

# The Time for Quality is Now

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During our travels and meetings with clients, we've noticed a few common themes emerging of late:

- Investors are beginning to take the idea of “rising interest rates” in earnest. True, the US 10-Year Treasury note interest rate has moved quickly towards a level of 2.9%, but many are speculating whether the 10-Year German Bund could be soon to follow—especially as communications from the European Central Bank (ECB) evolve between now and September.
- Investors are also wondering whether the increase in volatility observed during February of 2018 is signalling the beginning of the end of the bull market or if it is just a late cycle correction preceding a further push higher.

## **Dividends 2.0 with WisdomTree**

In 2013, WisdomTree developed a new approach of looking at dividend-paying stocks. Many might hear the word “dividend” and automatically assume things like “Utilities”, “Telecommunication Services” and “Defensive.” In recent memory, there was the first half of 2016 where the US 10-Year Treasury note Interest rate dropped all the way to 1.37%, and these types of higher-yielding dividend-payers did very well.

WisdomTree's innovation was to incorporate a measure of forward-looking earnings expectations into its dividend-focused approach. Additionally, the approach focuses on companies with high return on assets, return on equity and low leverage. The result of this approach is an exposure to dividend-payers that may not have a high current dividend yield but could very well have strong potential for future dividend growth.

## **Flipping the script on dividend-focused sector exposures: Combined Weight of Real Estate, Utilities & Telecommunication Services sectors**

**as of December 31, 2017**

*Sources: WisdomTree, Factset. You cannot invest directly within an Index.*

- If interest rates rise, what happens is that fixed income becomes a larger and larger source of important competition for asset flows that were formerly going to high yielding dividend payers. Many of those high yielding dividend payers are in the Utilities, Real Estate and Telecommunication Services sectors.
- Even though every constituent within WisdomTree's Quality Dividend Growth methodology must be a dividend-payer, this approach still leads to a very significant underweight to these sectors. This was true in the United States, the Eurozone and the Global Developed market regions.

*Initial Conclusion:* If interest rates are indeed likely to rise in 2018, we think the concept of Quality Dividend Growth could be one possible solution to better align an equity portfolio with that thesis. As we can see, the market capitalization indexes do not incorporate this tilt away from these more interest rate sensitive sectors.

### Was February 2018 a short-term correction or something more?

I wish we could answer this one with certainty—as do many clients. Unfortunately, that is simply not possible with the current set of tools available. What we can do is utilize an analysis of the factors looking back at history and figure out what time has told us about equity performance either late in the cycle or during the market correction. Joe Tenaglia, an Asset Allocation Strategist on our team, did some very interesting work on this exact subject.

### Late cycle factor performance

We are hearing wide agreement that the US equity market is late in the cycle after both a long-term bull market and economic expansion. If February of 2018 is merely a short-term blip on the radar preceding a longer grind higher, then it's important to look at how different factors performed before market corrections over the past 20 or so years.

### Factor Performance 12-Months before S&P 500 Index Market Corrections: Green Indicates Outperformance of the S&P 500 Index Return

US Equity Correction		Returns 12 Months Before Correction				
Start Date	End Date	Size	Value	Quality	Momentum	S&P 500 Index
07/10/1997	27/10/1997	35.87%	44.18%	43.36%	42.00%	42.39%
17/07/1998	31/08/1998	17.51%	36.60%	31.38%	34.37%	29.36%
16/07/1999	15/10/1999	3.10%	8.04%	20.72%	21.62%	21.49%
24/03/2000	09/10/2002	79.59%	1.62%	22.03%	49.68%	21.90%
27/11/2002	11/03/2003	-2.64%	-23.55%	-15.29%	-8.40%	-17.00%
09/10/2007	09/03/2009	13.46%	16.50%	21.72%	25.15%	18.04%
23/04/2010	02/07/2010	73.56%	54.97%	42.40%	51.25%	45.89%
29/04/2011	03/10/2011	15.74%	2.04%	16.86%	18.12%	15.26%
21/05/2015	25/08/2015	14.50%	10.63%	16.11%	18.07%	15.18%
03/11/2015	11/02/2016	3.01%	-1.60%	5.95%	8.75%	6.75%

