QUALITY AS A HEDGE FOR VALUE

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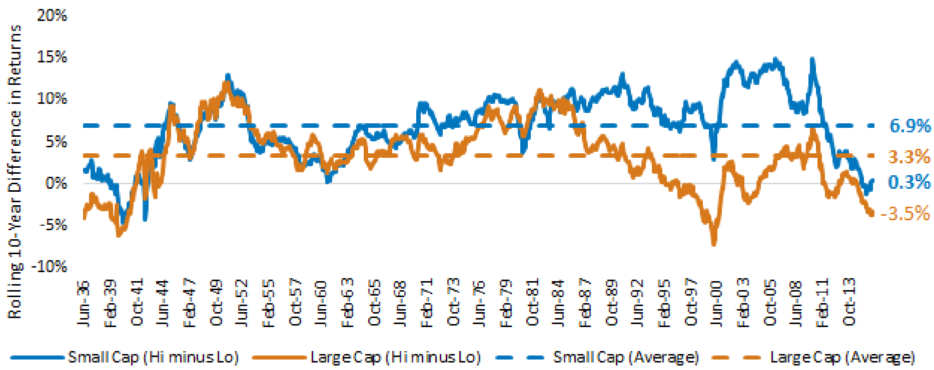
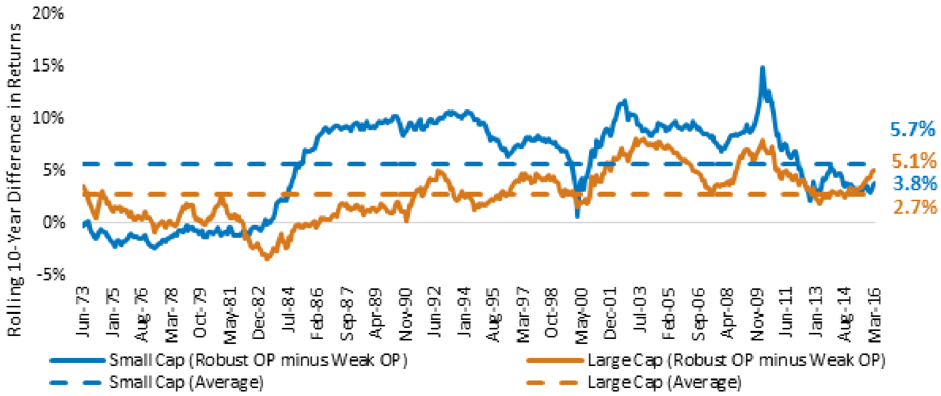
In a 2012 paper written by Robert Novy-Marx, we found the following statement particularly interesting: *"Strategies based on gross profitability generate value-like average excess returns, even though they are growth strategies that provide an excellent hedge for value."*[1] Why did this catch our attention? We have been noticing that the value style had been underperforming. From a portfolio perspective, few things are better than adding a strategy that has the potential to "zig" as another "zags." **Value vs. Quality** Value investing has been popularized over many decades, with names like Benjamin Graham and Warren Buffett contributing to its acclaim. The word "patience" comes up a lot, and it is not atypical for there to be periods of time where questions like "Has the value premium run its course?" become fairly common. Still, we ask, has it ever been a poor long-term strategy to attempt to buy low and sell high? Quality is a concept that, intuitively, has been on investors' minds for a long time, even if the word has only been coming up with greater frequency more recently. Warren Buffett's long-time partner, Charlie Munger, made the following statement in a speech that, to us, beautifully sums up the concept of quality: *"Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result."*[2] It's interesting that the Buffett–Munger partnership at Berkshire Hathaway is seen as one of the most powerful in history, embodying a powerful example of the potential for combining two different styles. **The Last 10-Years: Quality or Value?** WisdomTree launched its first fundamentally weighted Indexes focused on dividend-paying stocks 10 years ago. Today we ask two distinct questions: 1) Which has tended to outperform, quality or value, over the most recent 10-year period? 2) Where does the most recent 10-year period fit within the broader historical context of all available rolling 10-year periods? **Value Faced a Headwind; Large-Cap Quality Faced a Tailwind United States: High Book to Market minus Low Book to Market for Large Cap and Small Cap Companies (Rolling 10-Year Average Annual Returns) June 30, 1926 to March 31, 2016**



United States: Robust Operating Profitability minus Weak Operating Profitability for Large Cap and Small Cap Companies (Rolling 10-Year Average Annual Returns) June 30, 1963 to March 31, 2016



Sources: WisdomTree, Kenneth French Data Library. Past performance is not indicative of future results. You cannot invest directly in an index.

• **Value Trending toward Its Worst 10-Year Relative Returns:** What we see here for value is the difference in average annual rolling 10-year returns for stocks with high book-to-market value ratios (value stocks) and stocks with low book-to-market value ratios (growth stocks). Whether one is looking in large caps or small caps, the result—a trend of deterioration in rolling 10-year returns—is quite clear. In large caps it is also notable that for the most recent 10-year period the growth stocks actually outperformed the value stocks. • **Quality Added Value in Both Large- and Small-Cap Stocks:** In contrast with what we noted on the value side, quality stocks—shown here as the difference in rolling 10-year average annual returns of stocks with robust operating profitability minus those with weak operating profitability—with robust operating profitability outperformed in both large caps and small caps. Additionally, the most recent 10-year period saw above-average outperformance of stocks with robust operating profitability for the large-cap size segment. **The Value & Quality Complementarity Rings True** Citing Robert Novy-Marx, we said at the outset that quality can be a hedge for value. In future blog posts, we will explore a concept that we define as the income factor and how WisdomTree's original dividend Indexes may have been tapping into both quality AND value over their live history. [1]Robert Novy-Marx, "The Other Side of Value: The Gross Profitability Premium," Journal of Financial Economics 108(1), 2013. [2]Charlie Munger, "A Lesson on Elementary, Worldly Wisdom as it Relates to Investment Management & Business," speech given at USC Business School, 1994.

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DEFINITIONS

Gross Profitability : a company's total revenue (equivalent to total sales) minus the cost of goods sol.

Excess Returns : refers to investment returns on a securities above that of a benchmark or index exhibiting similar risk characteristics.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

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 tim.

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 tim.

Value Premium : The greater risk-adjusted return of value stocks over growth stock.

Fundamental weighting : A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.

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

Book-to-Market Value Ratios : a ratio used to find the value of a company by comparing the book value of a firm to its market valu.