WisdomTree®

DIVERSIFYING GLOBAL EQUITY EXPOSURE FOR CANADIAN INVESTORS

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A BETTER HOME COUNTRY BIAS

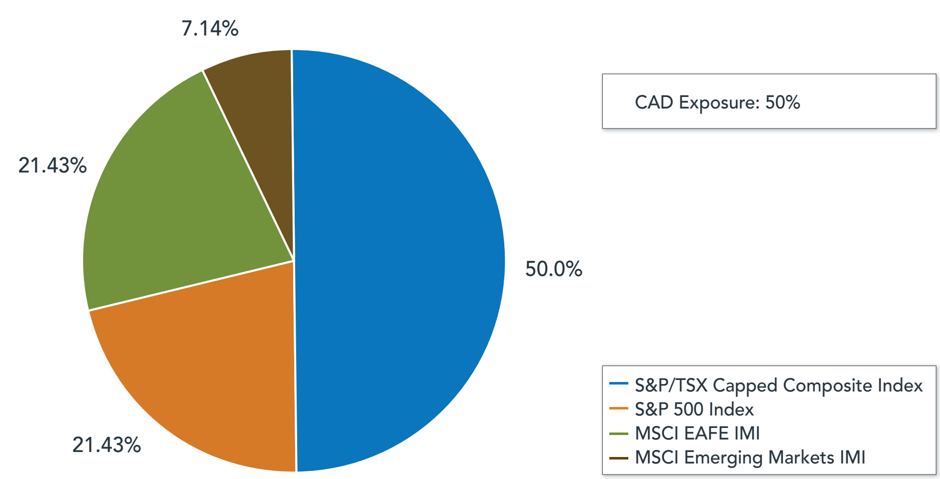
A common refrain in investing is that investors need to emphasize domestic investments because their expenditures—the mortgage, groceries and so on—are priced in the currency of their country of primary residence. Many Canadians, in turn, choose portfolios that seek out heavy exposure to Canadian dollar (CAD)-denominated securities. We think the proper approach is to create a more global portfolio while maintaining a Canadian dollar focus by hedging foreign currency risk.

The Bottom Line: Making a few simple tweaks to a portfolio can accomplish the same goal of targeting CAD exposure while minimizing the risk that comes from Canadian securities themselves.

HOME COUNTRY BIAS IN CANADA IS WIDESPREAD

We often come across portfolios that are characterized by large quantities of Canadian equities, a portfolio allocation decision that may not be ideal. Consider the case of a typical exchange-traded fund (ETF) growth model portfolio. Figure 1 shows the equity proportions in a sample 70% equity/30% fixed income model.

FIGURE 1: EQUITY MIX IN SAMPLE ETF MODEL PORTFOLIO



Source: WisdomTree.

SOLVING FOR HOME COUNTRY BIAS

Consider that Canada makes up 3.2% of the MSCI All Country World Index (MSCI ACWI),[1] yet the model portfolio above holds 50% in an ETF tracking the S&P/TSX Composite Index. This creates a 46.8% over-weight to Canada. We believe that allocating in a more global fashion while hedging currency risk may be a more appropriate approach.

[1] Source: MSCI. Data as of 3/31/17.

We are of the view that too many Canadian portfolios are top heavy in domestic equities, when the truth is that the portfolios need to emphasize Canadian dollars —the currency in which most Canadians' liabilities are denominated.

PORTFOLIOS FOR THE REAL WORLD

All portfolios, whether at the individual or institutional level, come back to real people with real lives when all is said and done.

Consider, for example, a cohabitating couple, both employed in financial services, both working on Bay Street in Toronto. Their employment is highly positively correlated to the state of Toronto finance, as is their home price and many other facets of their lives. In fact, the government's budget for schools, roads, fire and law enforcement is also directly related to the state of Toronto finance. Yet what does our industry often give this couple when it comes time for portfolio construction? A portfolio that is swimming in Canadian bank stocks, one of the largest exposures in market capitalization-weighted Canadian equity funds. What does our industry give investors in oil-rich Alberta? A portfolio that is brimming with energy and basic materials stocks—also large components of the Canadian broad market.

