THE DUPONT ANALYSIS: ONE OF THE MOST POWERFUL CONCEPTS IN FINANCE

Scott Welch — Chief Investment Officer, Model Portfolios
01/06/2023

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.

If, like me, you are a reader of my colleague Jeff Weniger's blog posts and social media posts, you know he makes regular references to "The DuPont Analysis." Those (also like me) with a background in corporate finance or commercial banking know exactly what he is referencing. But, given its relevance to the WisdomTree product suite and how we think about our Model Portfolios, I thought it would be worthwhile to offer a "primer" on what it is and why it matters.

The DuPont Analysis was created (naturally) by the DuPont Company back in the 1920s. The genesis idea is that the objective of any given firm is to maximize return on equity (ROE)—the return to shareholders on their invested capital.

It then breaks down ROE into three fundamental components that evaluate the profitability, operational efficiency and leverage of a given company. While it has myriad offshoots and derivatives that go increasingly "into the weeds," the fundamental "equation" breaks down like this:

$$\frac{\text{Net Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}$$

Let's look at each component:

1. **Net Income/Sales:** This is a measure of **profitability**—how much net income do you generate for each unit of sales? There is no "correct" answer to this: a large manufacturing company (e.g., Boeing) may generate huge net income on each airplane sold, while a fast-food franchise (e.g., McDonald's) may generate a small level of net income on each burger sold—but it sells far more burgers each year than Boeing sells airplanes. So, the metric is relevant to each company's peers. How profitable are you relative to your peers with respect to net income per unit of sale?
2. **Sales/Assets:** This is a measure of operational **efficiency**—what level of sales do you generate relative to your reported assets? While, again, this varies from sector to sector and industry to industry, the bottom line is intuitive —you are doing better than your peers if you generate more sales relative to your asset base.
3. **Assets/Equity:** This ratio is a measure of financial **leverage**—it indirectly measures how much debt with respect to equity you carry on your balance sheet relative to your asset base. While there are theories[1] that posit that investors should not focus on the capital structure of a company but rather on the present value of future cash flows, most investors intuitively understand that the more debt (leverage) relative to equity a company holds, the more susceptible it is to market or economic downturns. So, a company with a lower assets/equity ratio (i.e., more equity per unit of assets) may have a better ability to withstand economic or market disruptions.

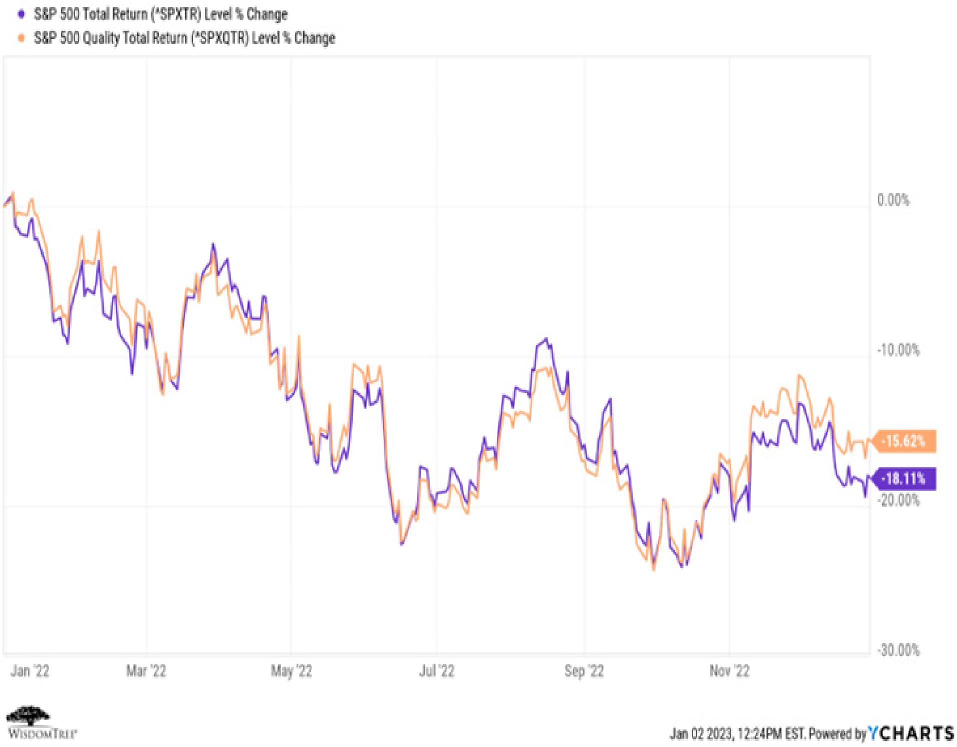
Why Does Any of This Matter?

