
QUALITY FOR VOLATILITY

Matt Wagner — Associate Director, Research
03/24/2022

When times get tough, it pays to allocate to [quality companies that can weather the storm](#).

But what's a quality company?

To some, quality is represented by a [basket](#) of securities like those of the [Dow Jones Industrial Average](#)—blue chip, brand-name companies broadly representative of the U.S. economy.

To factor investors, quality in its purest sense has been measured in academic research by profits over equity ([return on equity](#)), or over assets ([return on assets](#)).

To enhance this [quality](#) definition, some quality indexes include metrics like [dividends](#), financial leverage, earnings accrual ratios and earnings [volatility](#) in their selection.

These different quality metrics can often show subtle distinctions, resulting in broadly similar quality screens. Of greater importance in evaluating factor indexes are:

- The starting universe
- How securities are weighted
- Sector constraints and/or holding caps

Here's an overview of select indexes targeting quality.

Methodology Overview

Index	WisdomTree U.S. Quality Dividend Growth	S&P 500 Quality	MSCI USA Sector Neutral Quality
Index Universe	WisdomTree U.S. Dividend Index	S&P 500 Index	MSCI USA
Constituent Selection	50% 3-year ROE & ROA/50% Earnings Growth Est.	Trailing 12-month ROE, Leverage, Earnings Accrual	Trailing 12-month ROE, Leverage, year-over-year 5-year Earnings Variability
Count of Securities	300	100	124
Weighting	Dividend Stream	Modified Market-cap	Modified Market-cap
Sector Caps	25% Tech, 10% RE, 20% all others	40%	Sector Neutral to MSCI USA
Security Caps	5%	Lower of 5% and 20 times its market capitalization.	5%
Reconstitution	Annual – Dec.	Semi-Annual – Jun./Dec.	Semi-Annual – May/Nov.
Launch Date	4/12/13	7/8/14	12/12/14

Sources: WisdomTree, MSCI, S&P. Count of securities, as of 3/8/22.

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

Starting Universe

Most quality indexes start with a broad universe of [large-](#) and [mid-cap](#) securities.

WisdomTree's Quality Dividend Growth family (WisdomTree Quality) starts with a more refined universe of large- and mid-cap companies paying regular cash dividends.

Why dividends? A consistent dividend payment is a signal of corporate health and cash management discipline that aligns with the goal of building a quality portfolio.

Weighting

Both the [MSCI USA Sector Neutral Quality Index \(MSCI Quality\)](#) and the [S&P 500 Quality Index \(S&P Quality\)](#) use a modified [market cap-weighted](#) approach. Constituents are weighted by a combination of market cap weights and a [quality factor](#) score.

The WisdomTree Quality Indexes weight constituents based on [Dividend Stream®](#), or regular cash dividends paid. This approach gives greater weights to companies paying greater cash dividends.

This reinforces the concept that a dividend is a signal of quality, with the added benefit of producing a basket with a typically higher dividend yield and lower price-to-earnings ratios.

Fundamentals

	WT U.S. Quality Dividend Growth	S&P 500 Quality	MSCI USA Sector Neutral Quality	S&P 500
Price-to-Earnings	20.4	15.7	23.4	21.7
Est. Price-to-Earnings	17.4	15.5	21.1	19.3
Dividend Yield	2.14%	1.46%	1.08%	1.36%
Return on Equity	29.08%	25.56%	36.40%	19.26%
Return on Assets	8.90%	3.28%	14.36%	4.28%

Sources: WisdomTree, S&P, MSCI, as of 2/28/22. You cannot invest directly in an Index. Past performance is not indicative of future returns.