The result: Canadians who succumb to home country bias, holding large allocations in market capitalization-weighted Canadian equities, end up taking big stakes in domestic financials, energy and materials firms.

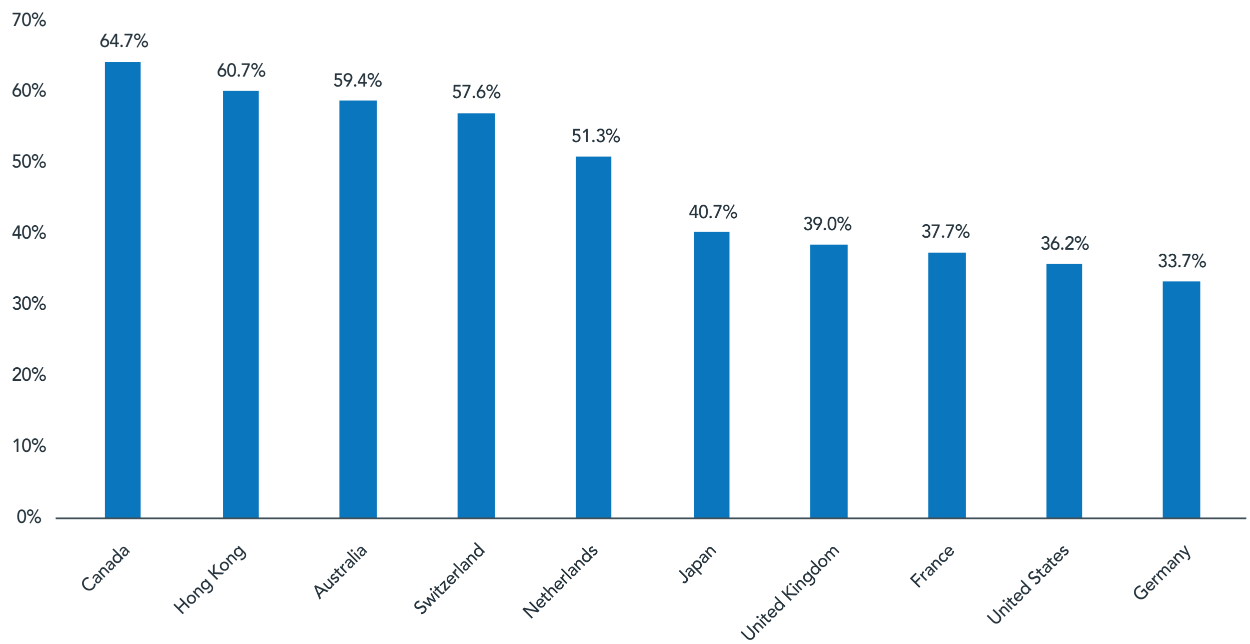
"CONCENTRATED EQUITY RISK" BY ANOTHER NAME

In portions of our industry such as high-net-worth and ultra-high-net-worth private client money management, it's common to see individuals who have the bulk of their wealth held in the stocks of their own companies or the companies they work for. Whether for emotional, tax or legal reasons, it can be difficult for them to liquidate those holdings.

Consider the portfolio decision process of a "concentrated stock" case: a Silicon Valley executive. The prudent money manager will seek to allocate any holdings that are not in the executive's single technology stock into investments that have low correlations to the fate of the U.S. tech sector, for logical reasons. If that sector has issues, it would be helpful to have components of the portfolio with greater potential to respond differently to market conditions.

This raises the question: Doesn't every Canadian investor, at some level, have "concentrated exposure" in the energy and financials sectors? The combination of those two sectors equals 65% of the MSCI Canada Index, the highest proportion of any of MSCI ACWI's top 10 country components (figure 2). If either of these sectors faced difficulties, it would be rather challenging for other parts of the portfolio to provide enough diversification to mitigate at least some of the risk.

