
HUNGRY FOR QUALITY? HERE'S WHERE TO GO

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In an earlier post, [we analyzed whether certain smart beta factors have been losing their efficacy over time](#). While some of the factors have seen their excess returns above the [S&P 500](#) taper off over the last few years, the quality [factor](#) has remained remarkably consistent in its ability to produce market-beating returns. If we conclude that [quality](#) is the best factor to which investors want exposure over the long run, how can they access it in their portfolios?

We surveyed the universe of U.S. [large-cap](#) exchange-traded funds (ETFs) that focus on quality using a highly scientific approach: funds that had the word "quality" in their name. For data consistency purposes, we looked only at funds that had over \$500 million in assets.¹ That left us with a list of four funds that track rules-based indexes aimed at capturing quality companies. Each of these underlying indexes takes its own unique approach to portfolio construction.

Fundamental Metrics on the Methodology Menu

Unsurprisingly, each index has its own definition of quality and unique fundamental metrics to measure it in their methodologies:

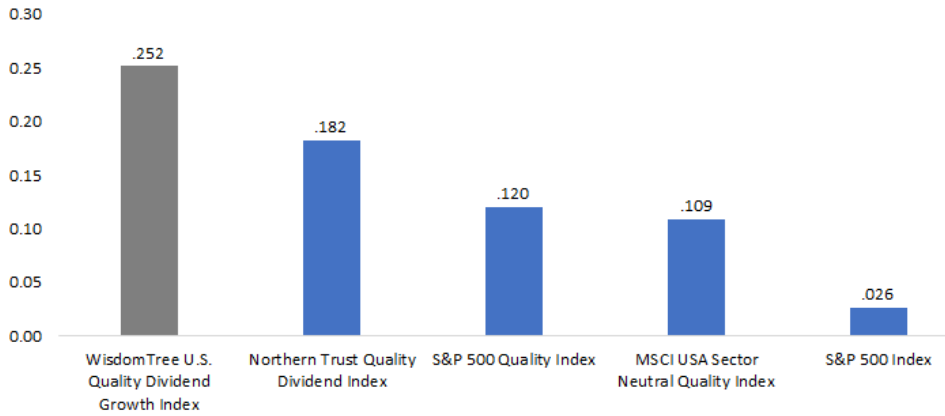
- [MSCI USA Sector Neutral Quality Index: Return on equity \(ROE\)](#), debt/equity and earnings variability²
- [Northern Trust Quality Dividend Index](#): Management expertise (e.g., corporate finance activities), profitability (e.g., assessment of the reliability and the sustainability of financial performance) and cash flow³
- [S&P 500 Quality Index](#): ROE, accruals ratio and financial leverage ratio⁴
- [WisdomTree U.S. Quality Dividend Growth Index](#): Dividend payout ratio, ROE, [return on assets](#) and long-term estimated earnings growth

Dividends as a Quality Appetizer

WisdomTree has found over its history that dividends are an organic way to tap into the quality factor; indeed, both the Northern Trust index and the WisdomTree Index include only dividend-paying stocks. However, each does this in a very different manner. While the Northern Trust index targets a dividend above that of its parent index, the WisdomTree Index omits all stocks with a dividend yield that is above a specified level (each individual stock's earnings yield). This screen provides a dual benefit: it ensures that the index includes only those stocks that have sustainable dividends, with the ability to grow that dividend down the road.

Given the nuances within each index methodology, let's run a regression to see which was able to most effectively tap into the factor that each of these indexes are targeting.

Loading to Quality Factor, 1/1/15–7/31/17

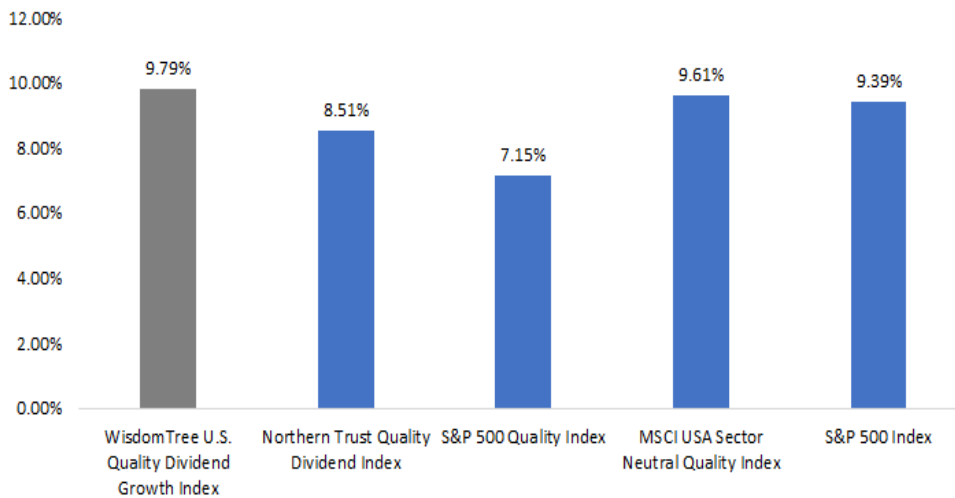


Sources: WisdomTree, Bloomberg, Kenneth French Data Library, with data for the period 1/1/15–7/31/17 and representing the latest date of available factor data. 1/1/15 is earliest full calendar month of each index's live performance period. Past performance is not indicative of future results.

The USDA Prime Quality Grade Goes to...

While each index had a significantly higher loading to the quality factor than the S&P 500, the WisdomTree U.S. Quality Dividend Growth Index had the highest quality exposure of them all. Given what we know about the performance-enhancing capabilities of the factor, how did each index's quality exposure translate into performance?

Annualized Total Returns, 1/1/15–8/31/17



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

Highest Quality and the Juiciest Returns

Not only did the WisdomTree Index have the greatest exposure to the quality factor, it was the best-performing index as well. The WisdomTree and MSCI indexes outperformed the S&P 500, the Northern Trust index slightly lagged and the S&P 500 Quality Index trailed by a relatively wide margin.

Admittedly, while less than three years of analysis is a relatively small sample size, we can infer from the 50+ years in our previous analysis that being closely tied to the quality factor has been a strong precursor of outperformance. In effect, the last three years have been a microcosm of the previous 50. When it comes to investing in quality, think of a steak: the highest quality is best.

Investors that are interested in the ETF that tracks this index can look to the [WisdomTree U.S. Quality Dividend Growth Fund \(DGRW\)](#).

And now I'm hungry...

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You cannot invest directly in an index.

DEFINITIONS

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

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

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.

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.

MSCI USA Sector Neutral Quality Index : Refers to the MSCI USA Quality Index which is a large and mid cap US equity index aiming to capture the performance of quality growth stock. The Index screens its parent index, the MSCI USA Index for ROE, stable year-over-year earnings growth, and low financial leverage. Seeks to match the sector exposures the MSCI USA Index.

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

S&P 500 Price Index : Designed to track high quality stocks in the S&P 500 by quality score, which is calculated based on return on equity, accruals ratio and financial leverage ratio.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.