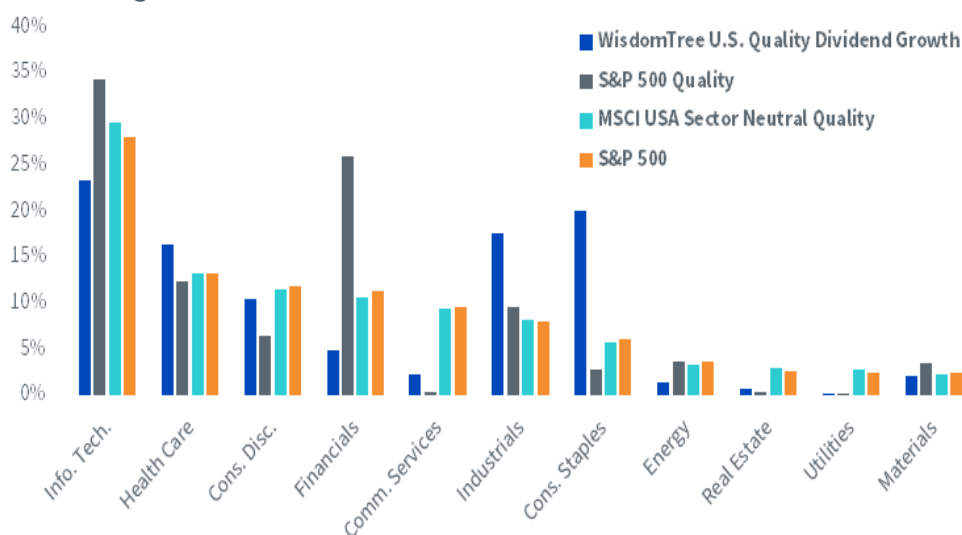
Constraints/Caps

MSCI Quality is sector neutral to the MSCI USA Index, with very little sector deviation from the S&P 500.

A by-product of this neutrality is that MSCI Quality typically has greater weight to lower-quality sectors like Communication Services, Real Estate and Utilities than either S&P Quality or WisdomTree Quality.

Both WisdomTree Quality and S&P Quality take more significant active sector bets. WisdomTree Quality caps the Information Technology sector at 25%, Real Estate at 10% and all other sectors at 20%. S&P Quality caps sector weights at 40%, allowing for a top weight of 35% to Information Technology.

Sector Weights



Source: WisdomTree, S&P, MSCI, as of 2/28/22. You cannot invest directly in an Index.

At a constituent level, each index caps holdings at 5% at rebalance. With Apple and Microsoft each at over 6% weights in the S&P 500, this cap forces each index to have modestly under-weight allocations in those names.

Top 10 Holdings

WisdomTree U.S. Quality Dividend Growth	S&P 500 Quality	MSCI USA Sector Neutral Quality	S&P 500
Apple -5.1%	Apple -5.0%	Apple -5.9%	Apple -6.9%
Johnson & Johnson -4.7%	Visa -4.9%	Alphabet -5.1%	Microsoft -6.1%
Microsoft -4.7%	Microsoft -4.7%	Microsoft -5.0%	Alphabet -4.2%
P&G -3.6%	JPMorgan Chase -4.7%	NVIDIA -4.4%	Amazon com -3.6%
Philip Morris Intl -3.6%	BofA Corp -4.7%	Johnson & Johnson -4.2%	Tesla -1.9%
The Coca-Cola -3.4%	Mastercard -4.6%	UnitedHealth Group -4.0%	NVIDIA -1.6%
Altria Group -3.2%	Pfizer -4.1%	Mastercard -3.9%	Berkshire Hathaway -1.6%
Merck & Co -3.0%	Wells Fargo -3.7%	Meta Platforms -3.5%	Meta Platforms -1.3%
Cisco Systems -2.5%	Adobe -3.0%	Visa -3.5%	UnitedHealth Group -1.2%
PepsiCo -2.4%	QUALCOMM -2.6%	Adobe -2.4%	Johnson & Johnson -1.2%

Sources: WisdomTree, S&P, MSCI, as of 2/28/22. You cannot invest directly in an index. Holdings subject to change.

