

WisdomTree US Multifactor Index: Taking on the competition

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WisdomTree believes it is possible to generate greater excess return over time by taking on greater active risk and concentrating holdings in stocks with greater exposure to the factors historically associated with excess return. We designed the WisdomTree US Multifactor Index to target these factors, and believe our method of combining factors to maximize the potential for higher absolute and risk-adjusted returns is unique.

Strong performance results

Historically, the WisdomTree US Multifactor Index was able to outperform other indices with similar objectives on both an absolute return and risk-adjusted return basis. It is also interesting to note that the Index showed 304 basis points (bps) of outperformance against the MSCI USA Index from 30 June 2017 to 30 June 2018, a barometer for US equity markets, while also exhibiting less risk—increasingly important given the rise in volatility that we saw in 2018 thus far relative to 2017.

One-year performance

Index Name	Avg. Ann. Return	Avg. Ann. Std. Dev.	Sharpe Ratio	Beta vs. MSCI USA Index	Correlation vs. MSCI USA Index
WisdomTree US Multifactor Index	11.21%	12.87%	0.77	0.87	0.93
MSCI USA Select Factor Mix Index	9.50%	13.13%	0.63	0.93	0.98
MSCI USA Diversified Multifactor Index	10.00%	14.07%	0.62	0.97	0.96
Scientific Beta USA Multi-Beta Multi-Strat EW-4F Index	9.84%	12.88%	0.67	0.90	0.97
S&P 500 Quality, Value & Momentum MultiFactor Index	10.56%	13.57%	0.69	0.90	0.92
MSCI USA Index	8.17%	13.85%	0.50	1.00	1.00

Sources: Factset, Bloomberg, MSCI. Data from 30 June 2017 to 30 June 2018. Returns assume reinvestment of net dividends, where “net” refers to net of tax withholdings. Includes backtested returns. The WisdomTree US Multifactor Index began live calculation on 12 June 2017. The MSCI USA Select Factor Mix Index began live calculation on 16 January 2017. The MSCI USA Diversified Multifactor Index began live calculation on 17 February 2015. The Scientific Beta USA Multi-Beta Multi-Strat EW-4F Index began live calculation on 20 December 2013. The S&P 500 Quality, Value & Momentum Multifactor Index began live calculation on 30 January 2017.

Historical performance is not an indication of future performance and any investments may go down in value.

WisdomTree US Multifactor Index

WisdomTree blends both fundamental and technical factors to create a composite factor score for the purposes of stock selection within its index. The composite score is an average of four factors, with value and quality being driven by fundamentals, while momentum and correlation are driven by technical factors or price. Because each factor has an equal weight, all of them push and pull the composite factor score of a given stock with the same force. In market environments exhibiting increased volatility, correlations and return dispersions, you might expect the technical factors to generate more force through larger changes in constituents' relative rankings on these factors, whereas the value and quality factors may not see as big changes in their relative rankings.

At the most recent quarterly rebalance, the largest change in scores for the stocks that dropped in weight were correlation, representing almost 50% of the total drops, and momentum, representing a little over 30%. The largest changes in scores for the additions were momentum (50%) and correlation (31%). Now, just because we didn't see a large change in individual fundamental scores doesn't mean the index fundamentals remain the same. The shifts, driven by the technical factors, did influence the composition and fundamentals of the index.

Due to sector-neutral constraints, we did not see large differences in the sectors in the index, however, there were some minor adjustments based on price changes since the last rebalance. The most notable changes to the basket are highlighted in the table below.

Comparison of fundamentals

Sources: WisdomTree, FactSet, as of 11 June 2018, the most recent rebalance as of this writing. Subject to change.

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- **Reinforced exposure towards mid-cap segment:** During the last quarterly rebalance, it was noticeable that the index rebalanced to include more mid-cap exposure, adding approximately 15%. This most recent rebalance saw continued confirmation of this with a small increase to mid-cap equities. This is important to note because since the last rebalance we have seen strong relative strength from the smaller capitalization segment. One comment about the equal-weighted S&P 500 is its mid-cap drift, and that can be seen in its weighted average market cap being \$48 billion compared with the S&P 500's \$203 billion. The WisdomTree US Multifactor Index now has a weighted average market cap of \$24 billion, showcasing even more of a size tilt away from pure mega caps.

- **Lower interest rate sensitivity continued:** We continue to witness increased volatility and poor performance from some of the “traditional” lower-volatility and high-dividend-yield securities. However, the risk-adjusted momentum score should work to potentially keep these types of securities from achieving a high composite rank. At the last rebalance, the aggregate index dividend yield fell by 33 bps, and the preference to remain in lower-dividend-yielding equities continued with this rebalance. The weighted average market cap and leverage of the index remain below the S&P 500; which both support potentially lower interest rate sensitivity.
- **Stepping up the quality:** Because quality is one of the factors, it’s no surprise to us that there was a slight increase in the return-on-equity and return-on-assets measurements. The quality score looks at companies that display strong quality metrics currently but also exhibit an improvement in the metrics. Typically, you would expect to “pay up” for this type of quality basket, so it is encouraging to see the index trade at a lower price-to-earnings (P/E) multiple than the S&P 500. On a trailing earnings basis, the index is priced more than 25% lower than both the S&P 500 and S&P 500 Equal Weight, which should attract interest from those concerned about rising multiples in the US.

The WisdomTree US Multifactor Index has been a relatively strong performing US equity index in 2018, and the rebalance process we just completed is a critical driver of its long-term addition to value. In follow-up posts, we will continue to showcase how the deep factor tilts of this process contrast with many other multifactor indices that involve much lower-grade tilts on the market. In our view, when designing a multifactor process that competes with a true alpha-seeking manager, one should lean into active share like this multifactor index does.

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