

# RISK FACTORS ARE ROTATING BACK INTO FOCUS

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*This article is relevant to financial professionals who are considering offering model portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.*

Regular readers of the WisdomTree blogs know that we write frequently [about risk factor diversification](#). As we approach the halfway point of what has been a very turbulent 2022, it is time to revisit this important topic.

As a reminder, most investors are familiar with the visual of an asset class “performance quilt,” which highlights the importance of asset class diversification.

																2007 - 2021	
2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD	Ann.	Vol.
EM Equity	Fixed Income	EM Equity	REITs	REITs	REITs	Small Cap	REITs	REITs	Small Cap	EM Equity	Cash	Large Cap	Small Cap	REITs	Com.dty.	Large Cap	REITs
39.6%	5.2%	79.4%	27.9%	8.3%	19.7%	38.8%	28.0%	2.8%	21.3%	37.8%	1.8%	31.5%	20.0%	41.3%	25.5%	10.6%	23.2%
Com.dty.	Cash	High Yield	Small Cap	Fixed Income	High Yield	Large Cap	Large Cap	Large Cap	High Yield	DM Equity	Fixed Income	REITs	EM Equity	Large Cap	Cash	Small Cap	EM Equity
16.2%	1.8%	59.4%	26.9%	7.8%	19.5%	32.4%	13.7%	1.4%	14.3%	25.5%	0.0%	28.7%	18.7%	28.7%	0.0%	8.7%	22.9%
DM Equity	Asset Alloc.	DM Equity	EM Equity	High Yield	EM Equity	DM Equity	Fixed Income	Fixed Income	Large Cap	Large Cap	REITs	Small Cap	Large Cap	Comdty.	Asset Alloc.	REITs	Small Cap
11.5%	25.4%	32.5%	19.2%	3.1%	18.6%	23.3%	6.0%	0.5%	12.0%	21.8%	-4.8%	25.5%	18.4%	27.1%	-3.9%	7.5%	22.5%
Asset Alloc.	High Yield	REITs	Com.dty.	Large Cap	DM Equity	Asset Alloc.	Asset Alloc.	Cash	Com.dty.	Small Cap	High Yield	DM Equity	Asset Alloc.	Small Cap	Large Cap	High Yield	Comdty.
7.1%	-26.9%	28.4%	16.8%	2.1%	17.3%	14.9%	5.2%	0.0%	11.8%	14.6%	-4.1%	22.7%	10.6%	14.8%	-4.6%	6.6%	19.1%
Fixed Income	Small Cap	Small Cap	Large Cap	Cash	Small Cap	High Yield	Small Cap	DM Equity	EM Equity	Asset Alloc.	Large Cap	Asset Alloc.	DM Equity	Asset Alloc.	REITs	Asset Alloc.	DM Equity
7.8%	-33.8%	27.2%	15.1%	0.1%	16.3%	7.3%	4.9%	-9.4%	11.6%	14.5%	-4.4%	15.5%	8.3%	13.5%	-5.3%	5.7%	18.9%
Large Cap	Com.dty.	Large Cap	High Yield	Asset Alloc.	Large Cap	REITs	Cash	Asset Alloc.	REITs	High Yield	Asset Alloc.	EM Equity	Fixed Income	DM Equity	High Yield	EM Equity	Large Cap
5.5%	-35.6%	21.5%	14.8%	-9.7%	16.0%	2.9%	0.0%	-2.0%	8.6%	10.4%	-5.8%	18.9%	7.5%	11.8%	-6.7%	4.8%	16.9%
Cash	Large Cap	Asset Alloc.	Asset Alloc.	Small Cap	Asset Alloc.	Cash	High Yield	High Yield	Asset Alloc.	REITs	Small Cap	High Yield	High Yield	High Yield	DM Equity	DM Equity	High Yield
4.8%	-37.0%	25.0%	13.8%	-4.2%	12.2%	0.0%	0.0%	-2.7%	8.3%	8.7%	-11.0%	12.6%	7.0%	1.0%	-5.8%	4.1%	12.2%
High Yield	REITs	Com.dty.	DM Equity	DM Equity	Fixed Income	Fixed Income	EM Equity	Small Cap	Fixed Income	Fixed Income	Com.dty.	Fixed Income	Cash	Cash	Fixed Income	Fixed Income	Asset Alloc.
3.2%	-37.7%	18.9%	8.2%	-11.7%	4.2%	-2.8%	-1.8%	-4.4%	2.6%	3.5%	-11.2%	8.7%	0.5%	0.0%	-5.9%	4.1%	11.7%
Small Cap	DM Equity	Fixed Income	Fixed Income	Com.dty.	Cash	EM Equity	DM Equity	EM Equity	DM Equity	Com.dty.	DM Equity	Com.dty.	Com.dty.	Fixed Income	EM Equity	Cash	Fixed Income
-1.6%	-43.1%	5.9%	6.5%	-13.3%	0.1%	-2.3%	-4.5%	-14.6%	1.5%	1.7%	-13.4%	7.7%	-3.1%	-1.5%	-6.9%	0.8%	3.3%
REITs	EM Equity	Cash	Cash	EM Equity	Comdty.	Comdty.	Com.dty.	Com.dty.	Cash	Cash	EM Equity	Cash	REITs	EM Equity	Small Cap	Com.dty.	Cash
-15.7%	-51.2%	0.1%	0.1%	-18.2%	-1.1%	-9.5%	-17.0%	-24.7%	0.3%	0.8%	-14.3%	2.2%	-5.1%	-2.2%	-7.5%	-2.6%	0.7%

