DESPERATELY SEEKING LOW VOLATILITY

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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.

All my friends know the low rider
The low rider is a little higher

Low rider drives a little slower
Low rider is a real goer

Low rider knows every street, yeah
Low rider is the one to meet, yeah

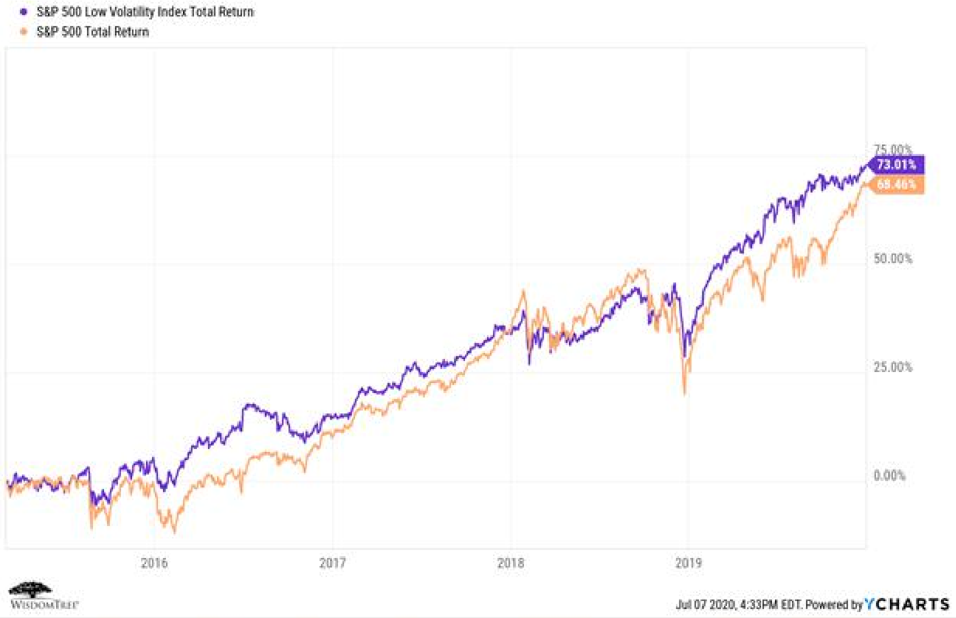
Low rider don't use no gas now
Low rider don't drive too fast

Take a little trip, take a little trip
Take a little trip and see

Take a little trip, take a little trip
Take a little trip with me

(From "Low Rider (On the Boulevard)," performed by War, 1975)

One of the more popular investment risk factors over the past 3–5 years has been "low volatility." Classic investment theory suggests that stocks with lower volatility should also have a lower expected return, but for the past five years up until the end of 2019, that simply was not the case:



Source: YCharts. Data from 1/1/ 15–12/31/19. You cannot invest in an index, and past performance is no indication of future returns.

For definitions of indexes in the chart, please visit our glossary.

That outperformance, however, has broken down in 2020, no doubt influenced by the virus-induced market disruptions:

Source: YCharts. Data from 1/1/20–7/6/20. You cannot invest in an index, and past performance is no indication of future returns.

As we have written about before, risk factors rotate in an out of favor just like asset classes do, and "low vol" is no exception (it is the bright yellow box in the "performance quilt" below):

Source: WisdomTree Asset Management. Data as of 6/30/20. You cannot invest in an index, and past performance is no guarantee of future returns. The starting universe for the referenced "factor portfolios" consists of the 800 largest companies listed in the U.S. Securities in the Low Correlation portfolio are selected based on their trailing 6- and 12-month correlation versus the broad market. Securities in the Low Volatility portfolio are selected based on their trailing 12-month standard deviation. Securities in the Momentum portfolio are selected based on their trailing 6- and 12-month risk-adjusted performance. Securities in the Quality portfolio are selected based on stronger current and historical (three-year) measures of profitability compared to their peers in the same GICS industry using four main variables: return on equity, return on assets, gross profits over assets and cash flow over assets. Securities in the Value portfolio are selected based on more attractive valuation metrics compared to their peers in the same GICS industry using six main variables: sales-to-price, book-to-price, earnings-to-price, estimated earnings-to-price, EBITDA-to-enterprise value and operating cash flow-to-price. Securities in the Size portfolio are selected based on their market capitalization compared to their peers in the starting universe. Securities in the Multifactor portfolio are selected based on a composite score calculated by equally weighting their low correlation, momentum, quality and value scores. Risk factors can toate in an out of favor just like asset classes do, performing better or worse in certain years.

Another characteristic of "low vol" investing is that its recent popularity with investors has driven the valuations of "low vol" stocks sky-high. The current P/E ratio of a popular S&P 500 "low vol" ETF is trading at only a slight discount to the P/E ratio of the mainstream S&P 500 Index ETF itself. And remember that the mainstream ETF includes what we view to be hyper-valued large-cap tech stocks. For now, dividends for the sector appear safe to us, providing a key level of near-term valuation support. But, nonetheless, "low vol" investing has become expensive.

Put differently, investors seem willing to "pay up" for a low-volatility allocation within their portfolio, but, as we know, the future potential performance of any investment is a function of how much you pay for it today. If you pay a high multiple today, your future potential performance typically is reduced.

We have written before about the inclusion of lower-correlated strategies into portfolios as a way of improving overall diversification, and we make those strategies explicitly available in our Endowment Model and our Volatility Management Model.

But there is another way to lower portfolio volatility without overpaying for "low vol" stocks. As a part of our Outcome-Focused Model Portfolio sleeves, we offer three versions of a "smart beta" or "multifactor" model portfolio—one each for the U.S., developed international and emerging markets. All these portfolios are designed specifically to deliver a high level of risk factor diversification, thereby potentially lowering the overall volatility of a broader portfolio.

Each of these models could be used as a stand-alone equity portfolio—they are geographically specific in nature, but within each region they are diversified across asset classes, styles and risk factors. But each of them (or a combination of them) can also act as a complement to an existing equity portfolio for advisors seeking to reduce volatility without having to make wholesale reallocations.

Currently, each of these the multifactor models has explicit allocations to a variety of risk factors, including:

- Value
- Size (both large cap and small cap)
- Quality
- Dividends
- Momentum, and
- Growth

As with all WisdomTree Model Portfolios, these models are "open architecture" (that is, they include both proprietary and third-party products), and they carry no strategist fee.

The inclusion of one or more of these models into an overall portfolio can help achieve a similar outcome to allocating to "low vol" stocks, *but at much more attractive valuation levels*.

For some perspective, consider the performance of the dark green "Multifactor" box in the risk factor performance quilt above. That box does *not* reflect the actual performances of the model portfolios—those boxes reflect index-level performances, and you cannot invest in an index, nor is past performance any guarantee of future results.

But you can get a sense of the historical improved performance consistency by incorporating multiple factors into a portfolio (that is, the green boxes tend to cluster around the middle of the performance quilt).

Just like with asset classes, when certain parts of the market are rallying strongly (e.g., large-cap tech), a more diversified portfolio will generally not keep up with that sector or risk factor.

But we believe we may have entered a new market regime, driven by both the ongoing pandemic and corresponding governmental intervention, that will be characterized by increased volatility.

For advisors seeking to improve the risk factor diversification of their overall portfolio and thereby potentially lowering portfolio volatility—but without "paying up" for "low volatility" securities—the WisdomTree multifactor models may be worth looking into.

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

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

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.

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.

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.

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.

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

Diversification : A risk management strategy that mixes a wide variety of investments within a portfolio.

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

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.

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.

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.

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.

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.