RISK FACTOR DIVERSIFICATION: A TALE OF TWO QUARTERS

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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.

It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness… it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us…

(From "A Tale of Two Cities" by Charles Dickens, first published in 1859)

To everything (turn, turn, turn)
There is a season (turn, turn, turn)
And a time to every purpose, under heaven
(From "Turn, Turn, Turn," arrangement and melody by Pete Seeger and covered infinite times, most famously by The Byrds in 1965)

We have written about factor rotation and [factor diversification] quite a bit. But the first half of 2021 provides perhaps the most vivid illustration of why we believe [risk] factor diversification is so important when constructing Model Portfolios.

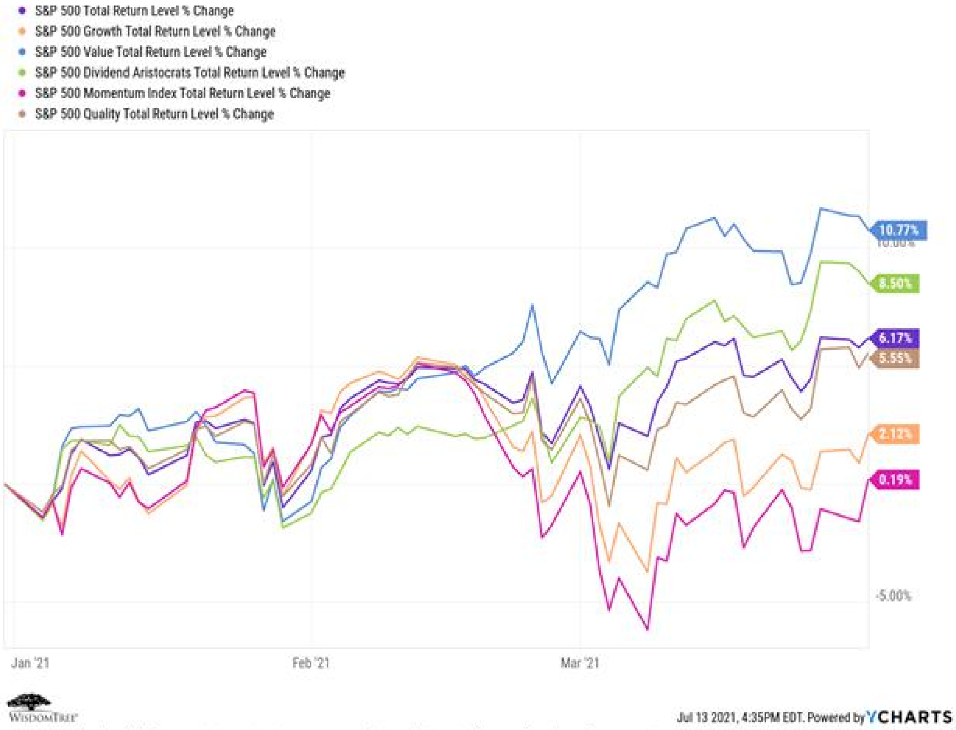
Let's compare three charts of risk factor performances—year to date (YTD), first quarter (Q1) and second quarter (Q2)—for the [S&P 500 Index].

First is YTD, which shows a distinct convergence of factor performances over the course of the year.

Source: YCharts, data from 1/1/21–7/12/21. You cannot invest in an index, and past performance is no guarantee of future performance.

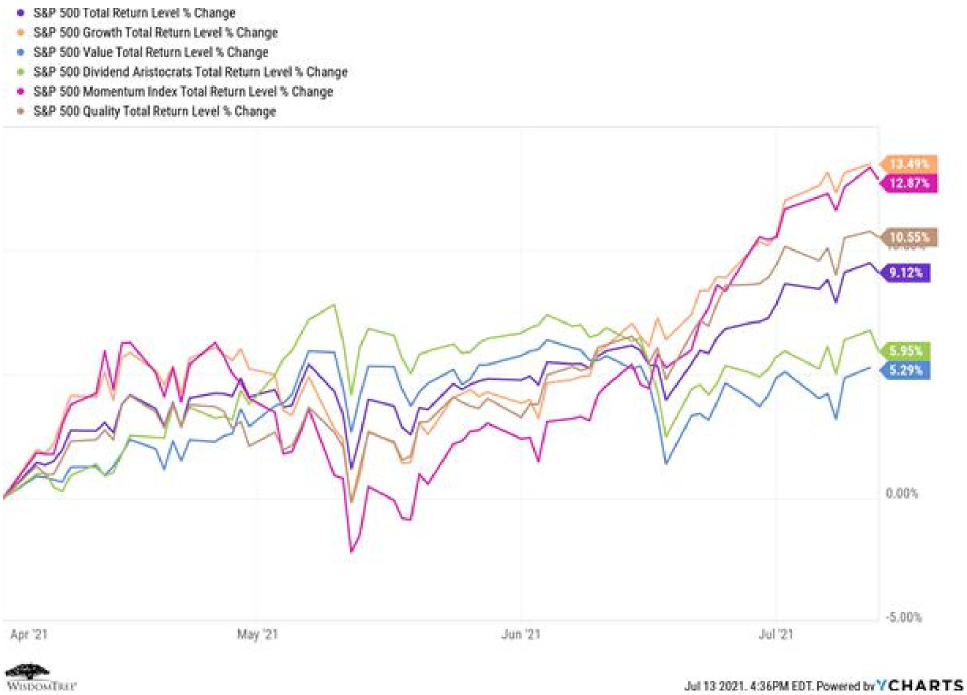
For definitions of terms in the table, please visit the glossary.

