

WHERE'S THE "HOT HAND"?

Alejandro Saltiel — Head of Indexes, U.S., Matt Wagner — Associate Director, Research
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If Shaquille O'Neal makes his first free-throw shot, what is the likelihood he makes the second?

Proponents of the "hot hand" theory say it's higher than Shaq's 52.7% free-throw percentage because he is "hot." Detractors would say each free throw outcome is random, so the likelihood of the next shot is simply his overall free-throw percentage.

Research into the existence of the hot hand has been done in virtually every field, from sports to investing, for decades. In investing, the hot hand is referred to as [momentum](#), or [trend-following](#). It has long been ubiquitous across asset classes.

As investors increasingly allocate to [passive factor](#) strategies, research has been published¹ on the existence of factor momentum—the theory that outperforming factors continue to outperform.

While there is compelling evidence in favor of factor momentum, many investors were caught wrong-footed by changes in factor performance in 2019—from defensive stocks outperforming to start the year to [cyclicals](#) outperforming toward the end.

This factor reversal raises portfolio allocation implications for how to position a portfolio for a possible continuation of Q4's factor leadership.

Factor Reversal

Based on the performance of a handful of the most widely tracked MSCI factor indexes, 2019 was a difficult year for long-only factor investing, and even trickier for factor momentum.

The [quality](#) index was the only factor index to outperform over the full year. Only [value](#) and [minimum volatility](#) were able to maintain outperformance for two consecutive quarters.

Minimum-volatility (min vol) and low-volatility ETFs garnered significant inflows following outperformance in the fourth quarter of 2018 and strong performance through the first three quarters of 2019. The largest min vol ETF took in an astonishing \$12 billion in assets for the year.

Global recession concerns on the back of an inverted [yield curve](#), weak economic data and trade war uncertainty were behind the outperformance of defensive, low-volatility stocks. As concerns abated in September, these stocks underperformed significantly through the end of the year.

Riskier, cyclical value stocks became top performers in Q4, outperforming the min vol index by over 700 [basis points \(bps\)](#).

That quarter provides a clear exhibit into the inverse relationship between value and min vol, and the risks of a factor going from having the hot hand to being ice cold.

Excess Returns vs. MSCI USA Index

Factor Index	Relative to MSCI USA Index				
	Q1	Q2	Q3	Q4	Full Year
MSCI USA Enhanced Value Index	-2.85%	-1.90%	0.31%	1.10%	-3.98%
MSCI USA Momentum Index	-1.03%	1.95%	-0.68%	-3.24%	-3.55%
MSCI USA Sector Neutral Quality Index	2.13%	-0.36%	-0.18%	0.81%	2.75%
MSCI USA Minimum Volatility Index	-1.21%	1.36%	2.72%	-6.05%	-3.68%
MSCI USA Low Size Index	1.38%	-0.33%	-1.36%	-1.46%	-2.36%

Sources: WisdomTree, Bloomberg, 12/31/18–12/31/19. Past performance is not indicative of future returns. You cannot invest directly in an index. Weights subject to change.

