

# DISTILLING WISDOMTREE'S U.S. MULTIFACTOR PERFORMANCE

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Since we launched the [WisdomTree U.S. Multifactor Index \(WTUSMF\)](#) just over 14 months ago, the strong relative performance of this Index has led to questions regarding what is driving it. The [S&P 500 Index](#) often acts as a barometer for core [large-cap](#) U.S. equity performance, which explains why investors may choose to benchmark to this index, and contributes to why we use it for comparison on our [Index attribution page](#). Relative to the S&P 500, since inception, WTUSMF has outperformed by 327 [basis points \(bps\)](#) on an absolute basis and with lower [volatility](#). But the S&P 500 is not the only logical benchmark, and understanding why can help distill some critical elements of the Index's methodology.

## Benchmarking: Why Look at the S&P 500 Equal Weight Index?

In the table below, we show the active share and the [market-cap](#) distribution of WTUSMF relative to three indexes that we are most often asked to compare with this strategy. The [S&P 400 Index](#), a broad benchmark of performance for mid-cap U.S. equities, merits comparison given WTUSMF's sizable allocation to this portion of the market—nearly 40% as of August 31, 2018. WTUSMF has sizably outperformed the S&P 400 on both an absolute and a [risk-adjusted basis](#).

However, our preferred benchmark is the [S&P 500 Equal Weight Index](#) because of WTUSMF's weighting mechanism, which results in more of an equal-weight than a market cap-weighted Index. Both indexes have most of their weight in large caps but with material exposure to mid-caps, providing a size tilt compared with the S&P 500. WTUSMF has the lowest active share relative to this benchmark, indicating this is the Index with which it has the greatest overlap, and, since inception, it has outperformed this benchmark by over 700 bps.

## Index Comparison, since WTUSMF Inception

Index	6/29/17–8/31/18		As of 8/31/18			
	Total Return	Sharpe Ratio	WT Active Share vs. Index	Large-Cap Wgt.	Mid-Cap Wgt.	Small-Cap Wgt.
WT U.S. Multifactor	22.27%	2.84	N/A	61.6%	38.4%	0.0%
S&P 500	19.00%	2.08	87.7%	98.1%	1.9%	0.0%
S&P 400	16.24%	1.80	87.4%	9.3%	88.6%	2.0%
S&P 500 Equal Weight	15.15%	1.76	82.2%	88.1%	11.9%	0.0%

Sources: WisdomTree, Zephyr StyleADVISOR, FactSet. Large-Cap Wgt. = Percentage of index weight in constituents with market capitalizations of \$10 billion or greater. Mid-Cap Wgt. = Percentage of index weight in constituents with market capitalizations of greater than \$2 billion but less than \$10 billion. Small-Cap Wgt. = Percentage of index weight in constituents with market capitalizations of less than \$2 billion.