FIGURE 2: CANADA'S EQUITY MARKET HAS THE LARGEST WEIGHT IN ITS TOP 2 SECTORS OF ANY DEVELOPED MARKET COUNTRY



Sources: WisdomTree, MSCI, as of 3/31/2017.

In our view, the goal should be to diversify from the home country and sector concentration risks. The next section offers some ideas on how we believe that can be accomplished.

A LOGICAL SOLUTION: WHAT WISDOMTREE BRINGS TO THE CANADIAN ETF MARKET

Figure 3 shows some changes to the sample ETF model portfolio that investors may find compelling. First, we reduced the original 50% allocation to Canadian equities by half and kept the emerging markets holding constant; because we do not offer an emerging markets ETF in Canada. Then we rotated from the ETFs that are tracking market capitalization-weighted U.S. and international developed indexes and split the remaining allocation between hedged units of the WisdomTree U.S. Quality Dividend Growth Index ETF (DGR) and non-hedged units of the WisdomTree International Quality Dividend Growth Index ETF (IQD.B)[2].

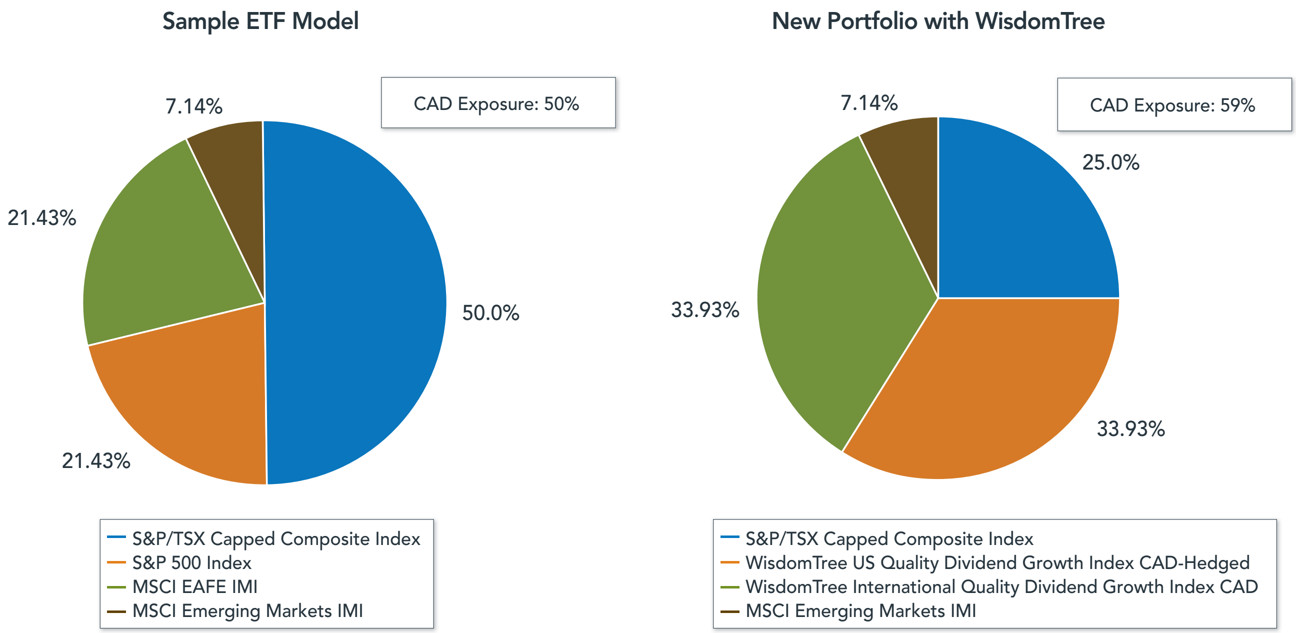
[2] DGR and IQD.B seek to track the price and yield performance of the WisdomTree U.S. Quality Dividend Growth Index CAD-Hedged and the WisdomTree International Quality Dividend Growth Index CAD, respectively.

