

FACTOR INVESTING: BACK TO THE FUNDAMENTALS

Christopher Carrano — Quantitative Research Analyst
08/07/2017

[Value](#), size, [quality](#), [momentum](#), [low correlation](#) and [low volatility](#)—these are some of the primary factors that investors have been considering on their quest for low-cost [alpha](#). Yet many struggle to effectively measure these factor exposures among their assets. One solution is through regression analysis, or observing the sensitivity of an asset's returns to certain factor premiums or other independent variables. For example, WisdomTree has used regression analysis to show why we believe [dividends](#) or earnings are efficient [ways to tap into factors such as low volatility, quality and value](#). But in a world where many [smart beta](#) strategies lack historical data, regression analysis may lose its efficacy.

The question then becomes this: Is there an effective way to measure factor exposures other than regression analysis? Our answer: Bring it back to the fundamentals.

Below we show three factors—quality, value and size—based on exactly that: fundamentals. We'll leave technical factors like low volatility, low correlation and momentum, which focus on changes in price, to a different piece.

In regard to quality and value, for each column, the first row represents the index with the most desirable fundamental number in that category. Similarly, the last row of each column represents the index with least desirable number. For example, the [WisdomTree U.S. Quality Dividend Growth Index](#) exhibits the best measure of [return on assets \(ROA\)](#), while the [S&P 500 Equal Weight](#) exhibits the worst, relatively speaking.

		Quality			Value				
		Return On Assets	Return On Equity	% Weight In Negative Earners	Price-To-Sales	Price-To-Book	Price-To-Free Cash Flow	Forward Price-To-Earnings	Price-To-Earnings
Most Desirable ↑ ↓ Least Desirable	WisdomTree U.S. Quality Dividend Growth (7.76)	WisdomTree U.S. Quality Dividend Growth (25.71)	WisdomTree U.S. Quality Dividend Growth (0)	WisdomTree U.S. Multifactor (1.28)	S&P 500 Equal Weight (2.82)	WisdomTree U.S. Multifactor (25.80)	WisdomTree U.S. Multifactor (17.30)	WisdomTree U.S. Multifactor (18.39)	
	WisdomTree U.S. Multifactor (4.49)	WisdomTree U.S. Multifactor (16.24)	WisdomTree U.S. Multifactor (0)	S&P 500 Equal Weight (1.61)	S&P 500 (3.15)	S&P 500 Equal Weight (32.75)	S&P 500 Equal Weight (18.12)	WisdomTree U.S. Quality Dividend Growth (20.60)	
	S&P 500 (3.10)	S&P 500 (13.97)	S&P 500 (2.81)	WisdomTree U.S. Quality Dividend Growth (2.10)	WisdomTree U.S. Multifactor (3.20)	WisdomTree U.S. Quality Dividend Growth (34.75)	WisdomTree U.S. Quality Dividend Growth (18.19)	S&P 500 (21.90)	
	S&P 500 Equal Weight (2.81)	S&P 500 Equal Weight (11.88)	S&P 500 Equal Weight (6.16)	S&P 500 (2.10)	WisdomTree U.S. Quality Dividend Growth (5.50)	S&P 500 (37.23)	S&P 500 (18.27)	S&P 500 Equal Weight (23.45)	

		Size		
		Weight		
Index		Large Cap	Mid Cap	Small Cap
WisdomTree U.S. Multifactor		60%	40%	0%
WisdomTree U.S. Quality Dividend Growth		94%	6%	0%
S&P 500 Equal Weight		83%	17%	0%
S&P 500		97%	3%	0%

Sources: WisdomTree, FactSet, as of 6/30/17. You cannot invest directly in an index.

WisdomTree U.S. Quality Dividend Growth Index

- **Quality:** WisdomTree's U.S. Quality Dividend Growth Index clearly captures the quality factor through higher return on assets and [return on equity \(ROE\)](#) than all three of the other Indexes shown, as well as 0% weight to companies with negative earnings.
- **Value:** In the value category, WisdomTree's quality Index has mixed results, sometimes showing more sensitivity to the factor than the S&P market Indexes and sometimes not.
- **Size:** As for size, WisdomTree's quality Index is 94% [large cap](#), suggesting little to no size exposure. WisdomTree, however, did create a [small-cap](#) version of this quality Index.¹

To us, these more desirable quality fundamentals are no surprise as this Index's methodology focuses on ROA, ROE and growth characteristics in the large-cap category. It does not aim to beat the market's value characteristics, though it does in some cases, such as its [price-to-earnings \(P/E\) ratio](#).

WisdomTree U.S. Multifactor Index

- **Quality:** Though our multifactor Index doesn't display the same strength in ROA and ROE as our dedicated quality Index, it does manage to best both market Indexes convincingly. Like our quality Index, it also holds 0% weight in companies with negative earnings.
- **Value:** In the value category, the WisdomTree U.S. Multifactor Index beats all other Indexes shown in four out of five categories.
- **Size:** While the WisdomTree U.S. Quality Dividend Growth Index and the [S&P 500 Index](#) never stood much of a chance in the size category, we do see that the WisdomTree U.S. Multifactor Index—[which we've described as modified equal weighting in the past](#)—has about 23% more of its constituent weight dedicated to [mid-cap](#) exposure than the S&P 500 Equal Weight Index, suggesting more size factor exposure.

Conclusion

Being that the design of the WisdomTree U.S. Multifactor Index is in fact to capture multifactor exposure, it was no surprise that its fundamentals show favorable factor exposures in quality, value and size. It's also intuitive that a dedicated factor Index, such as our WisdomTree U.S. Quality Dividend Growth Index, would be able to achieve more attractive quality fundamentals, while sacrificing on others, such as value. Given the significant improvement the U.S. Quality Dividend Growth Index makes regarding return-on-capital measures, it is a surprise to us that the P/E ratios or other valuations are not at a significant premium to the market, as they likely deserve higher multiples.

In short, it can be hard to judge factor exposures for new strategies that lack the live data necessary for in-depth statistical analysis. However, for both new strategies and those with meaningful histories, we believe it's important to understand their methodology, to see what fundamentals they seek to target, to consider which fundamentals are important to you and to see if they are achieving those favorable characteristics versus the market. If a "value" strategy chooses to capture value through dividends, but doesn't have a higher [dividend yield](#) than the market, it may not be what you think it is. Likewise, if a quality index is showing desirable quality fundamentals, or if a multifactor index is showing favorable fundamentals on quality, value and size, it may provide comfort that those indexes are indeed tapping into their desired factors or long-term drivers of excess return.

¹See the WisdomTree U.S. SmallCap Quality Dividend Growth Index.

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.

For more investing insights, check out our [Economic & Market Outlook](#)

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, Kara Marciscano, 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

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

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.

Momentum Factor : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Low Correlation : Characterized by assets that have a relatively lower correlation vs the market over time. This term is also associated with the Low Correlation Factor which associates these stock characteristics with excess returns vs the market over time.

Low Volatility : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

Dividend : A portion of corporate profits paid out to shareholders.

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

S&P 500 Equal Weight Index : Designed to track the equally weighted performance of the 500 constituents in the S&P 500 Index.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Small caps : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.