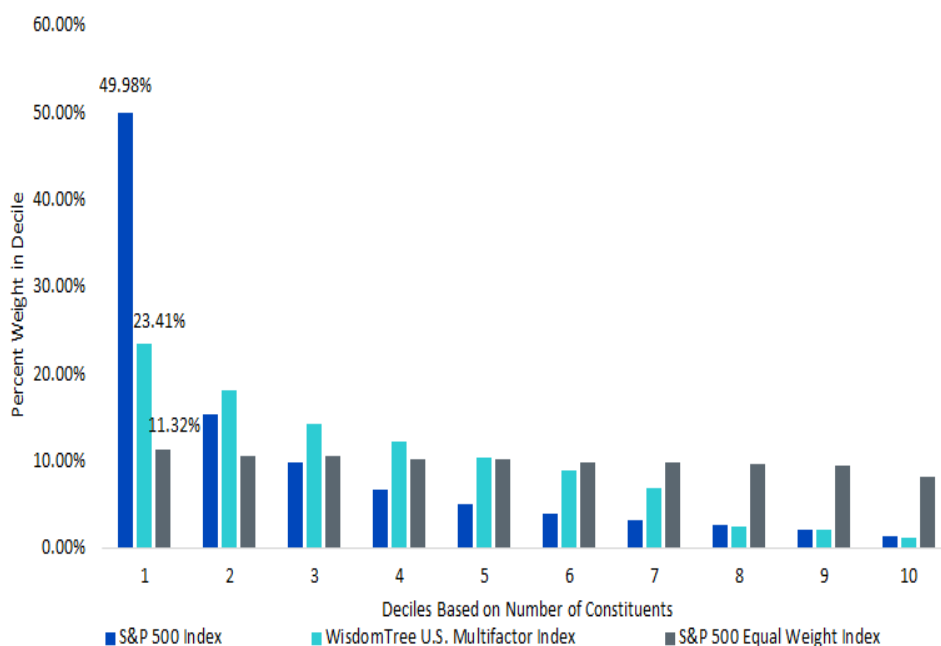
## Under the Hood of WTUSMF

To understand why we say this Index is more equally weighted, we need to start with how we arrive at our constituents and weighting. WTUSMF scores the 800 largest U.S. companies based on their exposure to [value](#), [quality](#), [momentum](#) and [low-correlation](#) factors and then selects the top 200 by their combined multifactor score. By starting with a universe

of 800, the selection process can include more mid-cap companies than if it used just the top 500 by market cap alone. WTUSMF also uses this [multifactor score as part of the weighting mechanism](#), which is complemented by a [low-volatility](#) component.

Given the ordinal nature of the scoring and weighting process, WTUSMF's final weights tend to feel closer to an equal-weighted portfolio rather than a market cap-weighted one. In the chart below, we illustrate the weights of WTUSMF, the S&P 500 and the S&P 500 Equal Weight by deciles. WTUSMF has significantly less weight allocated to its top 10%, or largest 20 constituents, than the S&P 500 Index, and its weighting distribution is closer to the equal-weighting distribution.

### Percent of Total Weight in Each Decile



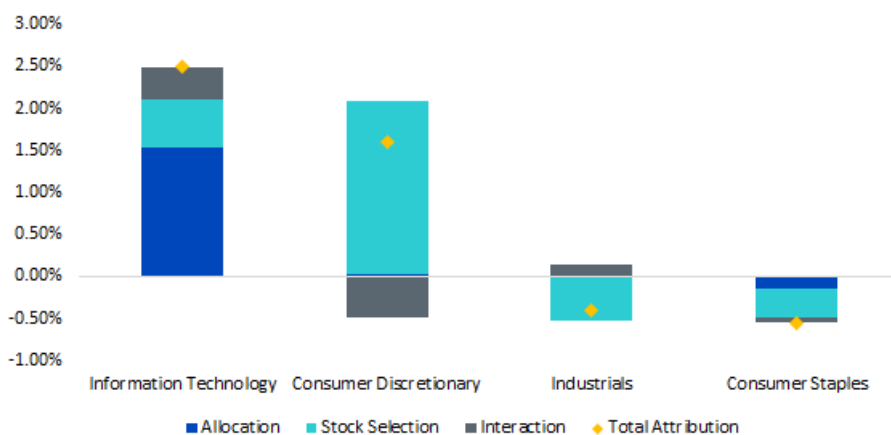
Sources: WisdomTree, Bloomberg, as of 6/30/18. The S&P 500 Equal Weight Index may experience drift between quarterly rebalances and unique stock classifications (such as the numerous shares classes of Alphabet), which may cause slightly unequal weight distributions. You cannot invest directly in an index. Past performance is not indicative of future results. Subject to change. S&P 500 Equal Weight Index takes the 500 stocks from the S&P 500 and equally weights them.

### Equal Weighting Underperforming

Over the last 14 months, the S&P 500 Index has outperformed its equal-weighted counterpart by almost 400 bps, with the Information Technology and Consumer Discretionary sectors being the main contributors while Industrials and Consumer Staples were the main detractors. Market cap-weighted indexes, such as the S&P 500 Index, are over-weight in the largest sectors and companies in the investment universe. During this time frame, the largest sectors and companies exhibited strong returns, which in turn explains why the S&P 500 Index outperformed the S&P 500 Equal Weight Index.

As can be seen in the chart below, the Information Technology sector, which has the largest weight in the S&P 500 Index, also had the best performance across sectors, deriving an important portion of its [alpha](#) from the allocation effect. Consumer Discretionary companies with large market caps outperformed smaller companies in the sector, thus resulting in a strong stock selection effect because these larger companies received greater weight in the cap-weighted index. On the other hand, smaller Industrials and Consumer Staples companies outperformed larger ones, explaining most of the performance drag from these sectors and shown as negative stock selection below.

### Sector Performance Attribution



Sources: WisdomTree, FactSet. Data for the period 6/29/17–8/31/18.

