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# QUALITY IS JOB ONE

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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.*

*“Quality Is Job One”*

*(Iconic advertising slogan for the Ford Motor Company for most of the 1980–90s)*

In this blog post, we focus on the [quality](#) risk factor. Why? Two reasons: (1) it permeates and forms the anchor of many WisdomTree products and Model Portfolios; and (2) we believe it will become increasingly important as we sail through the uncertain seas of the remainder of 2023 and beyond.

First, let’s define terms. “Quality” has its roots in the well-known [DuPont analysis](#), which defines quality firms as those with better relative earnings, [cash flow](#) and [balance sheets](#) (ROE, ROA and [leverage](#), respectively). At WisdomTree, we extend that line of thought to include [companies with better dividend sustainability and pricing power](#) (i.e., the ability to withstand margin pressures in times of economic distress).

We measure this through our proprietary [Composite Risk Score](#), which seeks to find the highest quality securities in many of the Indexes we manage. (Remember, we are a “self-indexing” firm—we do not license most of our Indexes from third parties, but create and manage them ourselves, and then wrap ETFs around them, thereby giving us control over which securities go into those ETFs.)

## Why Does Quality Matter?

Historical analysis suggests that quality is the most consistent performer of the various equity risk factors. It is rarely the best or worst performing factor, but is the most consistent, which is why it anchors many of our products and most of our Model Portfolios.

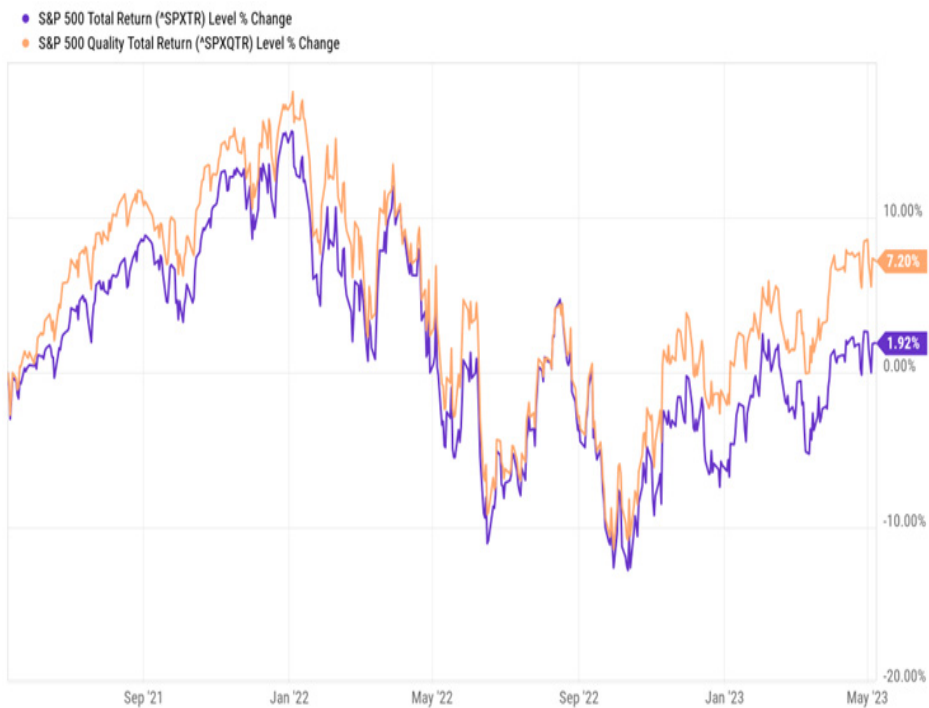
The following chart is busy, but focus on the teal line, which represents the historical performance of the quality factor.

Rolling 10-Year Excess Return vs. Market



Sources: WisdomTree, Kenneth French Data Library, as of 03/31/23, and represents the latest available data. Using French's definitions: Value = HI 30 portfolio, Size = Lo 30 portfolio, Quality = HI 30 portfolio, Low Vol = BIG LoVar portfolio and High Div = HI 30 portfolio.