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022 YTD
Momentum (-1.8%)	Value (46.32%)	Correlation (24.04%)	Quality (15.81%)	LowVol (19.36%)	Quality (10.93%)	LowVol (-23.16%)	Value (58.13%)	Quality (25.67%)	LowVol (12.37%)	Quality (18.82%)	Value (44.52%)	LowVol (17.2%)	Momentum (7.46%)	Value (18.44%)	Quality (25.42%)	LowVol (-1.27%)	Size (28.03%)	Correlation (25.54%)	Value (28.57%)	Correlation (5.05%)
LowVol (-2.58%)	Correlation (34.08%)	Multifactor (21.43%)	Value (15.24%)	Momentum (17.42%)	Correlation (7.33%)	Momentum (-25.15%)	Quality (38.07%)	Value (20.57%)	Momentum (12.08%)	Value (17.73%)	Size (35.77%)	Multifactor (16.54%)	LowVol (5.32%)	Quality (13.23%)	Size (22.21%)	Momentum (-2.14%)	Quality (27.97%)	Size (15.11%)	LowVol (23.91%)	Multifactor (4.15%)
Multifactor (-2.87%)	Quality (32.97%)	Value (19.55%)	Correlation (15.14%)	Value (17.36%)	Size (7.18%)	Multifactor (-32.53%)	Correlation (32.87%)	Correlation (20.12%)	Multifactor (10.85%)	Size (16.74%)	Correlation (34.81%)	Correlation (15.55%)	Quality (15.1%)	LowVol (13.06%)	Value (18.1%)	Correlation (-3.67%)	Value (27.75%)	Quality (13.77%)	Quality (21.77%)	Momentum (1.71%)
Correlation (-1.41%)	Multifactor (30.97%)	LowVol (18.53%)	Multifactor (14.05%)	Multifactor (15.42%)	Multifactor (5.85%)	Quality (-35.08%)	Size (32.79%)	Momentum (17.58%)	Correlation (4.47%)	Multifactor (15.67%)	Quality (33.78%)	Momentum (15.32%)	Size (0.66%)	Size (11.59%)	Momentum (18.77%)	Multifactor (-4.01%)	LowVol (27.45%)	Momentum (8.65%)	Size (21.47%)	LowVol (0.96%)
Quality (-9.27%)	Size (30.15%)	Quality (17.46%)	Size (7.53%)	Size (13.39%)	Momentum (5.53%)	Size (-36.67%)	Multifactor (24.53%)	Multifactor (17.38%)	Quality (3.41%)	Correlation (15.52%)	Multifactor (32.23%)	Size (14.23%)	Multifactor (0.55%)	Momentum (9.95%)	Multifactor (17.32%)	Size (-4.38%)	Momentum (26.07%)	Multifactor (4.24%)	Momentum (13.73%)	Value (-0.38%)
Value (-1.47%)	LowVol (27.01%)	Momentum (17.02%)	Momentum (5.53%)	Quality (12.57%)	LowVol (1.14%)	Value (-38.47%)	LowVol (20.2%)	LowVol (15.94%)	Size (11.05%)	Momentum (13.15%)	Momentum (27.99%)	Value (13.58%)	Value (-5.3%)	Multifactor (7.97%)	LowVol (17.24%)	Quality (-6.65%)	Correlation (23.15%)	LowVol (0.94%)	Multifactor (19.61%)	Quality (-3.45%)
Size (-22.17%)	Momentum (25.57%)	Size (13.15%)	LowVol (5.07%)	Correlation (11.24%)	Value (0.27%)	Correlation (-41.01%)	Momentum (15.13%)	Size (14.51%)	Value (-1.34%)	LowVol (12.91%)	LowVol (23.72%)	Quality (13.52%)	Correlation (-7.79%)	Correlation (7.59%)	Correlation (13.51%)	Value (-13.2%)	Multifactor (20.11%)	Value (-0.23%)	Correlation (6.98%)	Size (-4%)

