RISK FACTOR DIVERSIFICATION—A LOOK BACKWARD AND FORWARD

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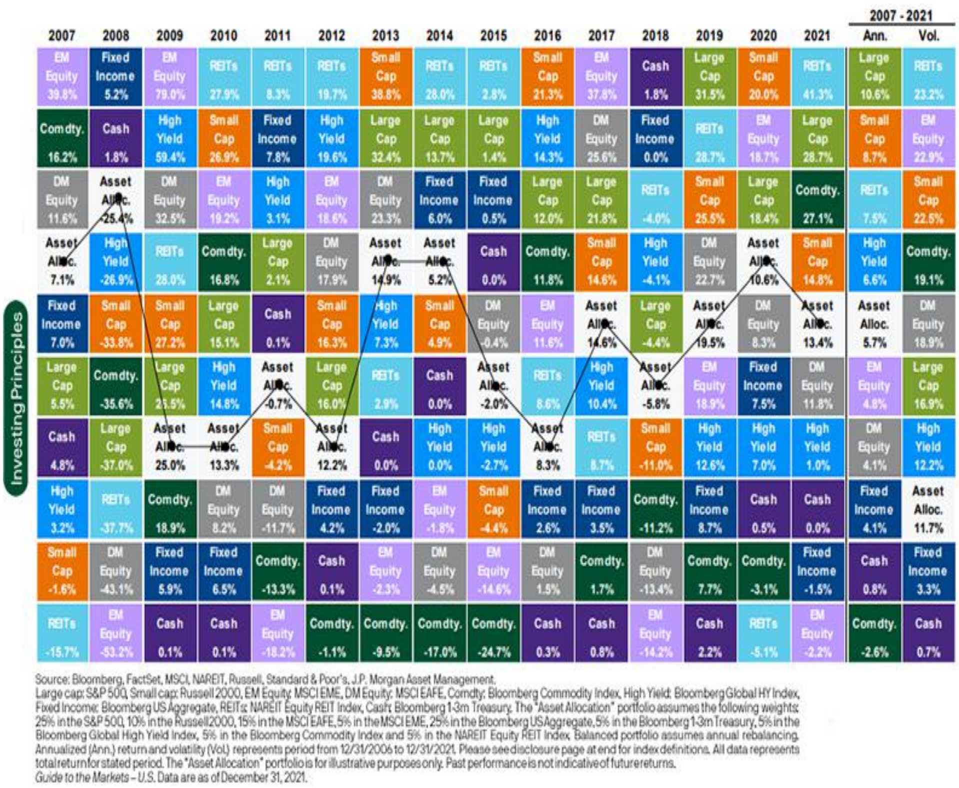
This article is relevant to financial professionals who are considering offering model portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

If you are a regular reader of the WisdomTree blogs, you know how seriously we take factor diversification in the construction of our Model Portfolios. With 2021 now behind us, it is time to revisit this important topic.

A quick reminder. Almost everyone understands and agrees on the importance of ***asset allocation***—that is, diversifying a portfolio across multiple asset classes to improve its consistency and risk-adjusted performance potential. And many are very familiar with the "asset class quilt chart," which illustrates just how difficult it can be to predict which asset classes will perform best and how diversifying may offer a more consistent performance, as illustrated in the example of the "Asset Allocation" portfolio below.