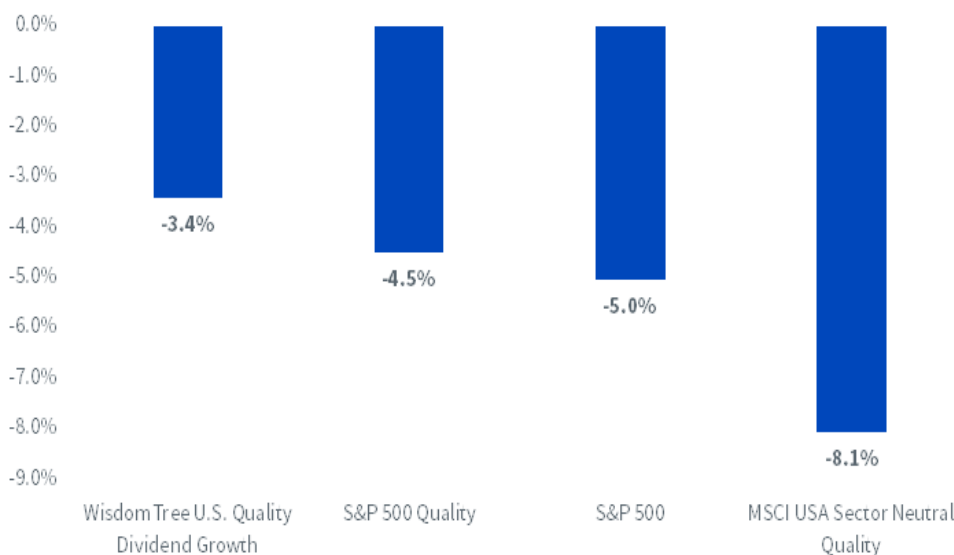
COVID-19 and 1Q22 Sell-offs

With all the different definitions of quality and approaches to index construction, how have these indexes fared amid recent market volatility?

So far in 2022, the S&P 500 Index is down over 5%, bouncing off its lows in recent weeks. The WisdomTree Quality and S&P Quality indexes have provided over 150 [basis points \(bps\)](#) and 50bps of downside protection, respectively, relative to the S&P 500.

MSCI Quality is the outlier, down over 300 basis points more than the S&P 500.

2022 YTD

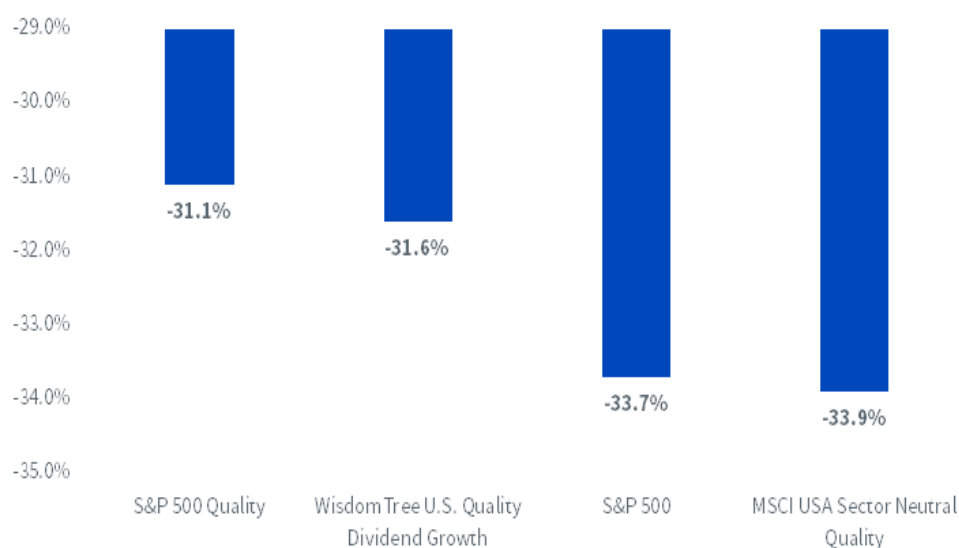


Sources: WisdomTree, S&P, MSCI, as of 3/22/22. You cannot invest directly in an index. Past performance is not indicative of future returns.

During the sell-off sparked by COVID-19 in spring 2020, there was not as great a dispersion in returns across these indexes. MSCI Quality was down roughly in line with the market, whereas S&P Quality and WisdomTree Quality each

provided over 200 basis points of downside protection.