Sources: WisdomTree and Bloomberg, as of 05/31/22. The starting universe for the referenced factor portfolios is the 800 largest companies listed in the U.S. Securities in the Low Correlation portfolio are selected based on their trailing 6- and 12-month correlation versus the broad market. Securities in the Low Volatility portfolio are selected based on their trailing 12-month standard deviation. Securities in the Momentum portfolio are selected based on their trailing 6- and 12-month risk-adjusted performance. Securities in the Quality portfolio are selected based on stronger current and historical (3-year) measures of profitability compared to their peers in the same GICS industry using four main variables: return on equity, return on assets, gross profits over assets, cash flow over assets. Securities in the Value portfolio are selected based on more attractive valuation metrics compared to their peers in the same GICS industry using six main variables: sales-to-price, book-to-price, earnings-to-price, estimated earnings-to-price, EBITDA-to-enterprise value, operating cash flow-to-price. Securities in the Size portfolio are selected based on their market capitalization compared to their peers in the starting universe. Securities in the Multifactor portfolio are selected based on a composite score calculated by equally weighting their low correlation, momentum, quality and value scores. Past performance does not guarantee future results.

For definitions of terms in the image above, please visit the [glossary](#).

## Year-to-Date Review

The first half of 2022 was unusual in the sense that bonds did not provide the hedge to equity risk they historically have.



Source: YCharts, year-to-date data through 06/21/22. You cannot invest in an index, and past performance does not guarantee future results.

For definitions of terms in the image above, please visit the [glossary](#).

Certain equity risk factors, specifically **dividends** and **value**, were more effective hedges to broad market equity risk.

Conversely, the rising interest rate environment over the first half caused havoc with **growth** stocks (i.e., stocks whose cash flows are expected further out in the future and so whose "discounted cash flow" valuations are therefore more sensitive to rising rates).

