

## Fundamental Value in ETFs

*WisdomTree is the first company that manages ETFs based on indexes it creates and owns. Luciano Siracusano believes that the standard capitalization-weighted indexes are flawed in their tendency to overweight the overvalued stock, sectors, and regions. That's why the company developed fundamentally weighted indexes to target better returns with lower volatility.*

**Q: How would you describe your investment philosophy? Why should investors consider the WisdomTree ETFs?**

**A:** Well-followed stock market indexes are capitalization-weighted, in other words, companies with larger market caps influence the index more than smaller companies regardless of their investment fundamentals and ability to generate return on capital. To reflect the fundamental nature of business we create a separate group of indexes that are fundamentally weighted and not capitalization-weighted. We are the first company to create these indexes and manage ETFs based on these indexes.

**Q: Would you highlight the main differences between ETFs and mutual funds?**

**A:** The most important difference, especially for individual investors, is that an ETF trades during the entire trading day and you can buy it and sell it anytime like another stock. Because it trades on an exchange, you don't have to wait until the market closes to determine the value of the underlying securities. That means greater liquidity than a mutual fund or an index mutual fund would provide. There is also greater transparency because you can see the holdings, while mutual funds report their holdings at the end of every quarter.

Another difference is the tax efficiency because mutual funds are more vulnerable to capital gains distribution, especially internationally. I think that the investors who consider international mutual funds should ask how much they will lose each year to capital gains distributions.

**Q: What are the major differences between fundamentally weighted indexes and capitalization weighted indexes? Why have you chosen the fundamental approach?**

**A:** The difference between the two is that we base the initial weight on fundamental measures of value. So we disregard the value that the market puts on the company, and we weight the indexes based on fundamentals, which are the dividends that the company pays or, in the case of our earnings funds, the earnings companies generated in the previous year.

We created the fundamentally weighted indexes because we believe that the capitalization-weighted indexes have a tendency to overweight the overvalued stock, sectors, and regions. According to our historical research, fundamentally weighted indexes have generated better returns and with less volatility than the comparable cap-weighted indexes.

Because of the return and the volatility, we believe that our indexes have the potential to better serve investors. After all, it is the return and the risk you take for the capital that matter. So we believe that the fundamentally weighted indexes provide a definite improvement over the traditional cap-weighted indexes. By capturing the income generating potential of the company directly, we believe we can reduce the volatility and increase the returns.

**Q: What type of earnings do you use for the earnings-weighted indexes?**

**A:** We use the earnings data collected by the S&P, which adjust the extraordinary items and the non-recurring events to define the core earnings generated by a company. We license the core earnings database from S&P and we weight the companies once a year based on those numbers.

**Q: Do the Wisdom Tree ETFs focus on domestic companies or they include international companies as well?**



**LUCIANO SIRACUSANO** Director of Research for WisdomTree Investments, Inc., oversaw the creation and development of the company's proprietary index methodology and other intellectual property.

Before joining WisdomTree in 1999, Siracusano was an equity analyst at Value Line, Inc. Prior to his career in finance, he served as a Special Assistant to HUD Secretary Henry Cisneros, and as a Special Assistant to New York Governor Mario M. Cuomo.

Siracusano is a graduate of Columbia College, Columbia University.

**“We disregard the value that the market puts on the company, and we weight the indexes based on solid fundamentals, which are the dividends that the company pays and the earnings it generated in the previous year”**

WisdomTree Fund Name	Ticker Symbol	NAV Total Returns Cum. Since Inception	Market Price Returns Since Inception
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#### WisdomTree Domestic Earnings ETFs

Total Earnings Fund	EXT	4.26%	4.24%
Earnings 500 Fund	EPS	4.36%	4.21%
MidCap Earnings Fund	EZM	3.75%	3.77%
SmallCap Earnings Fund	EES	0.09%	-0.47%
Low P/E Fund	EZY	4.81%	4.88%
Earnings Top 100 Fund	EEZ	5.60%	5.73%

#### WisdomTree Domestic Dividend ETFs

Total Dividend Fund	DTD	22.03%	21.77%
LargeCap Dividend Fund	DLN	22.46%	22.09%
MidCap Dividend Fund	DON	19.39%	16.71%
SmallCap Dividend Fund	DES	17.92%	17.68%
High-Yielding Equity Fund	DHS	21.41%	21.30%
Dividend Top 100 Fund	DTN	24.02%	23.81%

