

---

# WHAT FACTORS TO OWN IN TODAY'S MARKET

Joseph Tenaglia — Director, Model Portfolios

01/26/2018

Investing is hard. Trying to time the market is harder. Timing return [factors](#) at the right time? Forget about it.

The past few years have seen some of the industry's brightest minds publish papers concerning the feasibility of timing return factors. The conclusions have varied slightly, but most generally agree that when investing in factors, trying to determine which ones to invest in at a given time is an incredibly difficult undertaking.

However, most of these papers analyze factor timing from the lens of the [valuations](#) of these factors. What if we take a different approach and see if we can estimate which factors could outperform from the context of where we are in the market cycle?

## Where Are We Now?

The U.S. equity [bull](#) market started on March 9, 2009. In the almost nine years since then, the [S&P 500](#) has rallied nearly 400%.<sup>1</sup> We are certainly not calling for an end to the bull run—in fact, the market environment still appears benign, and corporate earnings have remained strong—but it is certainly not a stretch to claim that we are closer to the end of the cycle than we are to the beginning of it.

As of this writing, we are in the midst of the longest period without a 3% pullback in the history of the S&P 500.<sup>2</sup> With [implied](#) and [realized volatility](#) hovering near their all-time lows, it seems reasonable to expect more choppiness—if not an outright correction—coming in the next few months. Based on what we know from history, what factors tend to outperform in the late stages of market cycles?

## Factor Performance Prior to Market Corrections

U.S. Equity Correction		Returns 12 Months Before Correction				
Start Date	End Date	Size	Value	Quality	Momentum	S&P 500 Index
10/7/1997	10/27/1997	35.87%	44.18%	43.36%	42.00%	42.39%
7/17/1998	8/31/1998	17.51%	36.60%	31.38%	34.37%	29.36%
7/16/1999	10/15/1999	3.10%	8.04%	20.72%	21.62%	21.49%
3/24/2000	10/9/2002	79.59%	1.62%	22.03%	49.68%	21.90%
11/27/2002	3/11/2003	-2.64%	-23.55%	-15.29%	-8.40%	-17.00%
10/9/2007	3/9/2009	13.46%	16.50%	21.72%	25.15%	18.04%
4/23/2010	7/2/2010	73.56%	54.97%	42.40%	51.25%	45.89%
4/29/2011	10/3/2011	15.74%	2.04%	16.86%	18.12%	15.26%
5/21/2015	8/25/2015	14.50%	10.63%	16.11%	18.07%	15.18%
11/3/2015	2/11/2016	3.01%	-1.60%	5.95%	8.75%	6.75%

Sources: WisdomTree, Bloomberg, Yardeni Research Inc., Kenneth French Data Library. Past performance is not indicative of future results. You cannot invest directly in an index. Values shaded in green indicate outperformance vs. S&P 500 during that time frame. Size refers to the Lo 30 portfolio of all listed stocks in the bottom 30% of the total U.S. market capitalization. Value refers to the BIG HiBM portfolio of large-cap companies with high book/market ratios. Quality refers to the BIG HiOP portfolio of large-cap companies with high operating profitability. Momentum refers to the BIG HiPRIOR portfolio of large-cap companies with positive trailing price momentum.

### Late-Stage Outperformers: [Momentum](#), [Quality](#)

Dating back to 1990, there have been 10 distinct 10% corrections in the S&P 500,<sup>3</sup> with bifurcated results in the months preceding the correction. In the lead-up to the downturns, momentum and quality stocks have seen consistent excess performance compared to the market, whereas the [size](#) and value factors have generally underperformed.

These results provide an interesting backdrop for today's market. If we are indeed late in the cycle, and the market dropped 10% tomorrow, this trend would hold true once again. The [MSCI Momentum Index](#) and [MSCI Quality Index](#) have outperformed the S&P 500 over the last 12 months (by 1,700 and 320 [basis points \(bps\)](#), respectively), whereas the [Russell 2000 Index](#) and [Russell 1000 Value Index](#) (well-known small-cap and value indexes) have both lagged by more than 700 bps.<sup>4</sup>

While it is interesting to look at what factors worked well, we think it is also important to analyze what didn't. If size and value lagged, one can conclude that their complements—[large caps](#) and growth companies—outperformed as a result.

### Factor Performance During Market Corrections

US Equity Correction		Returns During Correction				
Start Date	End Date	Size	Value	Quality	Momentum	S&P 500 Index
10/7/1997	10/27/1997	-8.42%	-7.63%	-10.37%	-11.70%	-10.75%
7/17/1998	8/31/1998	-27.71%	-17.24%	-19.04%	-20.51%	-19.19%
7/16/1999	10/15/1999	-10.64%	-13.87%	-11.51%	-8.89%	-11.80%
3/24/2000	10/9/2002	-33.16%	-31.21%	-35.25%	-40.56%	-47.38%
11/27/2002	3/11/2003	-13.26%	-21.66%	-11.74%	-7.51%	-14.24%
10/9/2007	3/9/2009	-62.06%	-67.76%	-44.65%	-49.60%	-55.22%
4/23/2010	7/2/2010	-19.66%	-20.26%	-14.90%	-18.64%	-15.63%
4/29/2011	10/3/2011	-30.83%	-27.32%	-15.49%	-20.35%	-18.64%
5/21/2015	8/25/2015	-11.89%	-14.69%	-12.40%	-9.01%	-11.89%
11/3/2015	2/11/2016	-20.66%	-19.22%	-12.69%	-13.27%	-12.71%

