

# HOW TO ACHIEVE THE "BUFFETT FACTOR" IN INDEX CONSTRUCTION

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Within [smart beta](#) discussions today, factor exposures are a hot topic. [Quality](#) is one factor that has been popular, and it typically is defined as some combination of the following:

- Earnings growth, consistency or stability
- High [return on equity \(ROE\)](#), [return on assets \(ROA\)](#) or other measures of [net income](#) relative to a [fundamental](#) input (such as [return on invested capital \(ROIC\)](#))
- Low debt

Warren Buffett even wrote in one of his annual letters that, when thinking about acquisition criteria, quality would include "businesses earning good return on equity while employing little or no debt."<sup>1</sup>

## Diverse Approaches to Achieve This "Buffett Factor" in Index Construction

Two MSCI indexes that are focused on quality within U.S. equities are the [MSCI USA Quality Index](#) and the [MSCI USA Sector Neutral Quality Index](#). While each index defines quality and selects securities from the [MSCI USA Index](#) based on the same criteria (return on equity, [debt to equity](#) and earnings variability), the MSCI USA Sector Neutral Quality Index then normalizes the weights of securities within each sector so that the total sector weights match those of the MSCI USA Index at the semiannual index [rebalances](#).

The MSCI USA Quality Index has no such constraint placed upon its sector exposures.

## WisdomTree Entered the Quality Fray in 2013

In April 2013, WisdomTree began live calculation of the [WisdomTree U.S. Quality Dividend Growth Index](#). Critical differences from MSCI's approach to stock selection and weighting include:

1. All components pay regular cash dividends.
2. A growth criterion, focused on the forward-looking [growth estimates](#) of operating earnings.
3. Quality criteria, focused on three-year averages of return on equity and return on assets.
4. Components are weighted by their respective [Dividend Streams®](#).

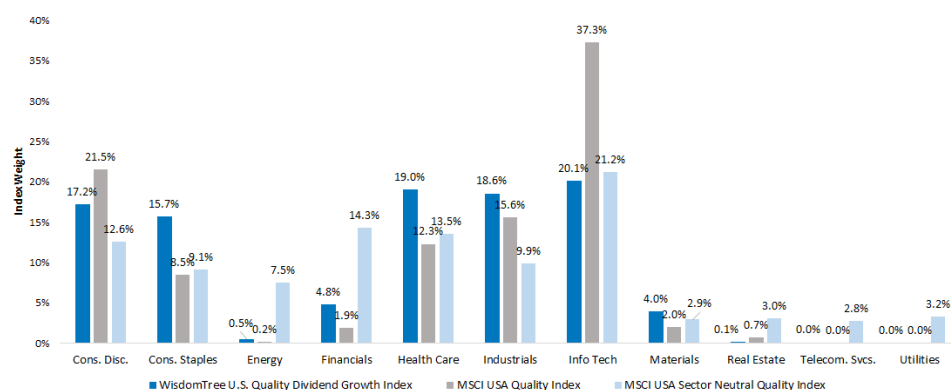
Individual constituents are capped at 5% and sectors are capped at 20% at each annual rebalance,<sup>2</sup> but there are no constraints relative to a parent Index or universe.

## Which Index Offers the "Best" Exposure to Quality?

We pose this question here precisely because, although it always may be an initial thought, its true importance depends on framing. Does best mean strongest performance in the future? Unfortunately, that one is impossible to know with certainty. Does best mean a strong set of quality metrics? Does best mean a broad-based, diversified approach balanced with strong quality metrics?

With any factor and ultimately any smart beta index, it's always important to take a step back and specify the characteristics that are most desirable as well as those that are open to compromise.

### Sector Exposures: The Obvious Difference



Sources: WisdomTree, Bloomberg, MSCI fact sheets, with all data as of 12/31/16. You cannot invest directly within an index. Subject to change.

- MSCI USA Quality vs. MSCI USA Sector Neutral Quality Indexes:** Given the nomenclature and difference in methodology that we've discussed, this is where the clear difference would be evident. The greater-than-37% weight to Information Technology of the MSCI USA Quality Index clearly stands out. On the opposite end of the spectrum, the extremely small exposures to Energy and Financials of the MSCI USA Quality Index also stand out.
- Quality Sectors:** Given that the WisdomTree U.S. Quality Dividend Growth Index has a differentiated approach to quality, we believe that sectors where the WisdomTree Index and the MSCI USA Quality Index are over-weight in very high-quality sectors relative to the MSCI USA Sector Neutral Quality Index. This would be true of Consumer Discretionary and Industrials, as of December 31, 2016. Both indexes were under-weight in the notably lower-quality sectors of Energy, Financials, Real Estate, Telecommunication Services and Utilities.

