

# Beyond traditional factors: an innovative approach to enhancing equity returns

Published 20 February 2025

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## Key Takeaways

- By leveraging a 60/40 portfolio to equity-like volatility levels, the WisdomTree Efficient Core strategy delivers a higher Sharpe ratio compared to traditional equity investments.
- Like classic equity factors, such as Value and Momentum, the WisdomTree Efficient Core strategy exhibits low correlation with other equity factors, making it a potential replacement or complement to existing equity strategies.
- Over time, the WisdomTree Efficient Core strategy can maintain strong participation in market gains while also mitigating drawdowns, offering a slightly defensive profile.
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When it comes to trying to outperform the equity markets, investors must usually rely on doing their own stock picking, investing in an active manager strategy, or using a systematic equity factor strategy. Whether they realise it or not, in all cases they engage in factor investing, as academic research and empirical data have consistently showed that much of the excess returns generated by active funds or stock picking in general can be traced back to systematic tilts toward well-documented equity factors such as Value, Momentum, Quality, and Minimum Volatility.

This is not a bad thing, as factor investing offers many potential advantages to investors. Factors provide systematic, repeatable sources of return by harnessing long-term premia that persist across market cycles. They also enhance diversification, as different factors tend to behave differently across the business cycle – some being more cyclical, others more defensive, and some acting as all-weather strategies. By thoughtfully combining factors such as Value, Minimum Volatility, or Quality, investors can construct more efficient equity portfolios with improved risk-adjusted returns.

## The WisdomTree Efficient Core strategy: a new tool to enhance equity portfolios

Building on this idea, what if investors could access an additional source of return premia—one not based on stock-specific characteristics but on a fundamental market dynamic? The well-documented diversifica-

tion benefits between equities and bonds create a powerful mechanism for improving risk-adjusted returns when structured efficiently.

By leveraging a traditional 60/40 portfolio to match the volatility of equities, investors can achieve a higher Sharpe ratio while maintaining a risk level similar to that of pure equity investments. This approach systematically captures the bond-equity diversification premium, functioning as a new ‘factor’ in its own right—one that can serve as both a complement to existing equity exposures and a potential replacement for traditional equity allocations.

## How does WisdomTree Efficient Core work?

WisdomTree has developed the [Efficient Core strategy](#), a unique investment framework designed to maximise the benefits of the bond-equity diversification premium. The strategy consists of:

- **Equity Exposure:** 90% allocated to a diversified ESG-screened basket of large-cap stocks.
- **Bond Exposure:** 60% allocated to a diversified basket of government bond futures, spanning maturities from 2 to 30 years.
- **Cash Collateral:** 10% cash, serving as collateral for the futures contracts.

By dynamically combining equity and bond exposures in a leveraged, risk-balanced structure, the Efficient Core approach enhances the traditional 60/40 portfolio while preserving equity-like characteristics. In essence, this Efficient Core functions as a new equity factor—one rooted in the bond-equity diversification premium—offering investors an alternative or complementary way to enhance their equity exposure.

## A new way to outperform equities

Figure 1 highlights that the [WisdomTree US Efficient Core strategy](#) (a portfolio investing 90% to physical US large cap equities and 60% to a portfolio of 5 US Treasury Bond future contracts) behaves like other equity factors by delivering similar outperformance and an improved Sharpe ratio.

## Figure 1: Performance statistics for US equity factors and WisdomTree US Efficient Core (Dec 2000 to January 2025)

*Source: WisdomTree, Bloomberg. 31 December 2000 to 31 January 2025. Includes backtested return. You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.*

Beyond outperformance, one of the defining characteristics of equity factors is their low correlation with one another. This diversification benefit is a critical advantage in portfolio construction. Figure 2 demonstrates that the excess returns of the [WisdomTree US Efficient Core strategy](#) exhibit similarly low correlations with traditional equity factors, reinforcing its potential as a distinct factor-like strategy.

## Figure 2: Correlation of excess returns between US equity factors and WisdomTree US Efficient Core

	Min Volatility	Quality	Small Cap	High Dividend	Value	Momentum	WisdomTree US Efficient Core
Growth	-39%	18%	-7%	-76%	-57%	39%	7%
Min Volatility		27%	-20%	68%	-6%	1%	49%
Quality			-16%	5%	-20%	3%	24%
Small Cap				-12%	44%	1%	-17%
High Dividend					30%	-26%	24%
Value						-27%	-21%
Momentum							8%

