

1H 2020: FACTORS IN REVIEW

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We just passed the halfway point in a year that already feels like an eternity. It's time to review the scorecard of factor performance.

On June 8, the National Bureau of Economic Research made the official announcement that the U.S. had entered a recession at the end of February. This ended a record 128-month expansion that began in June 2009.

Quality stocks tend to be among the best performers during this stage of the economic cycle. These companies are often characterized by cleaner **balance sheets** and/or higher profitability-attractive attributes during a fragile economy.

Through the first six months of the year, higher-quality stocks did indeed outperform. The first quintile by profitability (**return-on-equity**) outperformed the fifth quintile by 21.34%.

Value stocks, which tend to perform inversely to quality, have significantly lagged. The lowest price-to-earnings (P/E) **quintile** trailed the highest P/E quintile by 37%.

S&P 500 Index Quintile Performance

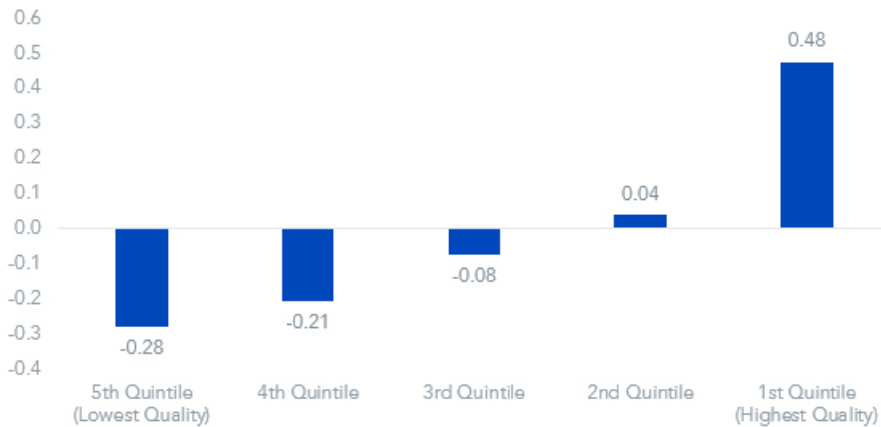
Quality		Value		Yield		Low Vol		Size	
ROE Quintiles		Earnings Yield Quintiles		Dividend Yield Quintiles		Volatility Quintiles		Market-Cap Quintiles	
1Q	6.04%	1Q	-23.20%	1Q	-17.88%	1Q	-4.24%	1Q	0.57%
2Q	1.29%	2Q	-12.61%	2Q	-15.68%	2Q	1.75%	2Q	-12.78%
3Q	-0.13%	3Q	-6.56%	3Q	-10.40%	3Q	-4.68%	3Q	-10.31%
4Q	-15.69%	4Q	7.01%	4Q	-1.78%	4Q	-6.14%	4Q	-11.28%
5Q	-15.30%	5Q	14.01%	5Q	8.11%	5Q	-8.50%	5Q	-23.96%
Neg. Ret.	-26.90%	Neg. Earn.	-34.88%	No Div.	12.95%	N/A	-	N/A	-
Total	-3.08%	Total	-3.08%	Total	-3.08%	Total	-3.08%	Total	-3.08%

Sources: WisdomTree, FactSet, from 12/31/19–6/30/20. ROE = return-on-equity. First quintile of earnings yield is the lowest P/E. First quintile of volatility is least volatile. Low vol uses trailing 12-month standard deviation. First quintile of market-cap is the largest companies. You cannot invest directly in an index. Past performance is not indicative of future returns.

Market Efficiency: Greater Safety, Higher Valuations

When **volatility** increases, we can see a positive relationship with the outperformance of higher-quality stocks, and underperformance for lower quality.

Correlation of 12-M Trailing Change in VIX and 12-M Trailing Excess Returns of Quality Quintiles



Sources: WisdomTree, Kenneth French Data Library, Cboe, 1/31/04–5/31/20. Quality measured by operating profitability. Past performance is not indicative of future results. You cannot invest directly in an index.

Market efficiency would suggest that the tendency of higher-quality companies to provide risk mitigation means there should be a [valuation](#) premium for these stocks.

And this is exactly what we see, historically.

Since 2002, the highest-quality stocks have had an average price-to-book (P/B) premium of over 2 times the P/B ratio of the lowest quality stocks. On [price-to-sales \(P/S\)](#), this premium has been about 1.7 times for the highest quality stocks.

Based on current P/B ratios, high-quality stocks are priced at a valuation extreme—matched only by levels seen during the last recession in March 2009. Valuations based on P/S show an even more dramatic valuation extreme for high quality.