If you know WisdomTree, you know we are the "more than beta" ETF shop. Almost all our products, and therefore our Model Portfolios, have distinct factor tilts embedded into them, such as value, dividends and size.

And quality. When we say "quality," we mean companies with stronger balance sheets, earnings and cash flows. Many, if not most, of our products are filtered through a "composite risk score", which weeds out lower-quality companies and results in custom Indexes that we then build and manage our ETFs around.

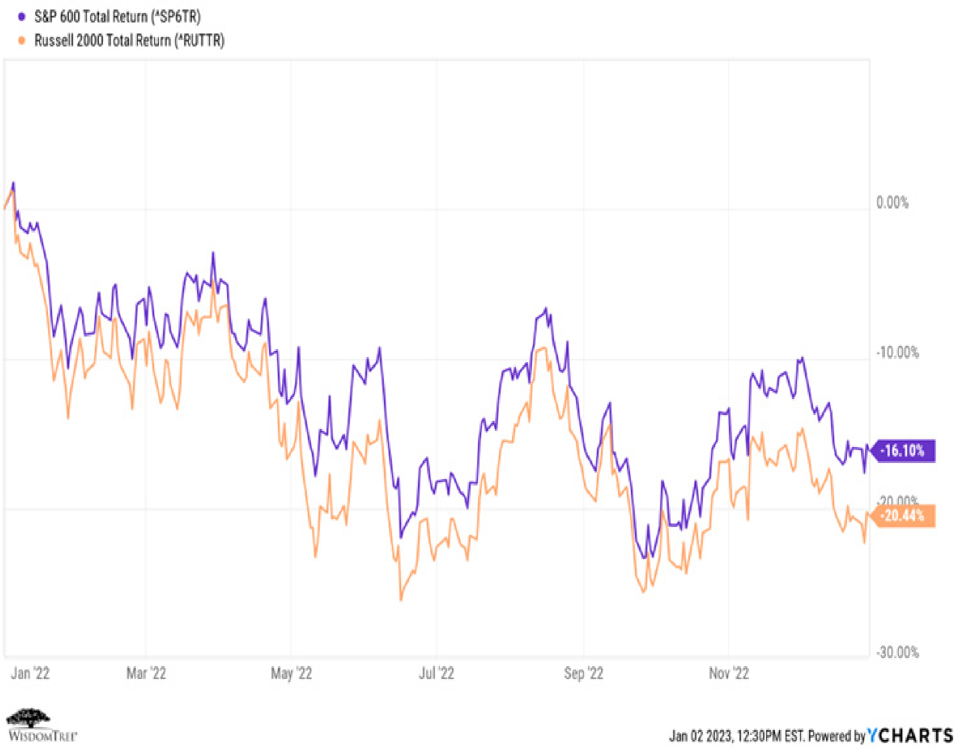
Our "house view" is that 2023 will be a year in which quality becomes increasingly important. As we sail into uncertain and volatile economic and market seas, companies with better balance sheets, earnings and cash flows should be better able to withstand whatever the market environment throws their way.

We saw signs of this in 2022 in both large-cap stocks:



Source: Ycharts, performance for calendar year 2022. You cannot invest in an index and past performance does not guarantee future results.