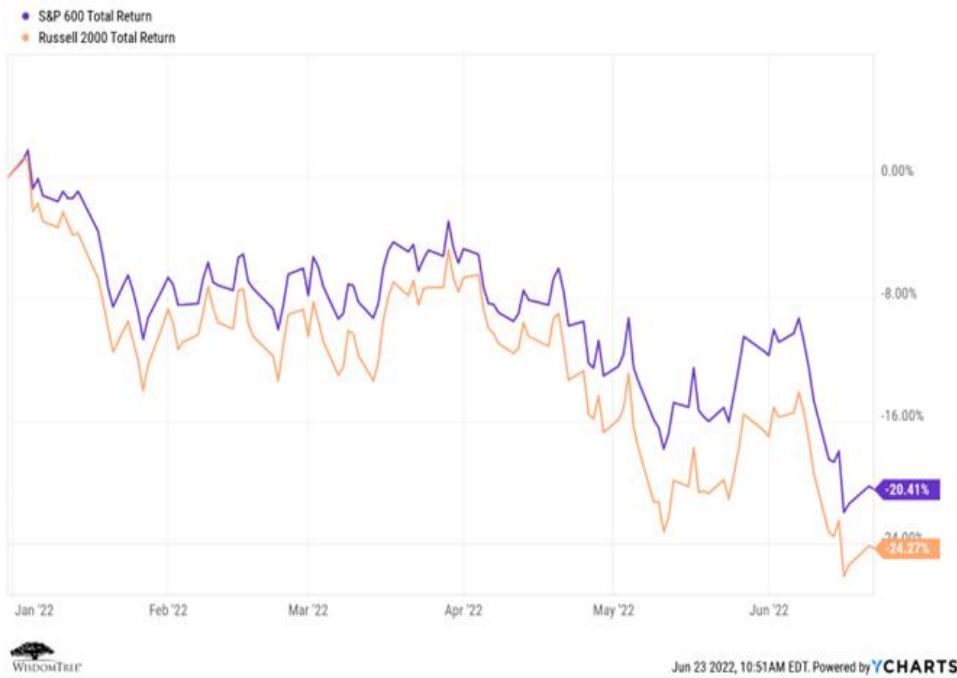
#### U.S. Factor Return YTD, as of 5/31/22



Source: WisdomTree, FactSet, Russell, MSCI, S&P. You cannot invest directly in an index. Past performance is not indicative of future returns. High Dividend: WisdomTree U.S. High Dividend Index. Quality Dividend Growth: WisdomTree U.S. Quality Dividend Growth Index. Value: Russell 1000 Value Index. Small-Caps: Russell 2000 Index. Min Vol: MSCI USA Minimum Volatility Index. Quality: MSCI USA Sector-Neutral Quality Index. Momentum: MSCI USA Momentum Index. Growth: Russell 1000 Growth Index.

For definitions of terms in the image above, please visit the [glossary](#).

Within **small-cap stocks**, we also see that **quality** was an important risk mitigator (using the **S&P 600** versus the Russell 2000 indexes as proxies for the quality factor, as the S&P 600 index excludes far more negative earnings companies than the **Russell 2000 index**).



Source: YCharts, year-to-date data through 06/22/22. You cannot invest in an index, and past performance does not guarantee future results.

As a final factor to examine, let's look at [size](#). Within U.S. [large-cap](#) stocks, we see year-to-date (YTD) outperformance by the smaller-cap stocks within the index (using the [S&P 500 equal-weighted index](#) as a proxy for those smaller-cap stocks).



Source: YCharts, year-to-date data through 06/22/22. You cannot invest in an index, and past performance does not guarantee future results.

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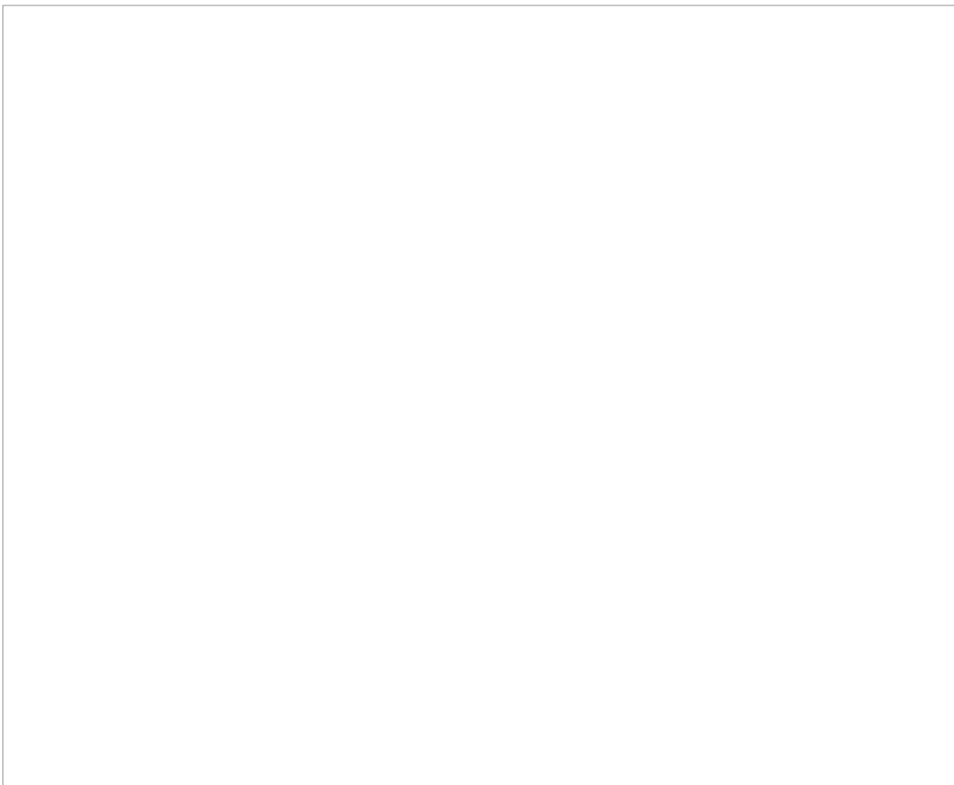
But, at a broader level, U.S. large-cap stocks outperformed U.S. small-cap stocks.