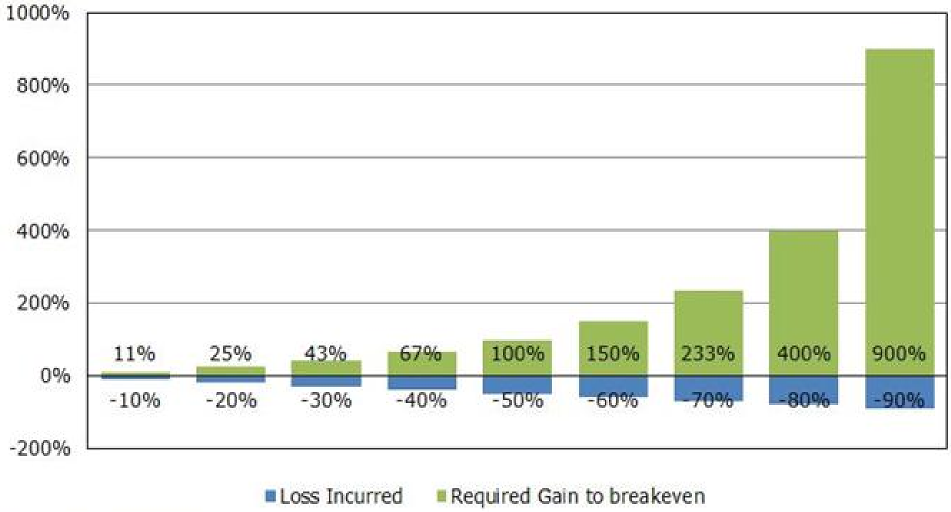
															2007 - 2021	
2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Ann.	Vol.
EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	Large Cap 31.5%	Small Cap 20.0%	REITs 41.3%	Large Cap 10.6%	REITs 23.2%
Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	REITs 28.7%	EM Equity 18.7%	Large Cap 28.7%	Small Cap 8.7%	EM Equity 22.9%
DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 25.5%	Large Cap 18.4%	Comdty. 27.1%	REITs 7.5%	Small Cap 22.5%
Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 22.7%	Asset Alloc. 10.6%	Small Cap 14.8%	High Yield 6.6%	Comdty. 19.1%
Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 19.5%	DM Equity 8.3%	Asset Alloc. 13.4%	Asset Alloc. 5.7%	DM Equity 18.9%
Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	EM Equity 18.9%	Fixed Income 7.5%	DM Equity 11.8%	EM Equity 4.8%	Large Cap 16.9%
Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	High Yield 12.6%	High Yield 7.0%	High Yield 1.0%	DM Equity 4.1%	High Yield 12.2%
High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 8.7%	Cash 0.5%	Cash 0.0%	Fixed Income 4.1%	Asset Alloc. 11.7%
Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 7.7%	Comdty. -3.1%	Fixed Income -1.5%	Cash 0.8%	Fixed Income 3.3%
REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 2.2%	REITs -5.1%	EM Equity -2.2%	Comdty. -2.6%	Cash 0.7%

Investing Principles

Source: Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Global HY Index, Fixed Income: Bloomberg US Aggregate, REITs: NAREIT Equity REIT Index, Cash: Bloomberg 1-3m Treasury. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg US Aggregate, 5% in the Bloomberg 1-3m Treasury, 5% in the Bloomberg Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period from 12/31/2006 to 12/31/2021. Please see disclosure page at end for index definitions. All data represents total return for stated period. The "Asset Allocation" portfolio is for illustrative purposes only. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of December 31, 2021.

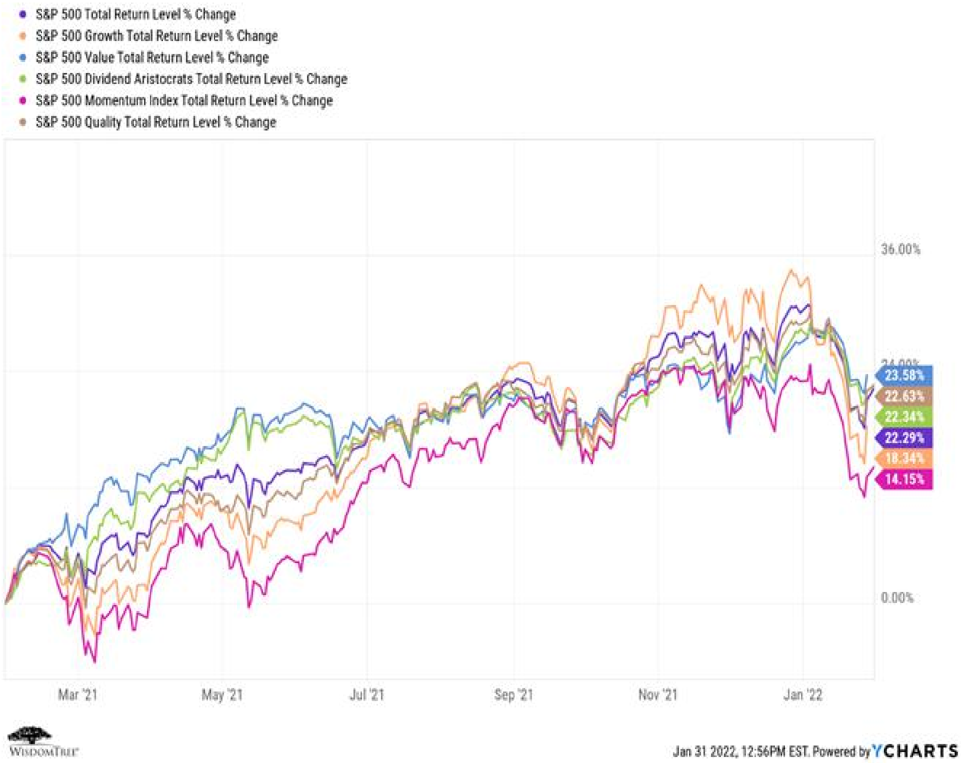
Source: JP Morgan "Guide to the Markets" as of 12/31/21. You cannot invest in an index and past performance does not guarantee future results.