These WisdomTree ETFs cover the broad market by utilizing proprietary indexing methodologies, the focal point of our business for more than a decade (long before anyone started using the term "smart beta").

Both ETFs screen for companies with adequate return on equity (ROE), return on assets (ROA) and earnings growth, while also weighting Index components by the dollar amounts of the dividends they pay.

Making these simple changes considerably cut down the portfolio's Canadian equity concentration risk while increasing CAD exposure to nearly 59% from 50%. Keep in mind that an investor who uses WisdomTree ETFs can change the CAD exposure to an even higher amount or, for that matter, a lower amount simply by choosing between the hedged, non-hedged and Variably Hedged™ versions of our ETFs. In fact, when we launched our Canadian business, we made a conscious effort to offer many of our ETFs in each of those flavors to ensure that very freedom for our clients.

FIGURE 3:



Sources: WisdomTree.

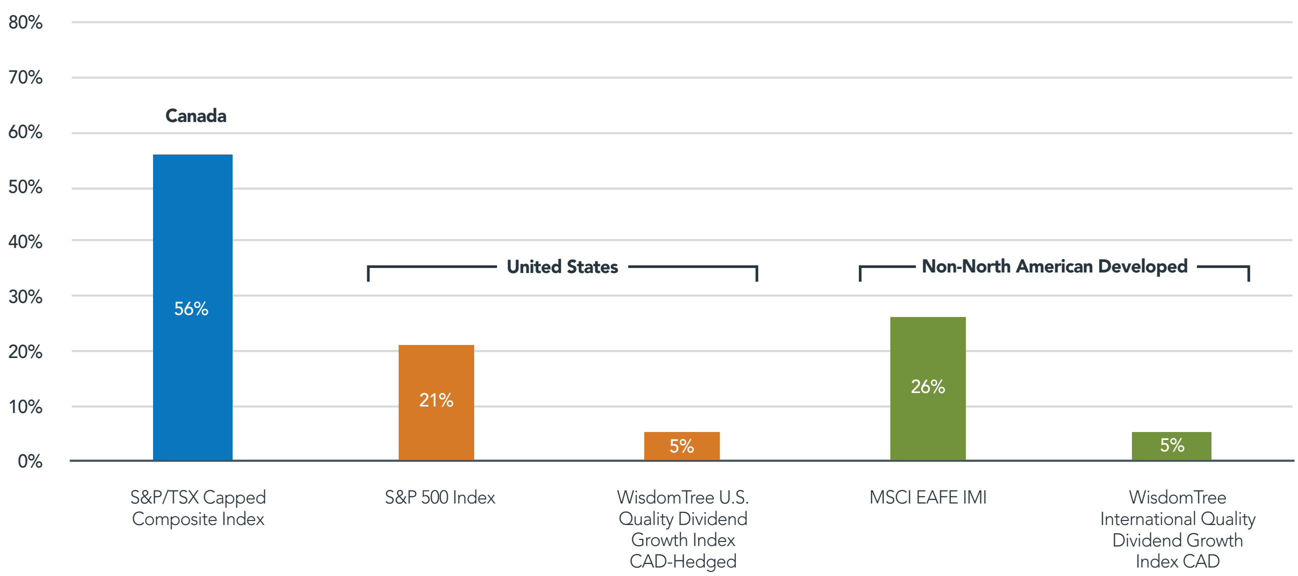
By shifting a portion of the portfolio into DGR and IQD.B, investors reduce exposure to financials and energy because many of the companies in those sectors do not meet our ROE, ROA and earnings growth screens embedded into the methodologies.

We believe reducing energy and financials may be appealing to Canadian investors due to the Canadian stock market's industry concentrations.