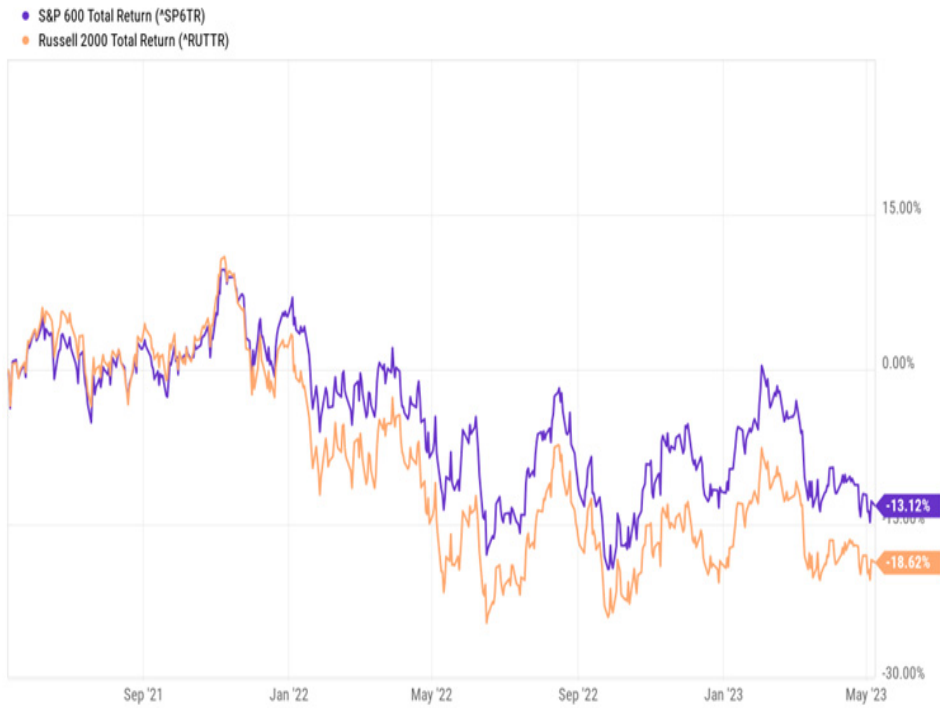
We see that over the past two years (inclusive of the awful 2022), quality added significant value in [large-cap](#) stocks...



May 09 2023, 11:41AM EDT. Powered by YCHARTS

Sources: Ycharts, 2-year data through 05/08/23. You cannot invest in an Index and past performance does not guarantee future results.

...and in [small-](#) and [mid-cap](#) stocks (using the [S&P 600](#) and [Russell 2000](#) indexes as proxies. The S&P 600 is considered a higher quality index because it excludes a higher percentage of negative earners).



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Source: Ycharts, 2-year data through 05/08/23. You cannot invest in an Index and past performance does not guarantee future results.

Longer term, we see that quality has outperformed outside the U.S. as well. Here we first compare the quality characteristics of our own [DNL ETF](#), which is our [Global ex-U.S. Quality Dividend Growth product](#) and which filters its security selection through our composite risk score, versus its benchmark [MSCI AC World ex-US Index](#), using the primary [DuPont analysis](#) metrics.

QUALITY METRICS as of 3/31/2023 <i>select a characteristic to view historical data</i>		
	DNL	MXWDU
Return on Assets (ROA%)	8.65%	1.78%
Return on Equity (ROE%)	25.74%	12.79%
Return on Sales %	15.81%	13.65%
Leverage	2.97	7.20

Sources: The WisdomTree Fund Comparison Tool, data through 03/31/23. DNL is an Investable product, but MXWDU is an Index. You cannot invest in an Index and past performance does not guarantee future results. The performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end performance, please call 866.909.WISE (9473) or visit the Fund's website.

And now we compare performance over the past 10 years.



Source: The WisdomTree Fund Comparison Tool, 10-year data through 05/08/23. IQDG is an Investable product, but MXWDU is an Index. You cannot Invest in an Index and past performance does not guarantee future results.

**What about Fixed Income?**

In a market environment marked by a slowing economy and rising interest rates, quality can be as important in fixed income as it is in equities. We apply quality filters to our security selection for both our [U.S. Corporate Bond Fund \(WFIG\)](#) and our [U.S. High Yield Corporate Bond Fund \(WFHY\)](#).

The quality screens for WFIG include [free cash flow](#) over debt service, [leverage ratio](#), and [return on invested capital \(ROIC\)](#). We then eliminate the lowest scoring 20% of issuers based on those metrics, by sector.

Despite these quality screens, investors have sacrificed little total return over a common performance period versus broad market U.S. corporate bond ETFs.