Why does consistency of performance matter? Let's remind ourselves of the ***power of compounding***—if you don't lose as much in down markets, you don't need to gain as much in up markets to still come out ahead.



Source: BizNews, September 2014.

As our friends and readers know, we take diversification one level further and diversify across risk factors as well as across asset classes. Take a look at the performances of multiple ***risk factors*** within the [S&P 500 Index] over the past 12 months and note there is an almost 9.5% return dispersion between them.



Source: YCharts, 12-month data through 1/30/22. You cannot invest in an index and past performance does not guarantee future performance.

For definitions of terms in the chart above please visit the glossary.

A factor that doesn't show up in the above chart is the size factor, that is, the performance of small-cap stocks versus large-cap stocks. Using the S&P 500 equal-weighted index – a large cap index – as a proxy (since it gives equal weighting to the stocks in the S&P 500 index that have smaller market capitalizations, versus the strict market capitalization weightings used for the broad index), we can see the outperformance of "smaller-cap" stocks within the S&P 500 – a large cap index – over the course of the past 12 months (despite the fact that those stocks have been punished in the current YTD market downturn, as illustrated in the second chart by the performance of the Russell 1000 – a large cap index – versus the Russell 2000 – a small cap index).

Source: YCharts, 12-month data through 1/30/22. You cannot invest in an index and past performance does not guarantee future results.

Source: YCharts, YTD data through 1/30/22. You cannot invest in an index and past performance does not guarantee future results.

For definitions of terms in the chart above please visit the glossary.

It is worth noting that factor performance is not consistent across asset styles. Compare the factor performances in the above S&P 500 index-based graph to that same graph using S&P 600 (small- and mid-cap) performances.

Source: YCharts, 12-month data through 01/30/22. You cannot invest in an index and past performance does not guarantee future results.

For definitions of terms in the chart above please visit the glossary.

If you look closely, you will notice that quality is the most consistent factor, with dividends close behind (focus on the turquoise and olive-green lines below, respectively). It is rarely the best but also rarely the worst.

The implication, therefore, is that a factor-diversified portfolio should be anchored on quality and dividends—which is what we do.[1,2]

As we enter what we believe will be a much more volatile year for the equity markets, and long duration assets feel the pinch of rising rates, higher inflation and increasing investor pessimism, we believe historical fundamentals such as quality, dividends and value will matter again. Our Model Portfolios are positioned accordingly.

As a final point, it is almost impossible to out-guess the market with respect to which risk factors will outperform, or for how long when they do. We prepare a risk factor performance quilt every month to highlight this point.

Conclusions and Model Portfolio Implications

While each WisdomTree Model Portfolio has a different mandate, they all have certain common characteristics at the asset allocation and portfolio construction levels:

1. Global in nature—we are a global shop, and we believe in global diversification
2. ETF-centric, to improve the potential for optimizing fees and taxes
3. Open architecture—they include both WisdomTree and third-party products, which is not only the right thing to do from the end client perspective, but also ensures that we can access any and all risk factor exposures we want to include in a given Model Portfolio
4. The ETF structure and embedded risk factor tilts inherent in the WisdomTree product set allow us to build "core/satellite" Model Portfolios, increasing the potential to deliver both cost and tax efficiency and outperformance versus cap-weighted beta portfolios over full market cycles
5. We charge no strategist fee—our revenue is derived solely from the expense ratios associated with the WisdomTree products we choose to include

We believe in diversification and the power of compounding—delivering consistent performance regardless of market regime. We believe that diversifying at both the asset class and risk factor levels optimizes our potential for meeting that objective.

We also believe that our quality, dividend and value tilt positions us well for the market conditions we expect in 2022.

You can learn more about our Model Portfolios at our Model Adoption Center.

[1] We define "quality" to mean companies with stronger earnings, cash flow, balance sheets and dividends.

[2] For a summary description of investment "risk factors" and the "Fama French Model", see: https://www.investopedia.com/terms/f/factor-investing.asp.

Important Risks Related to this Article

Neither diversification nor an asset allocation strategy assures a profit or eliminates the risk of experiencing investment losses.

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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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You cannot invest directly in an index.

DEFINITIONS

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

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.

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.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

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.

S&P 500 Equal Weight Index : Designed to track the equally weighted performance of the 500 constituents in the S&P 500 Index.

Russell 1000 Index : A measure of the performance of the 1,000 largest companies by market capitalization in the Russell 3000 Index.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

S&P 600 Index : The S&P 600 is an index of small-cap stocks managed by Standard and Poor's. It tracks a broad range of small-sized companies that meet specific liquidity and stability requirements.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

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.

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.

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.