But now let's break that YTD performance into Q1:



Source: YCharts, data from 1/1/21–3/31/21. You cannot invest in an index, and past performance is no guarantee of future performance.

And Q2 (and slightly into Q3):



Source: YCharts, data from 4/1/21–7/12/21. You cannot invest in an index, and past performance is no guarantee of future performance.

We see an almost total factor performance reversal. In Q1 (when interest rates were rising), the market was led by value, dividends and quality, with growth and momentum trailing far behind.

But since then (as interest rates have fallen), it has been exactly the opposite—growth, momentum and quality have led the way, while value and dividends dramatically underperformed.

We see a similar trend if we compare large-cap to small-cap performance. In Q1, it was all small-cap, all the time.

Source: YCharts, data from 1/1/21–3/31/21. You cannot invest in an index, and past performance is no guarantee of future performance.

For definitions of terms in the table, please visit the [glossary](#).

Since then, however, we have seen a complete reversal.

Source: YCharts, data from 4/1/21–7/12/21. You cannot invest in an index, and past performance is no guarantee of future performance.

We see a similar large-cap/small-cap reversal in EAFE markets as well. Only in emerging markets has the small-cap outperformance been consistent all year long, and, in fact, it accelerated in Q2.

In some respects, these factor rotations have been tied closely to changes in interest rates. In Q1, when interest rates rose fairly dramatically, value stocks led the way. Since then, however, interest rates have fallen steadily, and growth has taken the lead.

Source: The Credit Suisse Navigator, July 2021. 10-Year Yields are represented by U.S. Treasury Notes. LHS shows the ratio of Value versus Growth performance. RHS shows the level of 10-year Treasury yield.

At WisdomTree, we can and will take explicit factor tilts within our Model Portfolios from time to time as we believe market conditions warrant them. As an example, based on our opinion on where we were in the economic recovery cycle at the beginning of this year, we rotated out of an explicit momentum strategy (momentum has historically tended to lag in the early days of an economic recovery) and into a more explicit growth factor strategy. This trade has worked out very well for us so far.

Having said that, we also know that we cannot outsmart the market consistently, and furthermore, market conditions can change quickly and unexpectedly (such as the dramatic turnaround in interest rates beginning in Q2).

It is for this reason that all WisdomTree models are both **asset class** and risk factor diversified. We know we cannot consistently predict economic or market environments, and we believe that focusing on these two levels of diversification optimizes our potential for more consistent performance.

We produce the following "factor performance quilt" every month to illustrate the potential benefit of adopting a risk factor diversification portfolio construction approach.

In addition to being both asset class and risk factor diversified, all our models have other certain common characteristics, which collectively capture our investment "philosophy":

1. They are global in nature. We are a global firm, and we believe in global diversification.
2. They are ETF-focused, which we believe provides us with the best opportunity to optimize both fees and taxes.
3. They are "open architecture" and contain both WisdomTree and third-party strategies. We believe this is simply the right thing to do from the end client's perspective, and it also helps us to optimize our risk factor diversification.
4. The factor tilts inherent in most WisdomTree strategies allow us to deploy a "core/satellite" approach (which we call Modern Alpha®), which we believe helps to optimize fees and the potential for alpha generation.
5. We charge no strategist fee—our revenue is generated only from the expense ratios associated with the WisdomTree strategies deployed in the different models.

Conclusion

The first half of 2021 has been a perfect example of why we believe risk factor diversification matters and why it is such a core foundation of our portfolio construction approach. To everything (turn, turn, turn)/There is a season (turn, turn, turn) …

You can learn more about the WisdomTree Model Portfolio solution set by visiting our recently launched Model Adoption Center. There you will find complete transparency regarding all our publicly available models—performance, yield,

cost, holdings, allocations and so forth. You will also find the results of proprietary research we conducted that helps advisors drive model adoption with their end clients and within their overall practices.
We hope you will give it a look.

Important Risks Related to this Article

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View the online version of this article here.

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You cannot invest directly in an index.

DEFINITIONS

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

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.

Qualified dividends : Dividend paid by corporations meeting certain criteria defined by the Internal Revenue Service and therefore eligible in certain instances to be taxed at rates below a tax filer's tax bracket on ordinary income.

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.

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.

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.

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

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

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.

EAFE : Refers to the geographical area that is made up of Europe, Australasia and the Far East.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.