HOW THE INNOVATION FACTOR CAN HELP BOTH PORTFOLIOS AND ECONOMIC GROWTH

Jeremy Schwartz — Global Chief Investment Officer
05/08/2019

On last week's episode of the "Behind the Markets" podcast, Liqian Ren and I had a broad discussion focused on innovation in finance.

First, Chris Jones, CIO and Executive Vice President of Investment Management at Financial Engines, joined us to share his views on the field of retirement planning. Financial Engines manages over $200 billion of assets and is the largest registered investment advisor (RIA) in the country.

Later, Anne Marie Knott, author of the book, "How Innovation Really Works: Using the Trillion-Dollar R&D Fix to Drive Growth," discussed a new investment factor focused on measuring innovation in companies, highlighting a metric she believes could both create excess returns in stock portfolios and revitalize economic growth.

Financial Engines: The Early Robo

Looking for more entrepreneurial work, Chris Jones made a switch from his career in litigation consulting to become the third member to join Financial Engines back in 1996. He was initially tasked with building a team around its founder, Nobel Laureate William Sharpe, to develop implementation of automated investing for individual investors.

In 1998, they launched their first array of services to provide personalized investment advice in 401(k) plans, primarily for individuals. This service, now known as the Robo-Advisor, provides greater access to low-cost, non-discretionary, professional investment advice for the growing population of retirees.

Initially, the product was sold to Fortune 500 companies that would offer it to their extensive employee bases. In 2003, Financial Engines started offering managed account services more directly, where a client would delegate the responsibility of managing assets to Financial Engines for a small fee. This proved to be wildly successful; helping the company become the largest independent RIA in the country today, with $202 billion in assets under management (AUM).

Financial Engines believes very much in passive investing and utilizes about 75% passive solutions, but has 25% active solutions as well. Jones believes passive investing tends to outperform active solutions, but the markets aren't perfectly efficient and active management can provide value in some cases. Above anything, Financial Engines targets low-cost investing for its clients, which has driven it away from active strategies and toward low-cost passive products over time.

Jones notes Financial Engine's ability to offer advice to clients in a variety of ways, from interacting strictly online to talking with an advisor through a call center to sitting down with an advisor who will get to know each client personally. He highlights their ability to tailor investment strategy and advice to each individual client. Financial Engines can service any person with any sum of money at any stage of their life for any given investment horizon. Quality and tailored investment advice previously available only to fewer, wealthier investors is now provided to a much larger range of people.

The Innovation Factor

A few years ago, Anne Marie Knott approached companies to utilize a new metric she created called the Research Quotient (RQ), a vertical measure that captures research & development (R&D) productivity and predicts growth and market value.

Knott sees R&D levels as a key measure of innovation in a company, but it is generally hard to value accurately.

Knott's research shows a 65% decline in companies' RQ over the past four decades, and she sees this decline as correlated with economic growth. She believes if she can do her part to help restore companies' RQ, then we can revitalize economic growth, drawing inspiration from Paul Romer's growth theory that won him the Nobel Prize in 2018.

At a high level, RQ measures output elasticity of R&D, which indicates how much sales are generated in response to increasing levels of R&D. RQ can be broken down to the percentage increase in revenue that comes from a 1% increase in R&D.

Knott's research showed that a portfolio of high-RQ stocks outperformed the market substantially, having twice the predictive power of the momentum factor. This would make RQ one of the more powerful predictors of excess returns.

This conversation was one of the more unique, quantitative, factor-driven discussions we've had on the show, with broad implications for both the economy and long-term stock portfolios.

To listen to our full conversation, please see the link below.

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, 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

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

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

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.