In the case of WisdomTree's U.S. Quality Dividend Growth Index ETF (DGR), the equation can change considerably; our indexing methodology results in financials being less than 5% of the mix, while energy is nearly eliminated (Figure 4).

A similar story occurs in the developed world outside of North America. More than a quarter of the MSCI EAFE is in energy and financials, with the bulk of the allocation in banks. In contrast, the WisdomTree International Quality Dividend Growth Index ETF (IQD.B) obtains foreign exposure with a current allocation to financials of less than 5% and almost no current allocation to energy.

FIGURE 4: INDEX WEIGHTS: FINANCIALS + ENERGY



Sources: S&P, MSCI, WisdomTree, as of 3/31/17.

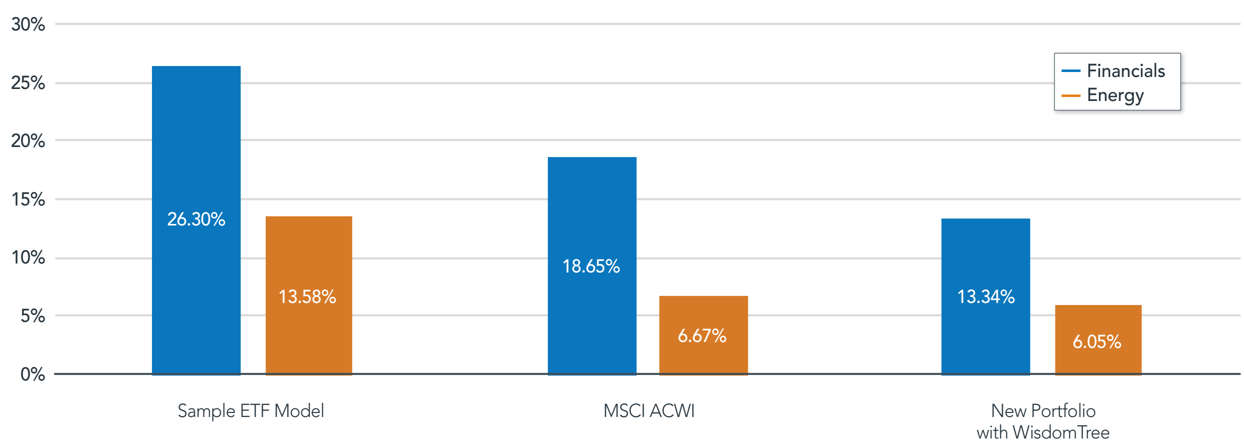
PORTFOLIO SECTOR ALLOCATION IMPLICATIONS

The difference in financials and energy sector exposures in the sample ETF model, MSCI ACWI and the new portfolio with WisdomTree ETFs is found in Figure 5. The sample ETF model portfolio has about 40% of its capital in those sectors, considerably more than MSCI ACWI's 25% weight in those groups.

By eliminating two market cap-weighted index trackers and plugging in two WisdomTree ETFs—ETFs that select their components based on the quality and growth profiles of their components instead of market capitalization—the equation changes. Financials and energy amount to just 19.4% of total equities in the portfolio that utilizes DGR and IQD.B. For investors who would like to avoid doubling down on the same two sectors year after year, we think portfolio changes such as this could impact long term returns.

Critically, diversifying sector exposures enables investors to better mitigate what may be the biggest risk – the behavioral problem of abandoning a strategy at precisely the wrong time – such as when energy stocks are owned in size while the oil price is sliding.

FIGURE 5: PORTFOLIO WEIGHTS: FINANCIALS AND ENERGY



Sources: WisdomTree, S&P, MSCI, as of 3/31/17.