Sources: WisdomTree, Bloomberg, Yardeni Research Inc., Kenneth French Data Library. Past performance is not indicative of future results. You cannot invest directly in an index. Size refers to the Lo 30 portfolio. Value refers to the BIG HiBM portfolio. Quality refers to the BIG HiOP portfolio. Momentum refers to the BIG HiPRIOR portfolio.

## Quality: The Best of Factors in the Worst of Times

Shifting our focus to the market corrections themselves, when the S&P 500 fell at least 10%, it is clear that quality was the most desirable factor by a relatively wide margin. Intuitively, that makes sense—when there is stress in the markets, high-quality companies should help protect investors during market downturns. Encouragingly, the factor excess performance was largest in the most severe market sell-offs (with the quality factor having captured only 74% of the market downside during the tech bubble and 81% during the financial crisis).

Again, value underperforms here, with size and momentum each having relatively more mixed results during market corrections.

## What Are Size and Value Good For?

An investor could look at this data and wonder, why would I want to own size and value? Aren't these stocks supposed to outperform the market? Over the long term, yes, those two factors have shown a propensity to beat the market—with particularly notable excess performance in the early stages of market cycles. Following historical market corrections, immediately after the market bottoms out and reverses upward, size and value have consistently done an effective job of capturing more upside than the market.

## Factor Performance Following Market Corrections

US Equity Correction		Returns 12 Months After Correction				
Start Date	End Date	Size	Value	Quality	Momentum	S&P 500 Index
10/7/1997	10/27/1997	-17.45%	20.70%	26.37%	25.06%	23.35%
7/17/1998	8/31/1998	31.92%	21.08%	39.03%	42.68%	39.82%
7/16/1999	10/15/1999	25.99%	12.07%	13.87%	21.77%	11.45%
3/24/2000	10/9/2002	80.52%	38.54%	25.40%	29.26%	36.14%
11/27/2002	3/11/2003	84.79%	55.87%	33.04%	34.67%	40.69%
10/9/2007	3/9/2009	114.18%	118.58%	62.05%	52.32%	72.26%
4/23/2010	7/2/2010	38.02%	22.30%	35.79%	40.76%	33.63%
4/29/2011	10/3/2011	40.23%	42.68%	33.12%	36.17%	35.00%
5/21/2015	8/25/2015	12.32%	13.78%	17.67%	12.71%	18.92%
11/3/2015	2/11/2016	52.01%	52.89%	28.53%	22.61%	29.34%

Sources: WisdomTree, Bloomberg, Yardeni Research Inc., Kenneth French Data Library. Past performance is not indicative of future results. You cannot invest directly in an index. Size refers to the Lo 30 portfolio. Value refers to the BIG HiBM portfolio. Quality refers to the BIG HiOP portfolio. Momentum refers to the BIG HiPRIOR portfolio.

## Portfolio Implications for Today

If we are indeed in the late stages of the market cycle, we believe investors should tilt portfolios toward momentum (or growth) and quality. In WisdomTree's U.S. equity suite, one strategy perfectly fits that bill.

The [WisdomTree U.S. Quality Dividend Growth Index](#) methodology implements a ranking system where each stock's growth and quality fundamentals are equally weighted, with the top scorers being selected for inclusion. While the Index's performance has beaten the S&P 500 over the last 12 months (by more than 550 bps) and since its inception (by 100 bps annualized),<sup>5</sup> we continue to lean into it today for its attractive quality fundamental characteristics, valuation discount to the S&P, rate-conscious sector exposures and well-positioned factor tilts.

For those reasons, the [WisdomTree U.S. Quality Dividend Growth Fund \(DGRW\)](#), the ETF that tracks the Index, is one of our favored U.S. equity strategies in the current market environment.

Once the inevitable market correction does come, we advise investors to keep a disciplined focus on quality—and be ready to pivot to smaller value companies when the tide turns back around.

<sup>1</sup>Source: Bloomberg, as of 1/17/18.

<sup>2</sup>Source: Comerica Wealth Management, as of 1/11/18.

<sup>3</sup>Source: "Stock Market Briefing: S&P 500 Bull & Bear Market Tables," Yardeni Research, Inc., last updated 12/1/17.

<sup>4</sup>Source: Bloomberg, as of 1/17/18.

<sup>5</sup>Source: Bloomberg, as of 1/17/18.

#### Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors may be more vulnerable to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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](http://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**

**Factor** : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

**Valuation** : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**Bullish** : a position that benefits when asset prices rise.

**Momentum** : 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.

**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.

**Size** : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.