

OUR ALPHA SIGNALS: WHAT'S WORKED THUS FAR

Matt Wagner — Associate Director, Research
10/10/2018

The [WisdomTree U.S. Multifactor Index \(WTUSMF\)](#), launched in June 2017, selects its basket of 200 stocks based on four equally weighted [alpha](#) signals: [Low Correlation](#), [Momentum](#), [Quality](#) and [Value](#). While 14 months is a short time frame in which to analyze the returns of [factors](#) proven to outperform over years and decades, we will review which factors have worked thus far, and how WTUSMF is positioned from a factor and fundamental characteristic perspective after its most recent quarterly [rebalance](#).

The WTUSMF has performed very well since it launched, outperforming the [S&P 500 Index \(SPX\)](#) by 327 [basis points \(bps\)](#). Let's look at which factors performed well over that period.

Technical and Fundamental Factor Returns

Using S&P 500 Index constituents, we can analyze the performance across the four factors by using WisdomTree's methodology, and the relative performance between the Good and Bad categories.

By design, the Good, Okay and Bad categories each contain roughly a third of the total [market cap](#) of the S&P 500. In comparing the Good baskets, we can see that Quality has been the best-performing factor in terms of absolute return, returning 25.15%, while Low Correlation has been the worst-performing factor. The Good basket underperformed the Bad basket by more than 17%.

S&P 500 Factor Returns

Technical Factors				Fundamental Factors			
Low Correlation		Momentum		Quality		Value	
Category	Group Return	Category	Group Return	Category	Group Return	Category	Group Return
Good	7.82%	Good	19.29%	Good	25.15%	Good	18.65%
Okay	23.46%	Okay	22.07%	Okay	20.80%	Okay	17.68%
Bad	25.69%	Bad	15.46%	Bad	10.49%	Bad	21.02%
Total	19.00%	Total	19.00%	Total	19.00%	Total	19.00%
Good Minus Bad	-17.86%	Good Minus Bad	3.84%	Good Minus Bad	14.66%	Good Minus Bad	-2.37%

Sources: WisdomTree, FactSet. Returns from 6/29/17 to 8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

We can make a few conclusions from these factor returns:

- **Big Companies Outperforming:** The run in the S&P 500 has been powered by a narrowing segment of the market, the biggest companies in the Index. Because these biggest companies are more highly [correlated](#) with the returns of a market cap-weighted index, they tend to rank poorly according to our Low Correlation factor and are in the Bad category. We can see an almost 1,800 basis point spread between Good/Bad correlation groups.

- **Momentum and Quality, Late Cycle:** Momentum and Quality factors typically outperform late in the cycle, and we are seeing that play out in real time. For WTUSMF, Momentum is uniquely designed to use risk-adjusted returns rather than absolute returns. This is to tap into the long-term absolute return potential of the factor, but with an eye towards improving [risk-adjusted returns](#).
- **Quality and Growth in favor, Value Out:** Seeing Good Value underperforming Bad Value (i.e., expensive “growth stocks”) also comes as no surprise, as this has been a persistent trend for several years now and is typical in the middle-to-late stage of a [bull](#) market. Many investors seem to be bracing their portfolios for Value [mean-reversion](#), but recent returns suggest we are not quite there yet.

We have done an [analysis on long-term returns for these factors](#), which helps support our conviction in their long-term staying power.

Low Correlation: What It Means for the “Tech Behemoths”

Two of the top contributors to the returns of the S&P 500, particularly in 2018, have been Apple and Amazon. Since its inception, WTUSMF has been under-weight in Apple by 3.36% and in Amazon by 2.33%. As a result, these companies have been the two biggest detractors from performance relative to the S&P 500,¹ making the outperformance of WTUSMF even more impressive.

In the table below we show our factor scores which rank companies between 0-100%, of Apple and Amazon at each of our five live quarterly rebalances. At our most recent September rebalance, Apple was included in WTUSMF for the third time, this time on the back of an improved Momentum score.

In our eligible universe of 800 stocks, both companies have tended to rank in the bottom third by Low Correlation. To be included, their scores for the other three factors need to make up for that low score. At this September's rebalance, Apple had scores in the top third on the other three factors, which offset an 18% Low Correlation score.