#### WisdomTree International Dividend ETFs

DEFA Fund	DWM	39.11%	38.96%
DEFA High-Yielding Equity Fund	DTH	37.79%	37.34%
Int'l LargeCap Dividend Fund	DOL	36.18%	35.03%
Int'l MidCap Dividend Fund	DIM	44.04%	43.03%
Int'l SmallCap Dividend Fund	DLS	42.59%	42.05%
Int'l Dividend Top 100 Fund	DOO	42.28%	40.82%
Emerging Mkts High-Yielding Equity Fund	DEM	N/A	N/A
Europe Total Dividend Fund	DEB	38.59%	37.86%
Europe High-Yielding Equity Fund	DEW	37.17%	36.09%
Europe SmallCap Dividend Fund	DFE	46.45%	44.00%
Japan Total Dividend Fund	DXJ	11.47%	11.89%
Japan High-Yielding Equity Fund	DNL	15.12%	15.48%
Japan SmallCap Dividend Fund	DFJ	2.12%	3.29%
Pacific ex-Japan Total Dividend Fund	DND	50.71%	51.07%
Pacific ex-Japan High-Yielding Equity Fund	DNH	51.37%	51.00%

#### WisdomTree International Dividend Sector ETFs

Int'l Basic Materials Sector Fund	DBN	44.11%	43.72%
Int'l Communications Sector Fund	DGG	26.69%	25.80%
Int'l Consumer Cyclical Sector Fund	DPC	27.80%	26.56%
Int'l Consumer Non-Cyclical Sector Fund	DPN	17.07%	16.27%
Int'l Energy Sector Fund	DKA	31.25%	30.07%
Int'l Financial Sector Fund	DRF	14.63%	13.71%
Int'l Health Care Sector Fund	DBR	8.88%	8.22%
Int'l Industrial Sector Fund	DDI	36.78%	36.15%
Int'l Real Estate Fund	DRW	N/A	N/A
Int'l Technology Sector Fund	DBT	11.48%	10.90%
Int'l Utilities Sector Fund	DBU	26.24%	25.51%

DATA THROUGH: 6/30/2007

**A:** We have 12 domestic indexes – six of them are weighted by dividends and six of them are weighted by earnings. These indexes cover companies incorporated in the United States that trade on domestic exchanges.

Internationally, we have 25 dividend-weighted indexes, and all of them cover developed markets outside of the U.S. and Canada. These indexes don't invest in the emerging markets; we cover the same developed countries as MSCI EAFE indexes. So we have ETFs in Europe, Japan, and the Pacific Region. (Note: WisdomTree launched an emerging markets ETF on July 13, 2007).

So we have a very broad index in the same 21 equity markets as MSCI. But the different weighting approach results in different country exposures from the MSCI index. For example, we have greater exposure to the United Kingdom and Australia and we're underweight in Japan because Japan pays out smaller dividends.

**Q: When you approach the international market, do you rely on the same earnings and dividend formulas as in the U.S., or you would account for international accounting practices?**

**A:** I would like to point out that the earnings family is very distinct from the dividend family and there is no merger of the data. All of the 25 international indexes are weighted by dividends; we don't use the earnings at all for the international ETFs. In that way, we base our weights on the dollar value of the dividends paid in the prior year.

That approach pretty much solves the accounting problem that you pointed out. When dealing with diverse countries and regions, cash dividends represent secure common ground. Since the dividend is paid in local currency, we calculate the dividend into dollars to avoid currency fluctuations in the different countries. But, overall, we don't buy the international capitalization or earnings stream; we buy the dividend stream.

**Q: Let's discuss the domestic earning-weighted indexes. Why do they tend to be less volatile and to provide higher returns than the capitalization-weighted indexes?**

**A:** The Russell 3000 Index, which is a broad measure of the U.S. market, includes about 600 companies that haven't been profitable in the previous year. For this reason our broad index, the WisdomTree Earnings Index, includes 2400 securities, not 3000. So we start with a universe

of profitable companies and that helps to reduce volatility.

Second, our research shows that when you weight directly by the earnings stream, you end up owning companies in proportion to their contribution to the U.S. earnings stream, which was about \$900 billion last year. Historically, that approach led to outperforming the capitalization-weighted indexes by anywhere from 100 to 300 basis points a year.

For example, Exxon Mobil, our largest holding, generated \$40 billion in earnings in 2006. That \$40 billion is about 4.5% of the \$900 billion income stream in the U.S., so their weight in our index was 4.5%.