*Bottom Line: Investors have to determine how important sector neutrality to a [market cap-weighted](#) index benchmark truly is in determining their focus on quality (or any factor, for that matter). At WisdomTree, we clearly believe in sector diversification and broadness of exposure, but if a focus on quality is truly the goal, we ask:*

***Why dilute the focus on quality by requiring market capitalization weights to lower-quality sectors?***

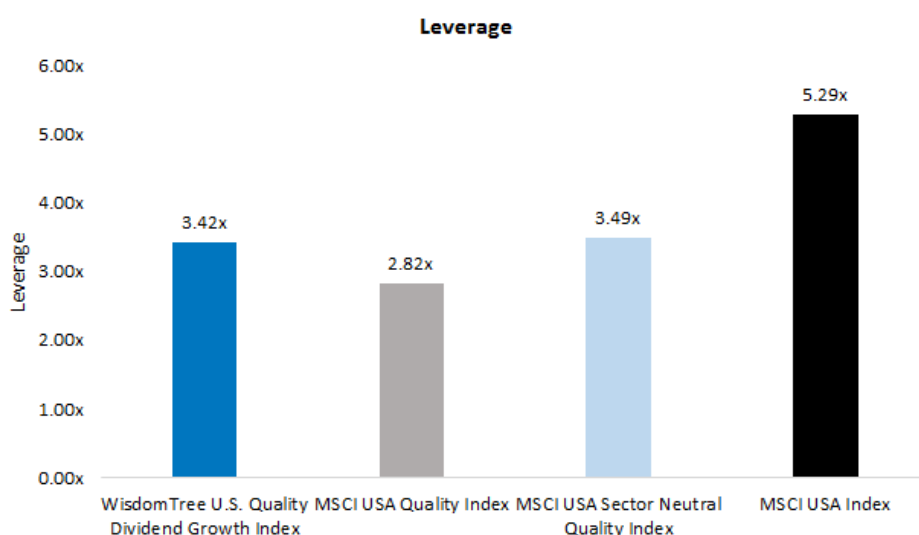
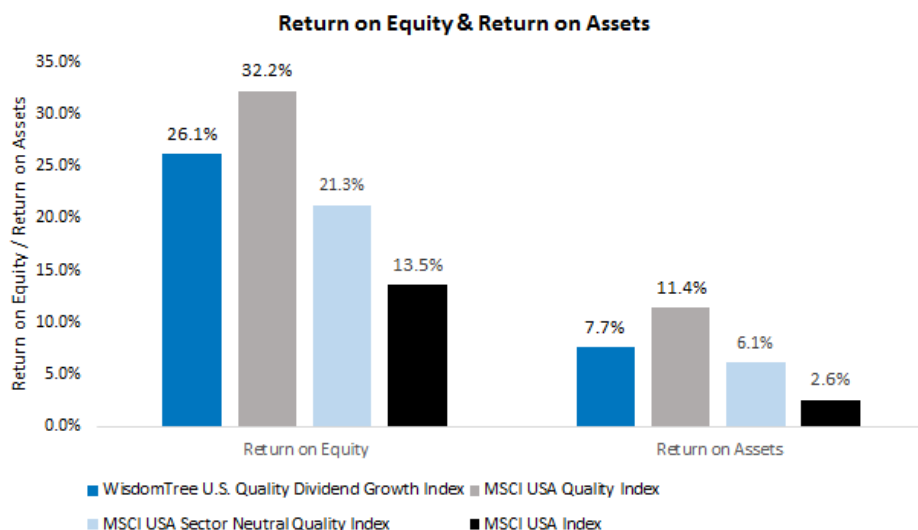
### WisdomTree's Approach: High Quality and Diversified Sector Exposures

Our prediction, based solely on index methodology, would be that the MSCI USA Quality Index would tend toward the highest measures of quality, as that is its sole focus.

Now, a greater-than-37% exposure to any single sector may not be feasible for all investors, creating a potential drawback.

*Can the WisdomTree U.S. Quality Dividend Growth Index generate more favorable measures of quality relative to the MSCI USA Sector Neutral Quality Index approach?*

## Measuring Three Quality Indicators



Sources: WisdomTree, Bloomberg, with data as of 12/31/16. You cannot invest directly within an index.

- **Return on Equity:** While the WisdomTree Index did not beat the MSCI USA Quality Index, it did exceed the MSCI USA Sector Neutral Quality Index.
- **Return on Assets:** The relative ordering of the indexes was the same on this measure as on return on equity.
- **Leverage:** Lower leverage tends to indicate higher quality. The WisdomTree and the MSCI USA Sector Neutral Quality Indexes were quite similar, with the WisdomTree slightly lower.

## Conclusion

So far, we've seen one of the major exchange-traded fund (ETF) providers switch their ETF from the original MSCI USA Quality Index to the MSCI USA Sector Neutral Quality Index. As we discussed in this post, while the original MSCI USA Quality Index had major sector bets and concentration, the sector-neutral approach does result in downgrade of potential ROE and ROA improvements. WisdomTree's Quality Dividend Growth methodology was designed to allow meaningful sector differentials and tilts versus the broader market, but we do so in constrained way—balancing what we believe is exposure to the quality factor while not concentrating too much in any one sector.

<sup>1</sup>Berkshire Hathaway Annual Shareholder Letter, 1/28/15.

<sup>2</sup>Between annual rebalances, individual companies may see their weights increase above 5% and sectors may see their weights increase above 20% due to market movement.

#### Important Risks Related to this Article

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You cannot invest directly in an index.

## DEFINITIONS

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

**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.

**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.

**Net income** : A company's total earnings (or profit), which are calculated by taking revenues and adjusting for the cost of doing business, depreciation, interest, taxes and other expenses.

**Fundamentals** : Attributes related to a company's actual operations and production as opposed to changes in share price.

**Return on Invested Capital (ROIC)** : Measures the efficiency of invested capital and how it relates to generated returns.

**MSCI USA 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.

**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.

**MSCI USA Index** : is designed to measure the performance of large and mid cap segments of the US market.

**Debt-to-Equity Ratio** : Measure of a firm's total outstanding debt to the book value, or value of its equity listed on its balance sheet. Higher values indicate greater debt issuance, and potentially greater risk if events occur that can negatively impact debt.

**Rebalance** : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

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

**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.