Investing in the Low Volatility Factor

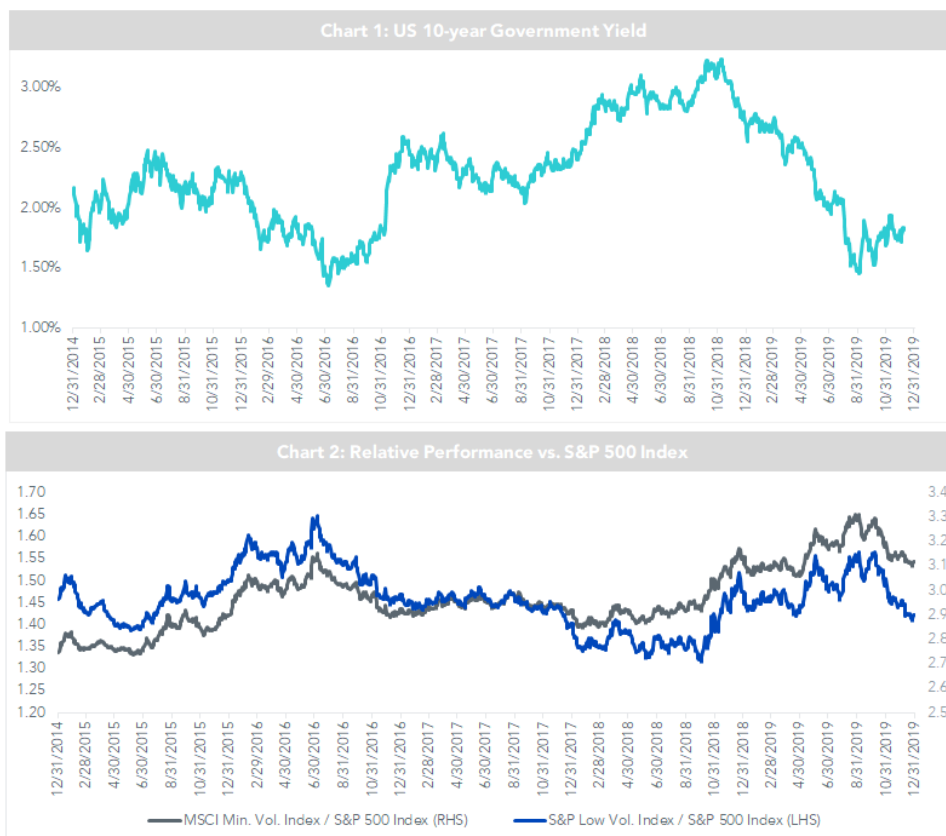
Different indexes track exposure to the low-volatility factor, each using varying definitions, sector considerations and

rebalance periods.

Among the most widely followed are the [MSCI USA Minimum Volatility Index \(MSCI Min Vol Index\)](#) and the [S&P 500 Low Volatility Index \(S&P Low Vol Index\)](#).

There are two main drawbacks associated with investing in the low-volatility factor:

- **Sector Tilts:** Both indexes tend to have sector tilts relative to the broad market, and are typically overweight defensive sectors and underweight cyclical sectors. So low-volatility indexes are very rate-sensitive, tending to outperform during falling rates. As shown in chart 2, the relative performance of both indexes versus the S&P 500 has improved when U.S. interest rates have declined.
- **Valuations:** As interest rates trend lower, valuations of low-volatility indexes become expensive. The aggregate [price-to-earnings \(P/E\) ratio](#) premium for these indexes increases versus the S&P 500 in periods of falling rates (currently about 15%).



Sources: WisdomTree, Bloomberg, 12/31/14–12/31/19. Past performance is not indicative of future results. You cannot invest directly in an index.

Given the defensive sector tilts and the premium valuations associated with low-vol strategies, portfolios with these exposures face underperformance risk if there's strong global economic growth in 2020.

Conclusion: Balancing Min Vol with Value

Investors who piled into defensive equities in 2019 now must face the prospects of reduced trade war risks and improving economic data, both of which will favor value over low volatility.

In order to mitigate the risk of underperformance in this type of environment, a value-tilted core exposure can bring down the aggregate P/E multiple of a portfolio and bring sector exposures more in-line with the market.

The [WisdomTree U.S. LargeCap Index](#), which completed its annual rebalance in December, is at a 28% discount to the MSCI Min. Vol. Index on a trailing P/E basis, while also having almost 250 bps higher [return on equity](#).

Adding this type of exposure to complement a low vol factor approach can help position a portfolio in case the value factor keeps its hot hand in 2020.

Fundamentals Table

As of 12/31/2019			
	WT U.S. LargeCap Index	MSCI USA Min. Vol. Index	S&P 500 Index
Price-to-Earnings (P/E) Ratio	17.94x	24.97x	21.61x
Dividend Yield	1.99%	2.21%	1.83%
Price-to-Book (P/B) Ratio	2.88x	3.44x	3.51x
Return on Equity (ROE)	15.45%	12.98%	15.13%
Return on Assets (ROA)	2.62%	3.33%	3.23%

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

¹Tarun Gupta and Bryan T. Kelly, "Factor Momentum Everywhere." *The Journal of Portfolio Management*, 2019

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.

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DEFINITIONS

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.

Trend-following : Also known as trend trading. It is a trading style that attempts to capture gains through the analysis of an asset's momentum in a particular direction.

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

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

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

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.

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.

Low Volatility : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Basis point : 1/100th of 1 percent.

MSCI USA Minimum Volatility Index : Aims to reflect the performance characteristics of a minimum variance strategy applied to the large and mid cap USA equity universe.

S&P 500 Low Volatility Index : Measures performance of the 100 least volatile stocks in the S&P 50.

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.

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