

EVERYONE TALKS ABOUT “QUALITY” FUNDS, BUT WHAT DOES THAT EVEN MEAN?

Jeff Weniger — Head of Equity Strategy
 07/20/2021

Our industry likes to toss around terms that strike different thoughts in different people.

Just look at the “[growth](#)” and “[value](#)” investing styles. What are we growing these days? Earnings? Revenues? The customer base?

For [valuations](#), some may want low [P/E ratios](#), others high dividend yields, while maybe the “right” answer is some combination—or different measures altogether.

[So it is with quality.](#)

As it applies to stocks, what does that word mean? To boil it down: a [smart beta](#) quality screen is for investors who want highly profitable companies that manage to pull it off without a mountain of debt.

The oft-cited profitability metric is [return on equity \(ROE\)](#), while the debt part is sometimes found by checking how the company stacks up in the context of [return on assets \(ROA\)](#). If ROA is low and ROE is high, we know how the firm achieves it: management gooses the balance sheet with debt. You can minimize the goosing by explicitly incorporating ROA into a smart beta screen, which is something we do in a bunch of our Funds.

Figure 1: Definition of Quality, by Index Provider

WisdomTree	FTSE Russell	Standard & Poor's	MSCI
Return on Equity	Profitability	Return on Equity	Return on Equity
Return on Assets	Efficiency	Accruals Ratio	Stable Earnings Growth
Leverage	Earnings Quality	Financial Leverage	Financial Leverage
	Leverage		

Sources: Respective index providers, as of 7/7/21.

The intellectual framework for ROE is intuitive. Look for three things: business strength, stability and operational efficiency. Each is in the [DuPont equation](#), which shows how quality—or ROE—is simply the interaction between profit margins, business efficiency and balance sheet risk (figure 2).

Ideally, achieving high ROE with low leverage is the way to go.

Figure 2: DuPont Equation for ROE

$$\text{ROE} = \text{Profit Margin} \times \text{Asset Turnover} \times \text{Financial Leverage}$$

Which Can Be Stated As:

$$\text{ROE} = \frac{\text{Net Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Total Assets}} \times \frac{\text{Total Assets}}{\text{Shareholder Equity}}$$

Source: WisdomTree.

The problem: while this is great in theory, quality strategies have been disappointing in recent market declines. Take a

look at what happened in five of the last nine swoons in the [S&P 500](#) (figure 3).

Figure 3: Quality Stocks' Struggles

Start	End	S&P 500 Index	S&P 500 Quality Index	Did Quality Stocks Outperform?
2/19/2020	3/23/2020	-33.79%	-31.20%	YES
7/26/2019	8/14/2019	-6.00%	-5.69%	YES
4/30/2019	6/3/2019	-6.60%	-6.75%	NO
9/20/2018	12/24/2018	-19.40%	-20.09%	NO
1/26/2018	2/8/2018	-10.10%	-9.50%	YES
11/3/2015	2/11/2016	-12.71%	-12.04%	YES
5/21/2015	8/25/2015	-11.90%	-12.75%	NO
9/18/2014	10/15/2014	-7.28%	-7.31%	NO
4/2/2012	6/1/2012	-9.60%	-10.67%	NO
10/28/2011	11/25/2011	-9.60%	-7.96%	YES
4/29/2011	10/3/2011	-18.64%	-11.46%	YES
4/23/2010	7/2/2010	-15.63%	-14.32%	YES
1/6/2009	3/9/2009	-27.19%	-22.66%	YES
11/4/2008	11/20/2008	-25.00%	-22.37%	YES
5/19/2008	10/27/2008	-39.93%	-38.09%	YES
10/9/2007	3/10/2008	-17.85%	-13.98%	YES
7/19/2007	8/15/2007	-9.27%	-9.29%	NO
Median		-12.71%	-12.04%	