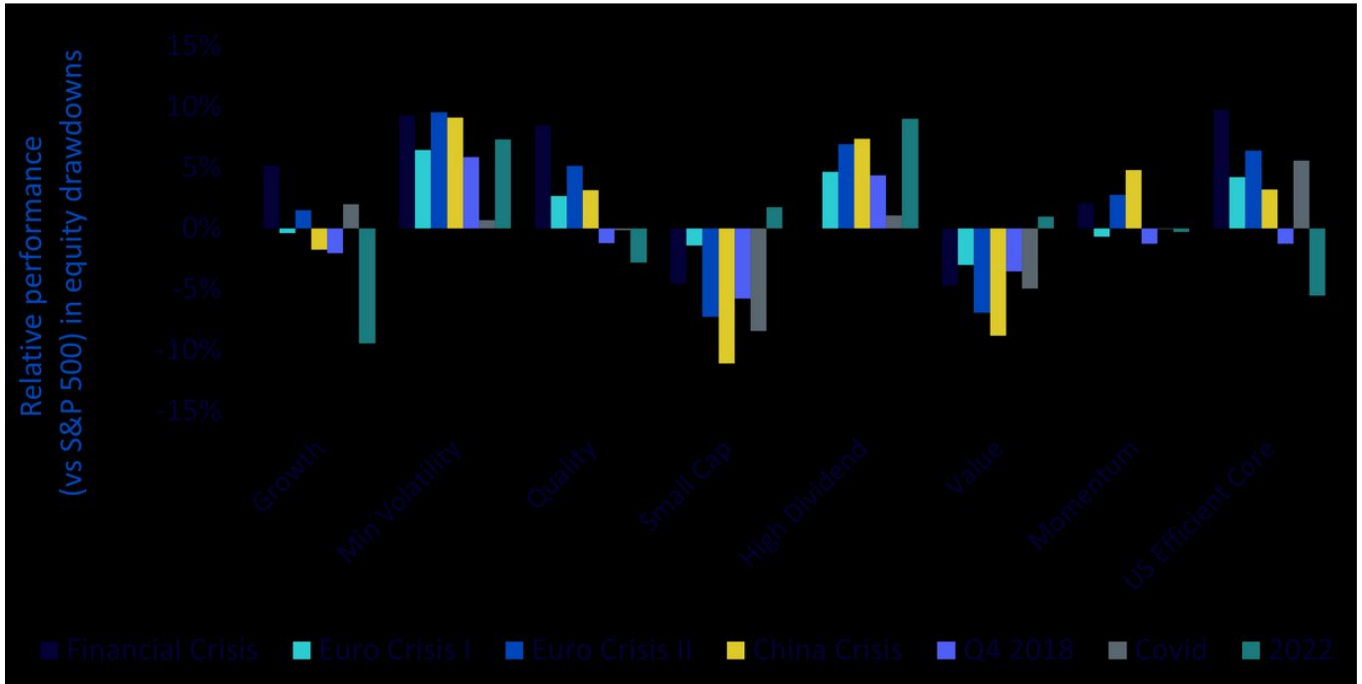
Source: WisdomTree, Bloomberg. 31 December 2000 to 31 January 2025. Includes backtested return. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

## A defensive approach to outperformance

As discussed, different equity factors behave differently across market cycles. Minimum Volatility tends to be defensive, outperforming during equity drawdowns, while Value is more cyclical and performs well early in the cycle. If WisdomTree Efficient Core acts as a new factor, understanding its behaviour across different market environments is essential.

A useful way to assess this is by analysing performance in major equity market drawdowns. Figure 3 highlights the relative performance of various equity factors and [WisdomTree US Efficient Core](#) during the seven largest equity market declines since 2000. The results show that, while Minimum Volatility remains the most defensive, consistently reducing drawdowns across all periods, cyclical factors such as Value and Small Caps tend to struggle. WisdomTree US Efficient Core, however, demonstrates a balanced defensive tilt—outperforming in five of the seven downturns and effectively mitigating losses.

### Figure 3: Relative performance of US equity factors and WisdomTree US Efficient Core in drawdown periods



Source: WisdomTree, Bloomberg. 31 December 2000 to 31 January 2025. Includes backtested return. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

Another way to assess defensiveness is through upside and downside capture ratios, which measure how much a strategy participates in market gains versus losses. Figure 4 illustrates that, while [WisdomTree US Efficient Core](#) is slightly defensive, it is less so than Minimum Volatility. Notably, its upside/downside asymmetry is particularly strong, with an upside capture ratio of 89% and a downside capture ratio of 86%, reinforcing its ability to enhance returns while preserving capital.

**Figure 4: Upside and downside capture of US equity factors and WisdomTree US Efficient Core**



Source: WisdomTree, Bloomberg. 31 December 2000 to 31 January 2025. Includes backtested return. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

## Conclusion: a smarter way to approach equity investing

The [WisdomTree Efficient Core strategy](#) introduces a new dimension to equity investing, leveraging the bond-equity diversification premium to create a new solution for equity outperformance. With comparable long-term returns to equities, a higher Sharpe ratio, and built-in defensive characteristics, WisdomTree Efficient Core serves as both a potential complement to equity portfolios and replacement for traditional equity exposures.

Just as Value, Momentum, and Minimum Volatility offer unique return characteristics, the WisdomTree Efficient Core strategy brings a new, systematic approach to enhancing equity investing. As market conditions evolve, incorporating this strategy into portfolios could provide investors with a more resilient and efficient path to long-term outperformance.

Footnotes:

- Minimum volatility is proxied by MSCI USA Min Volatility Gross total return index.
- Quality is proxied by MSCI USA Quality Sector Neutral Gross total return index.

- Momentum is proxied by MSCI USA Momentum Gross total return index.
- High Dividend is proxied by MSCI North America High Dividend Gross total return index.
- Small Cap is proxied by MSCI USA Momentum Gross total return index.
- Value is proxied by MSCI USA Enhanced Value Gross total return index.
- Growth is proxied by MSCI USA Growth Gross total return index.

Definitions for the drawdown periods

- Financial Crisis (16 July 2007 to 9 March 2009)
- Euro Crisis I (15 April 2010 to 5 July 2010)
- Euro Crisis II (2 May 2011 to 4 October 2011)
- China Crisis (15 April 2015 to 11 February 2016)
- Q4 2018 (21 September 2018 to 27 December 2018)
- COVID-19 Crisis (19 February 2020 to 23 March 2020)
- 2022 (3rd January 2022 to 12 October 2022)

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