Quarterly Rebalance Scores

Screening Date	Company Name	Value	Quality	Momentum	Low Correlation	Multifactor Score	Included in WTUSMF
8/31/2018	Amazon	8%	72%	79%	21%	53%	No
5/31/2018		7%	68%	71%	24%	51%	No
2/28/2018		6%	57%	79%	47%	58%	No
11/30/2017		6%	64%	51%	33%	47%	No
8/31/2017		6%	70%	72%	15%	51%	No
5/31/2017		7%	70%	88%	34%	60%	No
8/31/2018	Apple	71%	80%	71%	18%	70%	Yes
5/31/2018		76%	79%	55%	16%	67%	No
2/28/2018		75%	64%	66%	7%	65%	No
11/30/2017		70%	72%	69%	12%	68%	No
8/31/2017		66%	65%	84%	34%	78%	Yes
5/31/2017		70%	62%	96%	57%	86%	Yes

Sources: WisdomTree, FactSet. Index screening dates from 5/31/17 to 8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index. Weights subject to change.

Balanced Factor Exposures

While we believe different factors perform well during different times of the cycle, it is difficult to forecast which stage of the cycle we are in. This means that an equal weighting of our four desired factors is a natural starting point.

In the table below we show the index weights of WTUSMF and the S&P 500 in the Good, Okay and Bad groups, as of the WTUSMF rebalance screening date. As mentioned above, we see that the S&P 500 has roughly one-third of its weight in each group. The WisdomTree Index has its weight evenly distributed across factors, with weights of roughly 52% to 56% in each Good group and, just as importantly, significant under-weights in the Bad groups. What this tells us is that WTUSMF is tapping into the material factor tilts as we designed it to, without giving too much influence to any single

factor. While each factor tilt was improved by the rebalance, the biggest changes came from the two technical factors, Momentum and Correlation, which we often see, given the fast-moving nature of these factor scores.

Factor Quilt

Index	Group	Value	Quality	Momentum	Correlation
WisdomTree U.S. Multifactor (Pre-Rebalance)	Good	52.0%	49.4%	52.9%	50.0%
	Okay	32.3%	35.8%	27.9%	37.6%
	Bad	15.7%	14.8%	19.2%	12.5%
WisdomTree U.S. Multifactor (Post-Rebalance)	Good	52.9%	52.4%	56.2%	54.3%
	Okay	32.4%	34.5%	26.5%	36.2%
	Bad	14.6%	13.1%	17.4%	9.4%
S&P 500	Good	33.4%	33.3%	32.4%	31.6%
	Okay	34.5%	34.9%	35.4%	33.2%
	Bad	32.1%	31.8%	32.1%	35.2%

Sources: WisdomTree, FactSet. Data as of 8/31/18, the Index screening date for the WisdomTree U.S. Multifactor Index. Past performance is not indicative of future results. You cannot invest directly in an index.

Lower Price/Earnings and Improved Quality Metrics

Another way our factor tilts manifest themselves is in the valuations of WTUSMF compared to the S&P 500. The Value tilt is evident in the [price-to-earnings \(P/E\)](#) discount, and higher Quality from [return-on-equity \(ROE\)](#) and [return-on-asset \(ROA\)](#) improvements relative to the market. Another factor that we tap into via our alternative weighting mechanism is [Size](#), which can be seen in our material over-weight to [mid-caps](#).

Index	P/E	Div. Yld.	ROE	ROA	Large-Cap Wgt	Mid-Cap Wgt	Small-Cap Wgt
WisdomTree U.S. Multifactor (Pre-Rebalance)	15.7x	1.33%	19.70%	5.60%	61.61%	38.39%	0.00%
WisdomTree U.S. Multifactor (Post-Rebalance)	15.2x	1.40%	20.69%	5.86%	60.63%	39.37%	0.00%
S&P 500	21.7x	1.76%	15.48%	3.56%	98.13%	1.87%	0.00%

Sources: WisdomTree, FactSet. Data as of 8/31/18, the Index screening date for the WisdomTree U.S. Multifactor Index. Past performance is not indicative of future results. You cannot invest directly in an index.

Our quarterly rebalance plays a critical role in maintaining balanced factor exposures that should drive long-term outperformance. Over this time frame, Momentum and Quality have been the best-performing factors, while Low Correlation and Value have lagged. Given the cyclicity of factors and the challenges of factor timing, we believe our high factor tilt and higher [active share](#) approach is positioned to add relative value across different market environments.

¹Sources: WisdomTree, FactSet. Data from 6/29/17 to 8/31/18. Holdings for WTUSMF are displayed daily on the website. Holdings subject to change.

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](#)

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

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.

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.

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.

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.

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.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

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.

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.

Basis point : 1/100th of 1 percent.

Market Capitalization : 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.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Risk-adjusted returns : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.

Bullish : a position that benefits when asset prices rise.

Mean reversion : The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

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.

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.

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.

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.

Active Share : Active share is a measure of the percentage of holdings in a fund's portfolio that differs from the benchmark index.