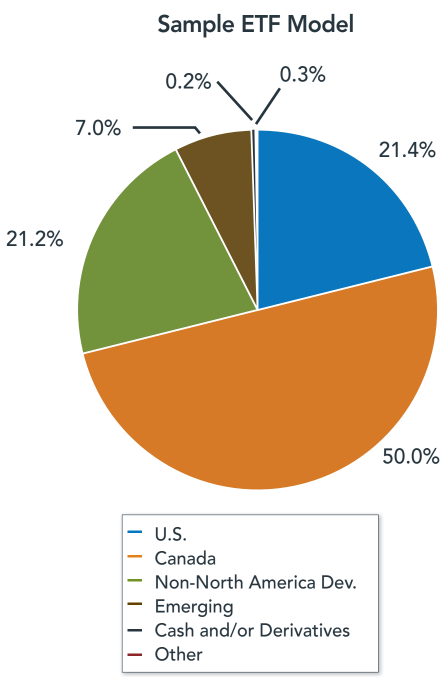
COUNTRY ALLOCATION IMPLICATIONS

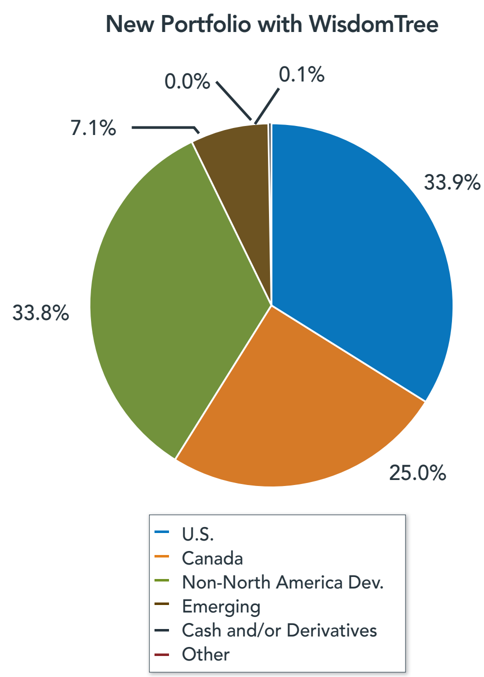
Figure 6 shows the sample ETF model side by side with MSCI ACWI and the new portfolio that includes DGR and IQD.B. Because the sample ETF model has half of its assets in Canadian equities, all of the other 39 nations are under-weight relative to MSCI ACWI.

By making a few simple changes, the new portfolio that utilizes WisdomTree ETFs enables the allocation to get closer to MSCI ACWI by de-emphasizing Canada. Additionally, the allocation to non-North American developed equities rises to 33.8% in the new portfolio, allowing it to more closely align with MSCI ACWI's 32.4% exposure to that group. The sample ETF model's 21.2% weighting in those markets was more than 11 percentage points short of the global benchmark.

In summary, we created a global mix by swapping only two ETFs, all the while increasing net CAD exposure.

FIGURE 6: COUNTRY ALLOCATION COMPARISON





Sources: WisdomTree, S&P, MSCI, as of 3/31/17. Sum may not equal 100% due to rounding errors.

For more than a decade, WisdomTree has been a smart beta innovator, pioneering the concept of self indexing, and offering a choice for investors who are frustrated with market capitalization-weighted indexes for their core portfolio exposures.

Too many Canadian investors are making a systematic error in their asset allocations—and those errors appear to be caused by models that are often heavily weighted to the Canadian broad market. In this case, with a few simple tweaks, we were able to create an easy-to-implement portfolio that:

+ Reduced exposure to the "concentrated stock" problem in Canadian equity markets.
+ Added foreign securities while decreasing foreign currency risk
+ Added companies that are more profitable
+ Added companies with better earnings growth prospects

The WisdomTree ETFs listed on the Toronto Stock Exchange are managed by WisdomTree Asset Management Canada, Inc. Commissions, management fees and expenses all may be associated with investing in WisdomTree ETFs. Please read the relevant prospectus, which is available at www.wisdomtree.com, before investing. WisdomTree ETFs are not guaranteed; their values change frequently, and past performance may not be repeated. Nothing in any commentary should be considered a recommendation to buy or sell a particular security. Tax, investment and all other decisions should be made, as appropriate, only with guidance from a qualified professional.

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