In general, the stock market represents the investors' estimate of future profits and their growth, and we believe that investors pay too much for growth. The market is efficient in the long term, but in the short run, stocks aren't always efficiently priced as they are subject to speculative bubbles. We use the opportunity to move away from capitalization weights and that strategy is especially useful for avoiding the bubbles, such as the one in 2000, or the bubble in Japan. Eventually, the market reverts back to the income stream. We believe you're better off just owning the income stream.

**Q: You mentioned the reconstitution of the indexes. How often do you do it?**

**A:** We reconstitute the indexes once a year. We do it in December for our domestic indexes, and in June for the international ones. In that process, we both select the companies and re-weight them. If a company has been profitable for the previous four quarters on a cumulative basis, it is included in the index. If it hasn't, it is deleted from the earnings index. If a company cancels a dividend during the year, it is removed from the dividend index. Overall, we have very few rules and we apply them once a year. In that way we limit the turnover on the indexes.

**Q: How do you handle the timing issue of the reconstitution, or the fact that the fiscal year of some companies may end at a different month, or that their earnings may not be published at the time?**

**A:** The approach we use with S&P is to look back at the most recent four fiscal quarters. So the fiscal year of the companies doesn't really matter. Regarding the dividends, our weights are based

on the most recently declared dividend per share. If a company has declared a dividend per share before November 30, and has regularly paid dividends in the past, then it is eligible for the index. We use the most recent dividend per share data available and we annualize it for our domestic dividend indexes.

**Q: When calculating the dividends of domestic companies, do you use the dividend per share only, or you include the diluted options as well?**

**A:** We look at the dividend per share and we multiply it by the common shares outstanding. In effect, the result is an index that is scaled to the size of the company, meaning that the larger companies have larger weights because the number of the shares outstanding is one of the factors. But instead of multiplying the shares by the stock price, which is a multiple of earnings and dividends, we multiply it directly by the dividends per share. So a company like GE, which pays dividends of \$10 billion annually, will represent about 4% of our index because the amount of dividends in the U.S. is about \$260 billion.

Ultimately, our methods tend to shift the weight in the index towards stocks with higher dividends and lower P/Es. There's a lot of research that shows that, over time, stocks with higher dividend yields and low P/Es have outperformed the market.

**Q: What is the correlation between the domestic ETFs and the domestic indexes?**

**A:** An ETF is designed to provide the return of the index. Some of the funds replicate the index, meaning that they hold all the securities in exactly same proportions, while others hold a sample of the index. So the funds that mirror broad indexes may hold 600 securities. Since the goal of the ETFs is to provide the total return of the index, they usually track the indexes closely.

Regarding the correlation, right now in our domestic funds it is at least 95%. There are some funds that are deviating by only 0.20%. For example, the WisdomTree Total Dividend Index tracks approximately 1,500 securities. Over the last year, the index returned 23.36%, while the fund was up 23.5%. The Bank of New York is actually running the portfolios that track the WisdomTree Indexes, and they have a lot of experience with ETFs over the last 10 years.

## WisdomTree ETFs

Website	<a href="http://www.wisdomtree.com">www.wisdomtree.com</a>
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### ETF FAMILY FACTS

Total Net Assets*	\$4,386
Total Number of ETFs	38

### ETF CATEGORIES

Domestic Dividend ETFs	6
Domestic Earnings ETFs	6
International Dividend ETFs	15
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### WISDOMTREE INDEXES

Domestic Dividend Indexes	6
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### EXPENSE RATIO

Low	0.28%
High	0.63%

\*millions

Data through: 06/30/07

Source: Company Documents

**Q: I suppose that many of the underlying stocks in international ETFs trade when the U.S. markets are closed. How do you reconcile that issue?**

**A:** That's correct; we use the local shares which trade on markets opened at different hours. The result is that the ETF trading in the U.S. to a secondary market, sometimes serves as a future. It is like a tracking basket that is updated every 15 seconds and is based on the previous night's closing prices of stocks, adjusted for the currency, and developments in the market when overseas markets are closed.

In that sense, the ETF actually gives an idea about the future. It can start trading away from the index, and that's an interesting feature, because investors actually use the ETF overnight to get a sense of how to handle markets that change quickly.

**Q: So it is good that you don't have ETFs that carry the volatility of the Shanghai market, which can fluctuate by 6% or 8% a day.**

**A:** Well, many people would actually be attracted to it, simply because there might be a way to profit or hedge against a loss. 