COVID-19 (2/19/20–3/23/20)



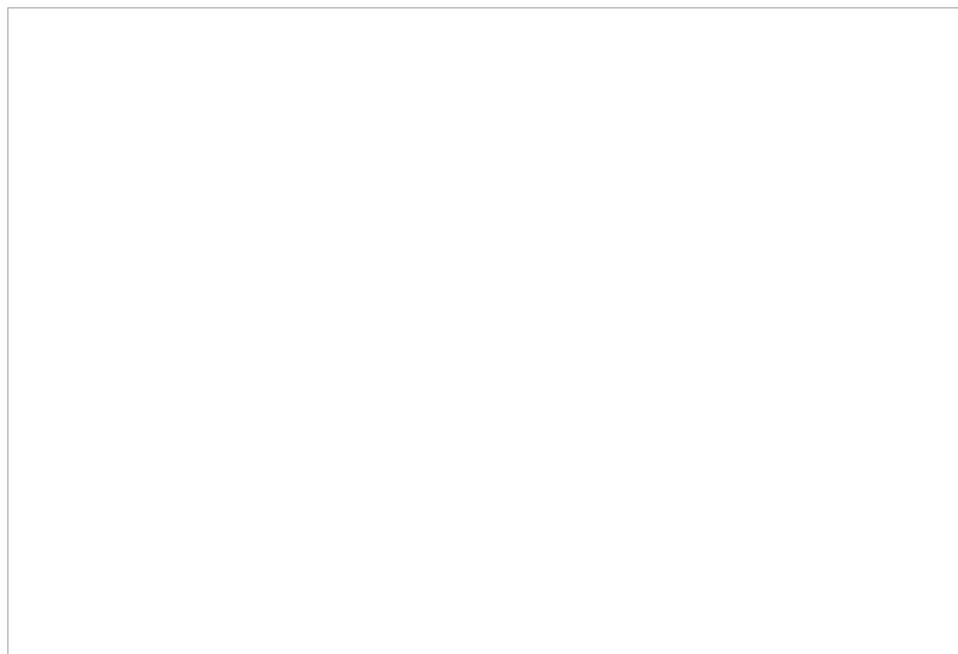
Sources: WisdomTree, S&P, MSCI. You cannot invest directly in an Index. Past performance is not indicative of future returns.

Conclusion

There are several ways to tap into quality companies. WisdomTree's approach to targeting a universe of dividend payers gives it an over-weight allocation to Consumer Staples and an under-weight allocation to Information Technology, an attractive combination in a volatile year when high-growth tech stocks [have lagged steady dividend payers](#).

We think the WisdomTree Quality approach provides a compelling option for investors that may be aiming to lower their equity [beta](#) and hedge the multitude of risks—geopolitical, Fed rate hikes, inflation, COVID-19—that market participants currently face.

Beta versus S&P 500



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.

Related Funds

- + [WisdomTree Emerging Markets Quality Dividend Growth Fund](#)
- + [WisdomTree U.S. SmallCap Quality Dividend Growth Fund](#)
- + [WisdomTree U.S. Quality Dividend Growth Fund](#)

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, 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

Baskets : The composition of an ETF in terms one creation/redemption unit.

Dow Jones Industrial Average : The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

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.

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.

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

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

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.

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.

MSCI USA Sector Neutral Quality Index : Refers to the MSCI USA Quality Index which is a large and mid cap US equity index aiming to capture the performance of quality growth stock. The Index screens its parent index, the MSCI USA Index for ROE, stable year-over-year earnings growth, and low financial leverage. Seeks to match the sector exposures the MSCI USA Index.

S&P 500 Quality Index : Designed to track high quality stocks in the S&P 500 by quality score, which is calculated based on return on equity, accruals ratio and financial leverage ratio.

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.

Quality Factor : Excess returns achieved by companies exhibiting higher quality or profitability vs the market. Typically measured using operating profitability, return on equity and/or return on assets.

Dividend Stream : Refers to the regular dividends per share multiplied by the number of shares outstanding.

Basis point : 1/100th of 1 percent.

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.