%; **iShares MSCI Mexico Index** (EWW), up 15.92%, and **iShares MSCI Austria Index** (EWO), which rose 16.40%.

Laggards included **WisdomTree Japan SmallCap Dividend** (DFJ), which had a small gain of 0.64%**, iShares Dow Jones U.S. Pharmaceuticals** (IHE), up 1.51%, and the **iShares GSCI Commodity-Index Trust** (GSG), which was down 5.09%.

As of Nov. 30, assets in exchange-traded funds totaled $396.7 billion, versus $296 billion at the end of 2005, according to the Investment Company Institute. The total still pales in comparison to the mutual-fund industry's more than $10 trillion. But ETFs are growing at a strong clip. These funds are already popular with financial intermediaries, and they continue to gain fans among individual investors, so 2007 should be another good year for them.