

QUALITY FOR UNCERTAIN TIMES

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In the last few months, market visibility has significantly declined. The war in Ukraine created major geopolitical uncertainty. [Inflation](#) and the [central banks' hawkish](#) stands weigh on developed economies and growth expectations. Quite logically, volatility is back in the markets. While the 20-day historical [volatility](#) of the [MSCI World Index](#) hovered around 10% for most of 2021, it has now increased sharply, with current levels between 20% and 25%. After sharply correcting in January and February, markets now appear to be moving sideways.

In such uncertain times, many investors are contemplating reducing risk in their portfolios. Still, a reallocation from equity to fixed income logically loses some of its appeal when interest rates may be on the verge of snapping a 40-year downtrend. Shifting equity exposures toward more robust higher-[quality](#) equity names could help protect the downside while maintaining exposure to the upside.

Quality for Lower Visibility and Increasing Volatility in the Markets

Profitability as a proxy for quality captures the outperformance of highly profitable firms that can continue to thrive in difficult economic and market conditions thanks to strong, proven business models. Such companies tend to be in demand when investors start to worry about future outcomes and when economic visibility is reduced, leading to outperformance in high-volatility and end-of-cycle periods.

In figure 1, we compare the behavior of highly profitable companies and less-profitable companies in different volatility regimes. To do so, we calculate the 20-day rolling historical volatility of U.S. equities since 1963 and split the periods into five groups ([quintiles](#)) based on the level of volatility. Quintile #1 regroups the one-fifth of the periods with the lowest observed volatility (all periods with volatility below 8.1% annualized). Quintile #5 regroups the one-fifth of the periods with the highest observed volatility (all periods with volatility above 17.5% annualized).

Figure 1: Behavior of Highly Profitable Companies and Less-Profitable Companies in Different Volatility Regimes



Source: Kenneth French Data Library. Data was calculated at a daily frequency from July 1963 to February 2022. "High Quality" represents the top 30% of companies by operating profitability, and "Low Quality" represents the bottom 30% by operating profitability. The portfolios are rebalanced yearly at the end of June. The market represents the portfolio of all available publicly listed stocks in the U.S. All returns are in USD. Operating profitability for year t is annual revenues minus cost of goods sold, interest expense, and selling, general and administrative expenses divided by book equity for the last fiscal year-end in t-1. **Historical performance is not an indication of future performance, and any investments may go down in value.**

We observe that less-profitable, low-quality companies tend to outperform in periods of low volatility (in quintile #1), but their average underperformance increases with volatility.

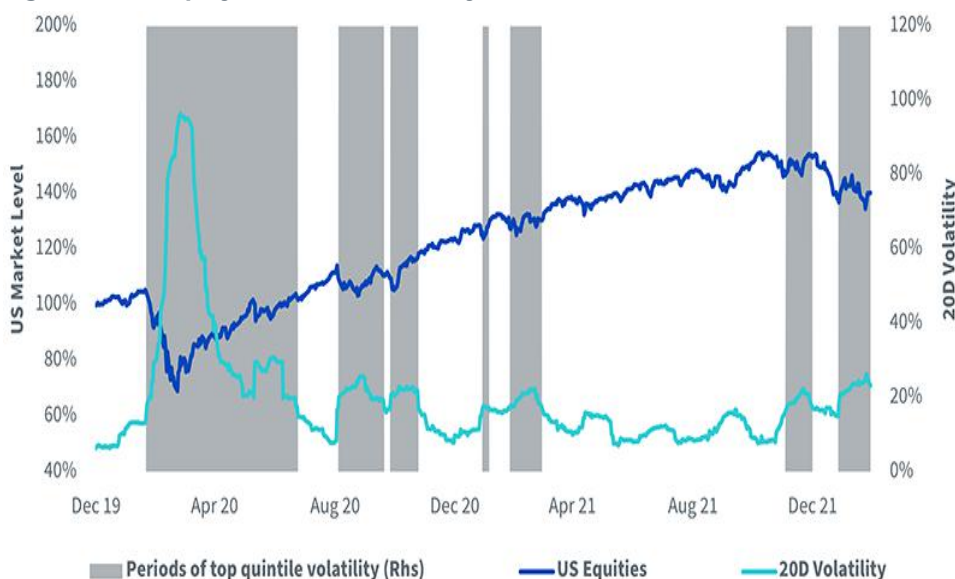
On the contrary, highly profitable, high-quality companies see their outperformance increase with volatility. In other words, highly profitable companies tend to act as a safe haven for investors in periods of stress and high volatility, leading to the highest outperformance in those periods.

It is worth noting as well that those high-quality companies historically outperform in all five volatility regimes. This is why [quality is considered the “all-weather factor”](#):

- It can help investors build wealth over the long term
- It can weather the inevitable storms along the way

It is worth noting, after a long period of relatively low volatility between March 2021 and November 2021, that the U.S. markets have gone through two periods of high volatility recently: one in December 2021 and one ongoing since January 2022.

Figure 2: U.S. Equity Market and Volatility Levels Since 2019



Source: Kenneth French Data Library. Data is calculated at a daily frequency from December 2019 to February 2022. The market represents the portfolio of all available publicly listed stocks in the U.S. All returns are in USD. **Historical performance is not an indication of future performance, and any investments may go down in value.**

Since quality companies generate high [revenues](#), they can grow and compound wealth in the future.

Thanks to their solid business models and financial strength, they can withstand unexpected events such as economic downturns or geopolitical shocks.