**Past performance is not indicative of future results.** You cannot invest directly in an Index. Sources: WisdomTree, Bloomberg, Yardeni Research Inc., Kenneth French Data Library. Values shaded in green indicate outperformance vs. S&P 500 Index during that time frame. Size refers to the Lo 30 portfolio of all listed stocks in the bottom 30% of the total US market capitalization. Value refers to the BIG HiBM portfolio of large-cap companies with high book/market ratios. Quality refers to the BIG HiOP portfolio of large-cap companies with high operating profitability. Momentum refers to the BIG HIPRIOR portfolio of large-cap companies with positive trailing price momentum.

- It's clear from the data that the Momentum factor delivered outperformance in the highest number of periods before market corrections in the last 20 years. If we recall, the 2017 calendar year saw very strong returns from the Momentum factor, confirming the market's "late cycle feel." It's notable, however, that Quality also did fairly well.

### Performance during equity market corrections

Of course, February of 2018 may very well signal a broader downturn in equities, so if that is indeed the case, we wanted to ask what the question as to what factors delivered during market corrections. This doesn't necessarily mean they delivered positive returns—the key is whether they mitigated some of the downside risk of the S&P 500 Index.

### Factor performance during S&P 500 Index market corrections: Green indicates outperformance of the S&P 500 Index return

US Equity Correction		Returns During Correction				
Start Date	End Date	Size	Value	Quality	Momentum	S&P 500 Index
07/10/1997	27/10/1997	-8.42%	-7.63%	-10.37%	-11.70%	-10.75%
17/07/1998	31/08/1998	-27.71%	-17.24%	-19.04%	-20.51%	-19.19%
16/07/1999	15/10/1999	-10.64%	-13.87%	-11.51%	-8.89%	-11.80%
24/03/2000	09/10/2002	-33.16%	-31.21%	-35.25%	-40.56%	-47.38%
27/11/2002	11/03/2003	-13.26%	-21.66%	-11.74%	-7.51%	-14.24%
09/10/2007	09/03/2009	-62.06%	-67.76%	-44.65%	-49.60%	-55.22%
23/04/2010	02/07/2010	-19.66%	-20.26%	-14.90%	-18.64%	-15.63%
29/04/2011	03/10/2011	-30.83%	-27.32%	-15.49%	-20.35%	-18.64%
21/05/2015	25/08/2015	-11.89%	-14.69%	-12.40%	-9.01%	-11.89%
03/11/2015	11/02/2016	-20.66%	-19.22%	-12.69%	-13.27%	-12.71%

**Past performance is not indicative of future results. You cannot invest directly in an Index.** Sources: WisdomTree, Bloomberg, Yardeni Research Inc., Kenneth French Data Library. Values shaded in green indicate outperformance vs. S&P 500 Index during that time frame. Size refers to the Lo 30 portfolio of all listed stocks in the bottom 30% of the total US market capitalization. Value refers to the BIG HiBM portfolio of large-cap companies with high book/market ratios. Quality refers to the BIG HiOP portfolio of large-cap companies with high operating profitability. Momentum refers to the BIG HIPRIOR portfolio of large-cap companies with positive trailing price momentum.

- In this case, the Quality factor was the standout, delivering some measure of downside risk mitigation in all of the S&P 500 Index corrections during the last 20 years, save one.

### The time for Quality is now

Many investors that we speak to have experienced very strong equity market returns within market capitalization-weighted indexes over the past decade. The style of selection or the differentiation in index methodology wasn't always that important. We think that the coming environment will more greatly reward

differentiated approaches, and that market capitalization weighting may not offer the best downside risk mitigation going forward.

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