And especially small-cap stocks (the S&P 600 Index is considered a "higher quality" index than the Russell 2000 Index because it filters out a higher percentage of negative earnings companies):

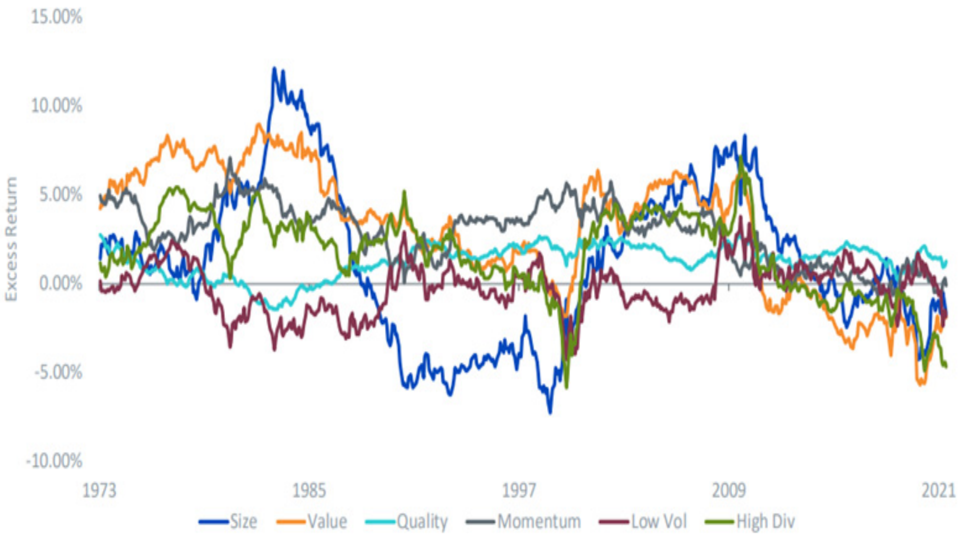


Source: Ycharts, performance for calendar year 2022. You cannot invest in an index and past performance does not guarantee future results.

Conclusion

The following chart illustrates comparative factor performance for the S&P 500 Index. Focus on the teal-colored line, which represents the quality factor. Specifically note that, while it rarely has been the best or worst performing factor, it has been the most consistent—it performed regardless of market environments.

Rolling 10-Year Excess Return vs. Market



Source: WisdomTree, Ken French, data as of 11/30/21, the most recent data available. You cannot invest in an index and past performance does not guarantee future results.

During the period between the global financial crisis of 2008 and, roughly, November 2021, a low interest rate environment powered large-cap growth stocks. The last two years of this rally—2020–2021—were also marked by a distinct "junk rally"; that is, the market rewarded companies that were lower quality, delivered few (if any) dividends and were dependent on low interest rates to support higher P/E multiples, since distant future cash flows discounted at low rates = higher present value of those cash flows.

But times have changed. Over the past 12+ months, interest rates have moved steadily higher, and fundamentals have come back into popularity. Investors have shown a distinct preference for value and dividends—and quality. We believe this trend will continue for several years at least.

This is why we are optimistic about the relative performance of the WisdomTree product set and our Model Portfolios, as they tilt exactly toward the factors we believe will be rewarded for many years.

In other words, higher quality = better resilience in what we believe will be a volatile and uncertain economic and market environment.

The DuPont Analysis, though simple in design, remains one of the most powerful analytical concepts in all of finance. My colleagues and I have been in the investments and corporate finance game a long time—we've all lived through multiple economic and investment regimes, including recessions and severe market disruptions. As the above chart supports, we will never apologize for having a quality tilt within our products and portfolios.

The DuPont Analysis provides an excellent tool for identifying higher-quality securities, products and model portfolios.

[1] See the Modigliani-Miller Theorem: Https://www.investopedia.com/terms/m/modigliani-millertheorem.asp.

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.

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

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. .

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

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

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.

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

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.

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.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

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

The Global Financial Crisis : Refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.