WisdomTree US Multifactor: Not the low volatility you’re used to

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Since the inception of WisdomTree’s US Multifactor Index (WTUSMF) just over 14 months ago, the yield on the 10-year US government treasury has increased 60 basis points (bps)1. As can be seen in the chart below, over this same period, the S&P 500 returned 19% annualized, led by its highest-volatility stocks, while low volatility has underperformed, in line with what we’ve seen in past rising interest rate periods.

Figure 1: S&P 500 volatility quintile returns: Low volatility has underperformed during rising rate periods

Sources: WisdomTree, FactSet, 30 June 2017 to 31 August 2018. Quintiles are created by cutting the S&P 500 constituents as of 30 June 2017 into 5 groups, each with an equal number of stocks. The groups are set on the basis of the volatility of each individual constituent, with the 20% least volatile stocks in the first quintile and the 20% most volatile stocks in the fifth quintile.

Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.

WTUSMF’s implicit tilt to low volatility

Despite not using low volatility as an alpha-seeking factor, we are aware of its prowess in risk-adjusted terms and therefore use it as part of our strategy’s weighting mechanism. Also, given some of our factor definitions, like risk-adjusted returns for momentum, the composite multifactor score rewards lower-volatility companies and implicitly tilts the strategy toward this factor.

Figure 2: WisdomTree US Multifactor Index vs S&P 500 - Volatility quintile attribution

Sources: WisdomTree, FactSet, 30 June 2017 to 31 August 2018. Quintiles are created based on the volatilities of the constituents within each index, the WisdomTree US Multifactor Index and the S&P 500 Index. Each Index is split into five equally-sized groups based on number of stocks. The first quintile of each index represents the 20% least volatile stocks, whereas the fifth quintile of each index represents the 20% most volatile stocks. The allocation impact measures the effect of the WisdomTree US Multifactor Index's weighting of its positions within the different volatility quintiles against the S&P 500. The Stock Selection impact measures the effect of the WisdomTree US Multifactor Index's stock selection within each of the volatility quintiles, against the S&P 500. The interaction impact measures a combined impact from both the allocation and selection impacts. The total attribution measures the out or underperformance of the WisdomTree US Multifactor Index vs. the S&P 500.

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Stock selection value added within lowest-volatility quintile

The table above shows the performance attribution of WTUSMF versus the S&P 500 in terms of volatility quintiles. It is interesting to see how, since its inception, WTUSMF has been over-weight the lowest-volatility quintile while being under-weight the rest.

The WTUSMF has outperformed the S&P 500, despite having its highest allocation and greatest over-weight in what was the worst performing segment for the S&P 500. Strong stock selection is evident throughout four of the five volatility quintiles, combining for 333 basis points of outperformance.

Typical single-factor low-volatility portfolios tend to naively over-weight the lowest-volatility stocks in the investment universe, resulting in significant deviations in active weight while not providing differentiated stock selection. As a result of their methodology, these pure low-volatility portfolios magnify their interest rate sensitivity, and their performance becomes heavily dependent on the path of rates, as they have no other means of factor diversification.

Conclusion

WisdomTree implements a composite multifactor blending approach targeting value-added stock selection. Although we do not explicitly target low volatility as an alpha-seeking factor, our methodology results in an implicit tilt toward it. This implicit tilt allows the stock selection benefits inherent in our methodology to persist and thus give alpha potential regardless of the path in interest rates.

1 Bloomberg, 30 June 2017 to 31 August 2018.

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