In a period where the largest sectors and companies led in performance, WTUSMF's stock selection and factor diversification allowed it to outperform both the equal-weighted and market cap-weighted versions of the S&P 500. *This indicates to us that simply deviating from market cap weighting is not enough: stock selection and factor diversification are critical.*

### Attribution vs. S&P 500 Equal Weight

At its core, the goal of constructing the WisdomTree Index was to outperform based on stock selection rather than sector allocation. Another interesting consideration for the Index's methodology to achieve this goal is its sector neutrality to the starting universe of the largest 800 U.S. companies by market cap. As a result, relative to the S&P 500 sector, active weights are close to 0%.

Sector weights relative to the S&P 500 Equal Weight Index, on the other hand, will have larger tilts because these are dependent on the number of constituents in a given sector rather than their market cap. Resulting sector tilts contributed 211 bps to WTUSMF's outperformance, but the greater portion of alpha is still coming from stock selection. Comparing the WisdomTree Index against an equal-weighted benchmark allows for a better sector-by-sector stock selection analysis.

The S&P 500 indexes hold, on average, 69 companies from the Industrial sector, and the equal-weighted portfolio of these companies returned close to 15% annually over the last 14 months. Meanwhile, WTUSMF, through its composite multifactor methodology, selected 14 companies that outperformed by 20%, a contribution of 2.76% to total alpha. Similarly, the 32 constituents of the Energy sector provided an equal-weighted annual return of 18%, while a more concentrated basket of seven constituents selected by WTUSMF doubled that performance. This gets back to the decision to select 200 stocks for the Index: broad enough to include a diverse basket but concentrated enough to be differentiated and to outperform the benchmark.

WisdomTree U.S. Multifactor Index vs. S&P Equal Weight Index (6/30/17–8/31/18)—Sector Allocation									
Category	Attribution Components				Average Category Weights			Category Performance	
	Allocation	Stock Selection	Interaction	Total Attribution	WT Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
Industrials	-0.08%	2.76%	-0.57%	2.11%	10.54%	13.64%	-3.10%	33.57%	14.91%
Information Technology	1.89%	-0.14%	-0.05%	1.70%	24.19%	13.70%	10.49%	30.80%	31.77%
Health Care	0.01%	0.91%	0.10%	1.02%	13.63%	12.22%	1.40%	20.14%	13.82%
Energy	-0.10%	1.17%	-0.06%	1.00%	5.97%	6.30%	-0.32%	35.94%	18.17%
Consumer Discretionary	0.00%	0.88%	-0.20%	0.69%	12.80%	16.43%	-3.62%	18.72%	14.04%
Financials	-0.06%	0.62%	0.05%	0.61%	14.75%	13.34%	1.41%	16.64%	12.66%
Real Estate	0.42%	-0.19%	0.25%	0.47%	2.37%	6.48%	-4.11%	4.61%	6.95%
Telecommunication Services	-0.14%	0.10%	0.21%	0.17%	2.06%	0.65%	1.41%	19.51%	6.89%
Utilities	0.20%	-0.19%	0.09%	0.09%	2.97%	5.57%	-2.60%	4.63%	7.49%
Consumer Staples	-0.18%	-0.01%	-0.03%	-0.22%	7.83%	6.72%	1.11%	4.65%	4.84%
Materials	0.15%	-1.52%	0.84%	-0.53%	2.89%	4.94%	-2.05%	-13.13%	11.48%
<b>Total</b>	<b>2.11%</b>	<b>4.37%</b>	<b>0.64%</b>	<b>7.12%</b>				<b>22.27%</b>	<b>15.15%</b>

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

## Conclusion

Comparing an index to different benchmarks can shed light on how different characteristics work. In this case, comparing WTUSMF to a broad, equal-weighted portfolio such as the S&P Equal Weight Index shows us that our composite multifactor approach has worked when selecting stocks across sectors, and alpha isn't a result of a simple size or sector tilt.

***Unless otherwise noted, returns are for the period June 29, 2017, through August 29, 2018, and are sourced from WisdomTree, Zephyr StyleADVISOR and FactSet.***

For the top 10 holdings of USMF please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/usmf>

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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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.

**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.

**Basis point** : 1/100th of 1 percent.

**Volatility** : A measure of the dispersion of actual returns around a particular average level.&nbsp;bsp.

**Market capitalization-weighting** : 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.

**S&P MidCap 400 Index** : provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

**Risk-adjusted basis** : When calculating the return, we refine the return by measuring how much risk is involved in producing that return.

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

**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.

**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.

**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.

**Low Correlation** : Characterized by assets that have a relatively lower correlation vs the market over time. This term is also associated with the Low Correlation 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.

**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.