Relative Price-to-Book: Highest Quality vs. Lowest Quality Quintiles



Relative Price-to-Sales: Highest Quality vs. Lowest Quality Quintiles



Sources: WisdomTree, FactSet, 1/31/02–6/30/20. Quality measure incorporates both static observations and trends of return on equity, return on assets, gross profits over assets and cash flow over assets for the 800 largest companies in the U.S. by market capitalization. Grey bars indicate recessions.

The cost of this safety premium is likely to be realized during an economic recovery phase. When investors are more optimistic about the economy, richly priced quality stocks are likely to lag stocks with lower multiples that may be perceived as riskier.

Quality selection + [dividend weighting](#) = Attractive Relative valuation

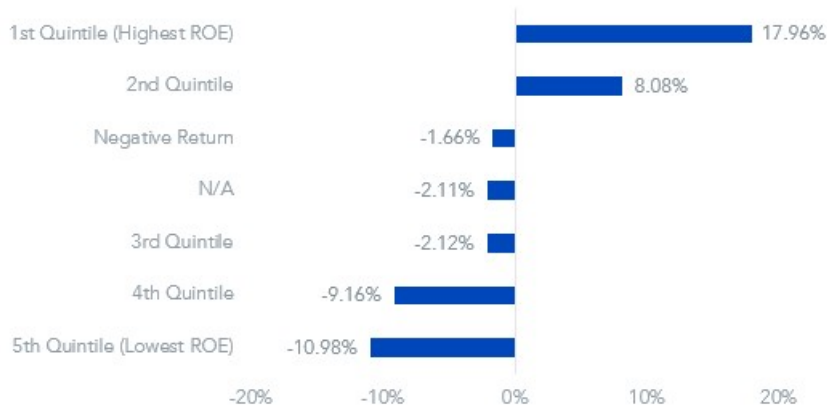
This trade-off, of valuation premium for safety, seems like a fair bargain, particularly for investors with a shorter time horizon.

But there is perhaps a way that investors can have their cake (higher-quality companies) and eat it too (controlling for valuations).

The [WisdomTree U.S. Quality Dividend Growth Index](#) selects 300 high-quality companies, and then weights constituents by their [dividends](#) paid. This [fundamentals](#)-based weighting helps to mitigate valuations risks that can occur in [market cap](#)-weighted indexes.

Over the full history back to 2013, the Index has had almost 18% greater weight in the highest-ROE quintile of companies, and an under-weight of about 11% to the lowest-ROE quintile.

Average Relative Quintile weights: WisdomTree U.S. Quality Dividend Growth vs. S&P 500



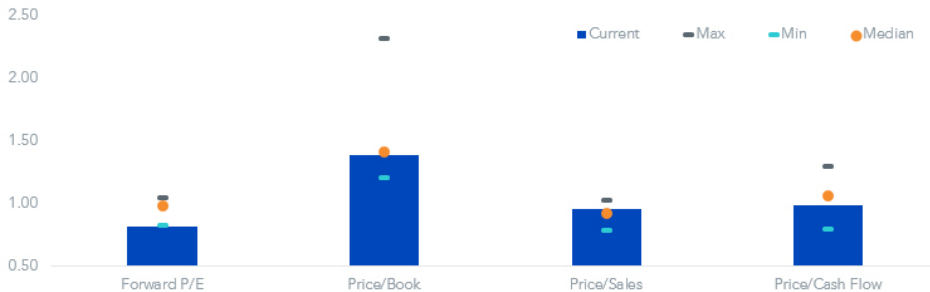
Sources: WisdomTree, FactSet, 4/30/13–6/30/20. The WisdomTree U.S. Quality Dividend Growth Index was launched on 4/12/13. N/A category includes companies without data and companies with negative equity. You cannot invest directly in an index. Weights subject to change.

As a result of the dividend weighting process, we see relative valuations for the quality dividend growth index that are at the historical median for price-to-book,

price-to-sales and price-to-cash flow. Based on forward P/E, the quality Index is at an all-time low relative to the S&P 500, which is currently at a 10-year high forward P/E of 22.36 times.

In our view, these relative valuations for a high-quality basket look attractively priced, particularly for this stage of the cycle.

WisdomTree U.S. Quality Dividend Growth vs. S&P 500 – Relative Valuations



Sources: WisdomTree, FactSet, 4/30/13–6/30/20. The WisdomTree U.S. Quality Dividend Growth Index was launched on 4/12/13. Past performance is not indicative of future results. You cannot invest directly in an index.

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](#)

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DEFINITIONS

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.

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

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

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 time.

Quintile: One of the class of values of a variate which divides the members of a batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

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

Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Price-to-sales (P/S) ratio: share price divided by per share revenue.

Dividend weighted: Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

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

Fundamentals: Attributes related to a company's actual operations and production as opposed to changes in share price.

Market Capitalization: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.