Quality for Inflationary Times

In inflationary times, companies' bottom lines live or die by their [pricing power](#), i.e., their capacity to increase prices in line with their costs. Very often, pricing power and high-quality business go hand in hand. In the word of Chairman and CEO Warren Buffett, "If you've got the power to raise prices without losing business to a competitor, you've got a very good business, and if you need a prayer session before raising the price by a tenth of a cent, you've got a terrible business."¹

Highly profitable companies with a high return on equities and a high return on assets tend to display such high pricing power. Using such fundamental screens tends to unearth:

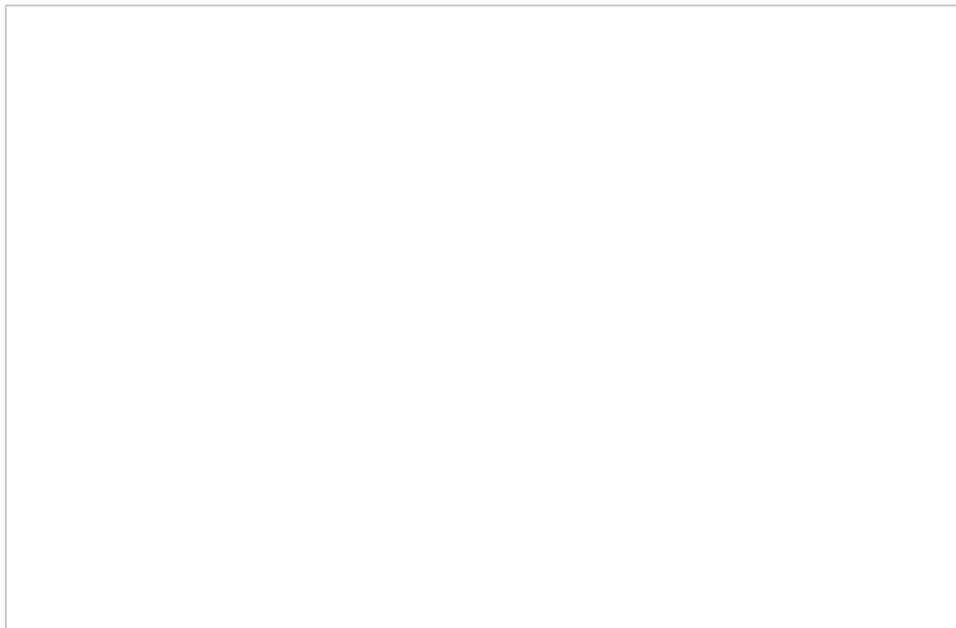
- Luxury companies
- Companies with strong brand names

Looking at the [WisdomTree U.S. Quality Dividend Growth Index](#), we find Apple, Microsoft, Coca Cola and PepsiCo in the top 15. Coca-Cola and PepsiCo raised prices within days of each other last July and have recorded substantial margins since then.

Or, taking the example of Apple, its products are very often recognized as "the best" in the industry. It gives the

company the right to charge a premium over its competitors. Apple's pricing power is obvious, looking at the price of the top-shelf iPhone since 2008 in figure 3. When the [Consumer Price Index \(CPI\)](#) grew by 25.6% over the period, the price of the iPhone went up by 128%. Yet Apple's sales numbers remained very high.

Figure 3: Evolution of the Price of iPhones vs. Inflation



Quality in the [Value vs. Growth Debate](#)

With the beginning of the [rate hiking](#) cycle in the UK and the U.S., investors started to worry about the implied duration in their equity portfolio. This led to a sharp outperformance of value stocks versus growth stocks over the last three to four months. The [quality factor](#) ended up caught in the crosshairs.

Using fundamental filters to find quality stocks with no other considerations will very often lead to a growth bias that can be very detrimental to the strategy in the current market environment. The [MSCI USA Sector Neutral Quality Index](#) is a clear example of this bias at the moment. Its methodology does not control for its value or growth exposure, leading to growth being the third biggest [factor](#) exposure in the portfolio after profitability and momentum². Year to date, this led to an underperformance of -3.3% versus the S&P 500³.

However, it is possible to find high-quality stocks in all parts of the market, in all sectors and in all factors. It is possible to find high-quality stocks that are cheaper than the market. Building a high-quality strategy with a value tilt is possible, for example, if the investment process is built with valuations in consideration. Quality-oriented strategies that factor in value metrics in their processes have tended to do better this year. The WisdomTree U.S. Quality Dividend Growth Index, for example, outperformed the S&P 500 by 1.2%³ over the same period, a 4.5% differential from the MSCI Index. This is the result of our focus on high-quality, dividend-paying companies, which allows us to deliver a high-quality exposure laced with a value tilt.

¹ Andrew Frye and Daking Campbell, "Buffett Says Pricing Power More Important Than Good Management," Bloomberg, 2/18/11.

² Sources: WisdomTree, Bloomberg, as of 3/28/22. Analysis is run on holdings using PORT in Bloomberg. Factor definitions and calculations are explained in "US Equity Fundamental Factor Model," which is available in PORT Help in Bloomberg. **Historical performance is not an indication of future performance, and any investments may go down in value.**

³ Sources: WisdomTree, Bloomberg, 12/31/21–3/28/22. **You cannot invest in an index. Historical performance is not an indication of future performance, and any investments may go down in value.**

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Pierre Debru is an employee of WisdomTree UK Limited, a European subsidiary of WisdomTree Asset Management Inc.'s

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DEFINITIONS

Inflation : Characterized by rising price levels.

Central bank : Refers to the the monetary authority of any country.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

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

MSCI World Equity Index : The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

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.

Quintile : One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

Revenue : Income that a company receives from its normal business activities, usually from the sale of goods and services to customers.

Pricing power : Describes the effect of a change in a firm's product price on the quantity demanded of that product. Pricing power is linked to the price elasticity of demand. Price elasticity is a measure of the degree to which individuals, consumers, or producers change their demand or the amount supplied in response to price changes.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

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. .

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.

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