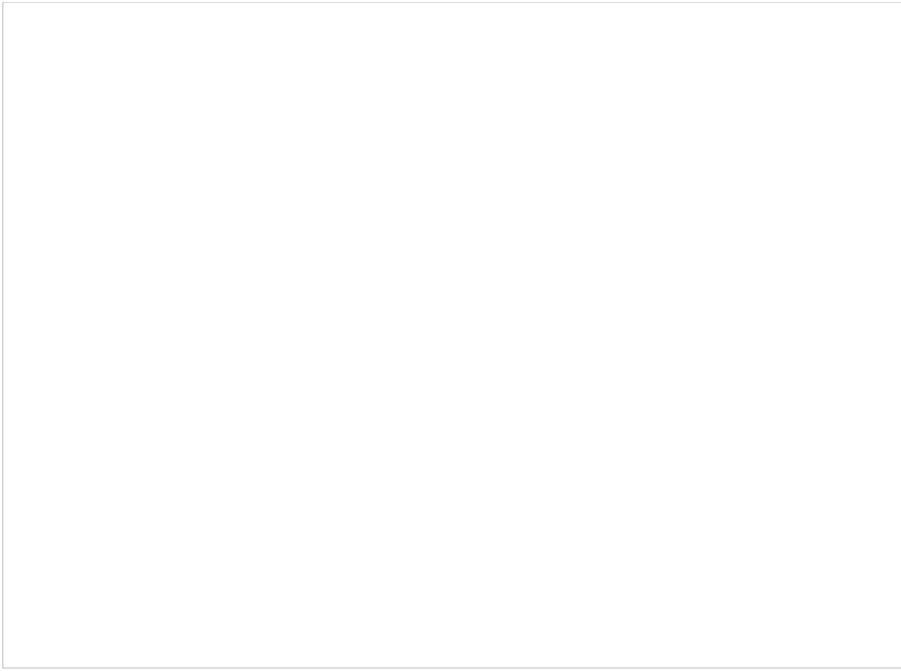
Source: The WisdomTree Fund Comparison Tool, common date performance from 4/26/16–5/08/23. WFIG has an expense ratio of 0.18% and is a corporate bond ETF that seeks to track, before fees and expenses, the WisdomTree U.S. Corporate Bond Index, which is a rule-based alternatively weighted index designed to capture the performance of selected issuers in the U.S. investment-grade corporate bond market that are deemed to have attractive fundamental and income characteristics. SPBO has an expense ratio of 0.03% and is a U.S. corporate bond ETF offered by State Street, and seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the Bloomberg U.S. Corporate Bond Index. USIG has an expense ratio of 0.04%, and is a U.S. Corporate Bond ETF offered by iShares, and seeks to track the investment results, before fees and expenses, of the ICE BofA U.S. Corporate Index. SPBO and USIG were chosen for comparison due to their similar investment strategies. Past performance does not guarantee future results.



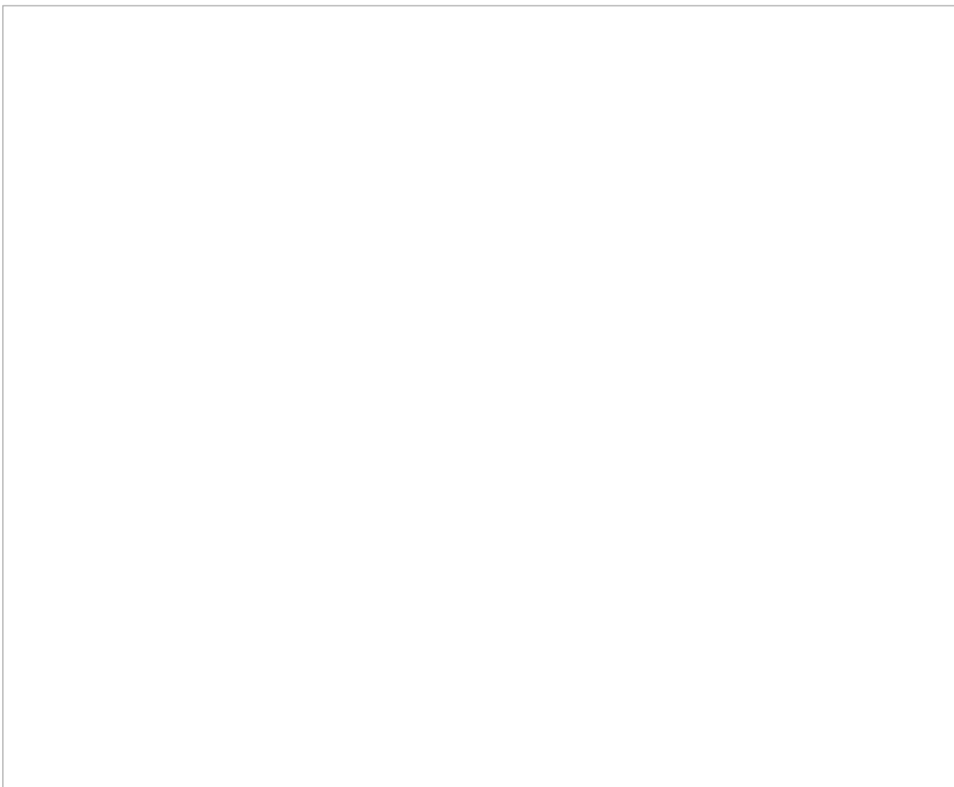
*For the most recent month-end and standardized performance, current yield, and to download the fund prospectus, click the respective ticker: [WFIG](#), [SPBO](#), [USIG](#).*

Our [WFHY](#) product accesses the broad U.S. [high-yield](#) market, but with an important caveat –it screens out issuers with negative cash flow. The result is a far lower [default](#) rate in comparison to the broader high-yield market.

