

QUALITY: THE ALL-WEATHER FACTOR FOR YOUR EQUITY PORTFOLIO

Pierre Debru — Head of Quantitative Research & Multi Asset Solutions at WisdomTree in Europe

12/06/2021

A little bit more than a year ago, President Biden was elected, and the cyclical recovery rally kicked into gear. Low-quality stocks (lower profitability, higher debt), which had particularly suffered earlier in 2020, benefited the most and outperformed all other parts of the market. However, with the [Fed](#) starting to [taper](#), hinting at a more [hawkish](#) stand, and with increasing fear of a rebound of the coronavirus this winter, investors may start to be more selective with their investments. Such mid-cycle behaviors tend to favor high-[quality](#) stocks (high profitability, low debt). After a period when they took a back seat to their lower-quality counterparts, such stocks may now benefit from their high pricing power and stronger [balance sheets](#) to help them face rising costs and compressing margins and outperform.

Market Timing the All-Weather Factor

At WisdomTree, we believe that quality stocks are the cornerstone of an equity portfolio. We have often described quality as the all-weather factor that can help investors build wealth over the long term and withstand the inevitable storms along the way:

- Since quality companies generate high revenues, they have the potential to grow and compound wealth in the future.
- Thanks to their solid business models and financial strength, they generally can withstand unexpected events such as an economic downturn or a pandemic.

Of course, no factor strategy is perfect and outperforms every day and in all market environments. Quality stands out among all factors because its periods of underperformance are relatively easy to identify and because this underperformance tends to remain pretty contained. Most factors can post double-digit underperformance in a short period of time, which has been less the case historically for quality.

Figure 1 shows the relative performance of the 30% most profitable U.S. equities compared to the full U.S. equity universe. Market [drawdowns](#) (in red) are periods of consistent, large outperformance. The relative outperformance line (in blue) increases, highlighting that quality stocks are performing better than the market as a whole. However, during the subsequent market recoveries (in green), low-quality stocks tended to recover faster than high-quality stocks, leading to some underperformance for the quality factor. The blue line goes down, meaning that the market is outperforming quality stocks. Outside of early recoveries and drawdowns, quality also outperforms quite nicely (the blue line creeps up), even if more slowly and usually toward the middle to the end of the business cycle.

Figure 1: Historical Outperformance of Quality vs. U.S. Equities over Time



Source: Kenneth French data library, 12/1998–9/2021. Data is calculated at a daily frequency. Stocks are selected to be above the median market cap, with “Quality” representing the top 30% by operating profitability. The portfolios are rebalanced yearly at the end of June. The market represents the portfolio of all available publicly listed stocks in the United States. All returns are in USD. Operating profitability for year t is annual revenues minus cost of goods sold, interest expense and selling, general, and administrative expenses divided by book equity for the last fiscal year-end in $t-1$. **Historical performance is not an indication of future performance, and any investment may go down in value.** Median market cap = The midpoint of market capitalization (market price multiplied by the number of shares outstanding) of the stocks in a portfolio.

A statistical analysis of the returns over the same period highlights the same pattern. High-quality stocks outperform:

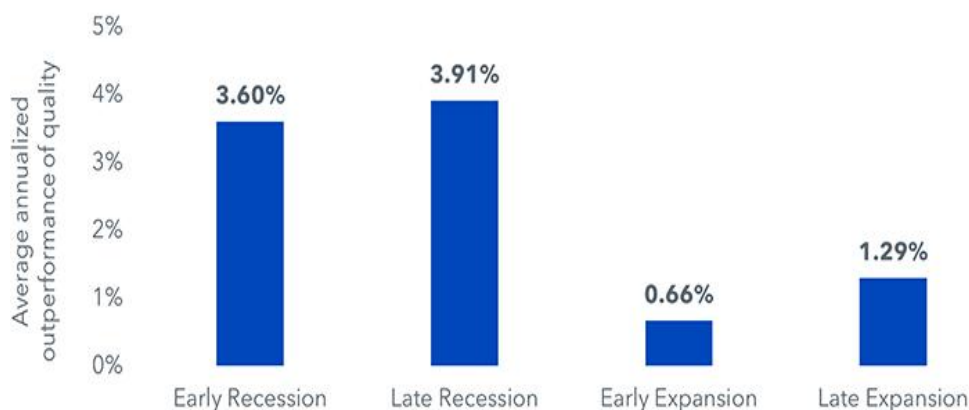
- 56% of business days during market drawdowns
- 45% of the time in the first 12 months of the recovery (i.e., the 12 months following the bear market low)

When Investors Get Picky, Quality Companies Benefit

“A rising tide lifts all boats” is a famous aphorism that applies very well to the market behavior in the first month of the economic expansion. Following a recession and a market drawdown, [fiscal](#) and [monetary policy](#) end up pretty loose, and [liquidity](#) flows to all corners of the economy. This pushes the prices of all companies up, in particular those of the companies that suffered the most in the crisis. This phenomenon usually leads to a low-quality rally at the beginning of the expansion cycle. However, at some point, central banks turn hawkish, liquidity dries up, [volatility](#) starts to reappear and investors start to get pickier when it comes to their investment. Investors start to look for solid companies with solid earnings and safe business models. High-quality stocks tend to benefit and see their price rise with increased demand at that point of the cycle.

Figure 2 exhibits the average annualized outperformance of high-quality stocks (defined as the top 30% by operating profitability in the U.S. equity universe) versus the market over four distinct parts of the cycle. The National Bureau of Economic Research defines [recession](#) and expansion periods. Then each of those periods is split into two halves of equal [duration](#). Clearly, the quality factor’s outperformance is the largest during recessions. However, its outperformance in late expansion is also very strong—significantly better than in early expansion.

Figure 2: Quality Outperformance over the Business Cycle vs. U.S. Equities



Source: Kenneth French data library, 12/1969–9/2021. Data is calculated at a monthly frequency. Stocks are selected to be above the median market cap, with “Quality” representing the top 30% by operating profitability. The portfolios are rebalanced yearly at the end of June. The market represents the portfolio of all available publicly listed stocks in the United States. All returns are in USD. Operating profitability for year t is annual revenues minus cost of goods sold, interest expense and selling, general, and administrative expenses divided by book equity for the last fiscal year-end in t-1. **Historical performance is not an indication of future performance, and any investments may go down in value.**

The latest two years fit that pattern to a T. Quality performed very strongly at the end of the previous cycle, i.e., in 2019 and in the early part of the COVID-19 crisis in early 2020. Since the election of President Biden and the rollout of the vaccine, the low-quality rally has kicked into gear, and high-quality stocks have taken a bit of a back seat to the rest of the market. However, as we approach the first anniversary of the Biden presidency, and with the Fed starting to taper and hinting at a more hawkish stand, it appears that the early recovery phase may be ending, especially in the U.S.

Important Risks and Information Related to this Article

Pierre Debru is an employee of WisdomTree UK Limited, a European subsidiary of WisdomTree Asset Management Inc.’s parent company WisdomTree Investments, Inc.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Funds

- + [WisdomTree U.S. LargeCap Dividend Fund](#)
- + [WisdomTree U.S. Quality Dividend Growth Fund](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Drawdowns : Periods of sustained negative trends of return.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Volatility : A measure of the dispersion of actual returns around a particular average level.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.