We saw similar (and more dramatic) YTD underperformances with [EAFE](#) and [EM](#) small-cap stocks in comparison to their respective large-cap indexes, though non-U.S. small-cap stocks have outperformed non-U.S. large-cap stocks over longer time horizons (e.g., 10 years).

#### **Outlook for the Remainder of 2022**

As the [Fed](#) (and other [central banks](#)) engages in more aggressive [rate hike](#) regimes, we see the market interpreting that as a signal for impending recession. The result has been a mini rally in growth stocks over the past two weeks as investors have leaned away from value-oriented sectors such as financials, utilities and especially energy.



For definitions of terms in the image above, please visit the [glossary](#).

Despite this, we believe that [value](#) and [dividends](#) will outperform over the remainder of the year. We further believe that quality will become increasingly important as we head into an uncertain economic environment marked by generally rising interest rates and increased market [volatility](#). We believe that investors will once again refocus on companies that exhibit stronger earnings, [cash flows](#) and [balance sheets](#).

For valuation-driven (and therefore longer-term) investors, U.S. small-cap stocks present an interesting potential opportunity—[the market has driven small-cap valuations down, seemingly in expectation of a sooner-than-we-expect recession](#).

Let's compare commonly-used valuation metrics of the S&P large cap and small cap indexes (labeled "500" and "600", respectively, in the chart below) – we see a significant discount in the small cap index numbers versus the large cap index numbers. Since what you can earn on any investment is at least partially a function of how much you pay for it today, longer-term investors may see a relative attraction to small cap stocks, despite the current market environment.



A more historical perspective tells a similar story—despite the downturn so far this year, [mid-](#) and small-cap stocks remain more attractively valued than large-cap stocks.



### **Conclusions**

Given the factor tilts inherent in many, if not most WisdomTree strategies (dividends, value, size and quality), we remain comfortable with the positioning and allocations within our Model Portfolios. Most of our strategic models are benefitting from these factor tilts and are beating their respective benchmarks YTD.

Given the difficulty in forecasting asset class and risk factor performances, however, we intentionally diversify our portfolio at both of those levels.

As a reminder, almost all publicly available WisdomTree Model Portfolios have certain common characteristics:

1. They are global in nature
2. They are diversified at both the asset class and risk factor levels
3. They are ETF-focused, to optimize fees and taxes
4. We charge no strategist fee

We are an **open-architecture** shop (that is, all our Models include both WisdomTree and third-party products) for many reasons: (a) it's the right thing to do, (b) it's what end clients assume, and advisors expect, and (c) it allows us to build more risk factor-diversified portfolios.

We like the factor tilts currently embedded in our Model Portfolios, as we believe dividends, value and quality will continue to shine as we move through 2022. We also believe size may be positioned for a positive rotation.

Given our strategic investment mandates, however, we also remain diversified at both the asset class and risk factor levels.

#### **Important Risks Related to this Article**

Neither diversification nor an asset allocation strategy assures a profit or eliminates the risk of experiencing investment losses.

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