**Cumulative HY Defaults (Mar '16–Feb '23)**



Over a common performance period, however, [WFHY](#) has not sacrificed total return relative to broader market competitors.





*For the most recent month-end and standardized performance, current yield, and to download the fund prospectus, click the respective ticker: [WFHY](#), [JNK](#), [HYG](#).*

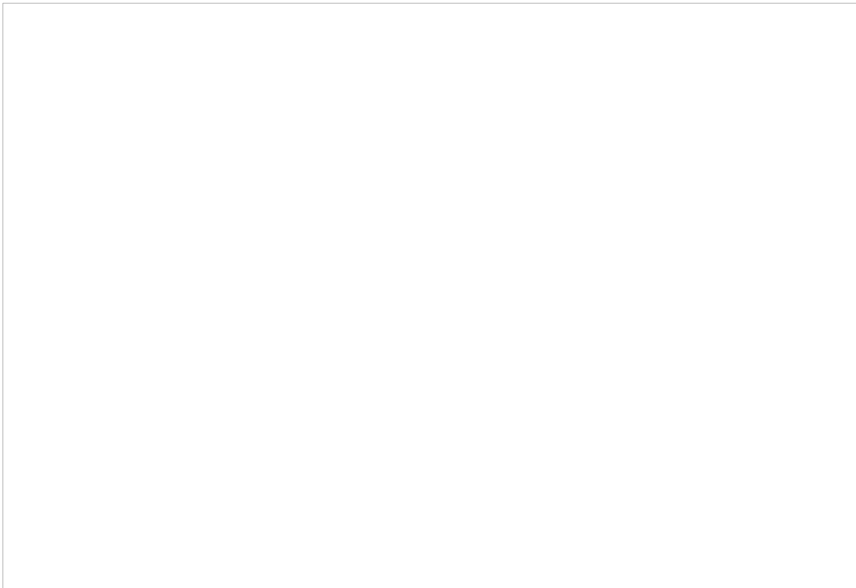
An important consideration is as follows. Default rates in the age of low interest rates were low, perhaps leading some investors to wonder why quality screens matter.

A fair question, but one that may have a different answer going forward. Consider the trend lines of default rates for both corporate and high yield bonds—still low but trending in the wrong direction.

**Default Rates Remain Low, But Signs of Distress Are Increasing**



### Q1 Defaults have Already Surpassed the Full Year Totals of 2021 and 2022 Combined (Quarterly Volumes of Defaulted USD Corporate Debt)



#### Conclusions

Here at wisdomTree, we will never apologize for anchoring many of our products and Model Portfolios to the quality risk factor. Historical performance suggests that doing so provides the potential for much more consistent performance over full market cycles.

Given what we believe will be [volatile](#) and uncertain markets over the remaining course of 2023 and beyond, we have even higher conviction in tilting toward the quality factor.

As the ad slogan said, at wisdomTree, “Quality Is Job One.”

#### Important Risks Related to this Article

**DNL:** There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.



**WFIG & WFHY:** There are risks associated with investing, including the possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. While the Funds attempt to limit credit and counterparty exposure, the value of an investment in the Funds may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Funds' portfolio investments.

Please read the Funds' prospectus for specific details regarding the Funds' risk profiles.

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 Global ex-U.S. Quality Dividend Growth Fund](#)
- + [WisdomTree U.S. High Yield Corporate Bond Fund](#)
- + [WisdomTree U.S. Corporate Bond 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.

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## DEFINITIONS

**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.

**Cash flows**: a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.

**Balance sheet**: refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new positions.

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

**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.

**Leverage**: Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

**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.

**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.

**S&P 600 Index**: The S&P 600 is an index of small-cap stocks managed by Standard and Poor's. It tracks a broad range of small-sized companies that meet specific liquidity and stability requirements.

**Russell 2000 Index**: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**MSCI ACWI ex-U.S. Index**: A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets excluding companies based in the United States.

**DuPont Equation**: At the DuPont Corporation, Donaldson Brown created the concept that Return on equity (ROE) is broken down into the interaction between profit margin, by asset turnover, and the equity multiplier. These three pieces multiplied together are equal to ROE.

**Free Cash Flow** : A measure of how much cash is left in the company after taking into account all the necessary expenses, including net capital expenditures.

**Leverage Ratio** : Total amount of debt given a total amount of assets i.e., total Debt divided by total asset.

**Return on Invested Capital (ROIC)** : Measures the efficiency of invested capital and how it relates to generated returns.

**High Yield** : Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.

**Default** : A failure to meet the legal obligations (or conditions) of a loan.

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