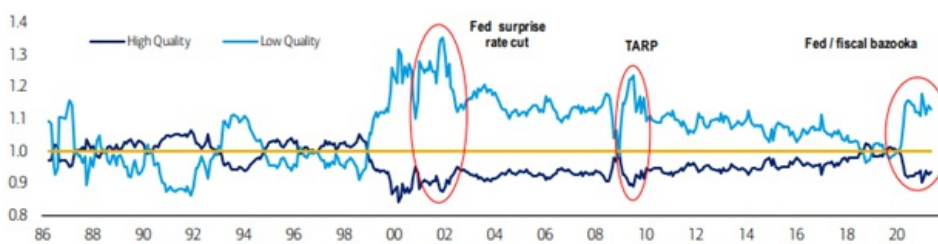
Source: WisdomTree, 06/30/07–06/30/21. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the table, please visit the [glossary](#).

Not only that, but quality has been lagging in this 15+ month market moon shoot. Sure, you could have bigger problems in life than watching the S&P 500 Quality index go up "only" 95.6% since March 23, 2020. Nevertheless, that is 4 percentage points short of the 99.7% run in the S&P 500 off the COVID-19 lows.

It's showing up in valuations. According to Bank of America's quant team, we have not seen high quality stocks this cheap relative to low quality peers in over a decade (figure 4).

Figure 4: High Quality (B+ or better) S&P Quality Ranks vs. Low Quality (B or worse) Fwd. P/E Relative to BofA Universe (1986–5/31/21)



Sources: FactSet, BofA U.S. Equity & Quant Strategy.

Though low quality has been running higher as the COVID-19-inspired economic depression transitioned to early recovery, one of these days we will enter the middle of the economic cycle—if that stage is not already here. The impulse to buy anything and everything, with little regard for operational efficiency, should seemingly fade as the clock ticks. That environment would enable quality concepts to claw out of this tunnel of frustration.

Here is a sample of our U.S. equity mandates, sorted by ROE. Many of them are clocking in higher than the S&P, with lower P/E ratios. Use this as a hunting ground for upping portfolio quality metrics.

Figure 5: Quality Spectrum

Fund	Ticker	Return on Equity (ROE)	Return on Assets (ROA)	Leverage (ROE Divided by ROA)	Forward P/E
WisdomTree U.S. High Dividend Fund	DHS	14.3%	2.5%	5.8	13.1
S&P 500	SPX	14.6%	3.1%	4.8	22.0
WisdomTree U.S. Dividend ex-Financials Fund	DTN	15.7%	4.6%	3.4	14.4
WisdomTree U.S. Quality Shareholder Yield Fund	QSY	17.1%	3.2%	5.3	14.7
WisdomTree U.S. LargeCap Fund	EPS	17.3%	3.3%	5.3	17.9
WisdomTree U.S. LargeCap Dividend Fund	DLN	18.7%	3.3%	5.8	16.9
WisdomTree U.S. Multifactor Fund	USMF	19.3%	4.7%	4.1	14.9
WisdomTree U.S. Quality Dividend Growth Fund	DGRW	26.9%	7.5%	3.6	17.6

Source: WisdomTree Digital Portfolio Developer, as of 6/30/21. You cannot invest directly in an index.

There are risks associated with investing, including the possible loss of principal. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. While QSY is actively managed, the Fund's investment process is expected to be heavily dependent on quantitative models and the models may not perform as intended. Due to the investment strategy of USMF, it may make higher capital gain distributions than other ETFs. Please read each Fund's prospectus for specific details regarding the Fund's risk profiles.

Related Blogs

+ [Quality 101: What it Is and Why it Works](#)

Related Funds

- + [WisdomTree U.S. Quality Dividend Growth Fund](#)
- + [WisdomTree U.S. LargeCap Dividend Fund](#)
- + [WisdomTree International Hedged Quality Dividend Growth Fund](#)
- + [WisdomTree International Quality Dividend Growth Fund](#)

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

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.

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.

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

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

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.

DuPont Equation : At the DuPont Corporation, Donaldson Brown created the concept that Return on equity (ROE) is broken down into the interaction between profit margin, by asset turnover, and the equity multiplier. These three pieces multiplied together are equal to ROE.

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.