Checking In on Risk Factor Diversification

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Scott Welch, CIMA ®

Chief Investment Officer, Model Portfolios

This article is relevant to financial professionals who are considering offering Model Portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

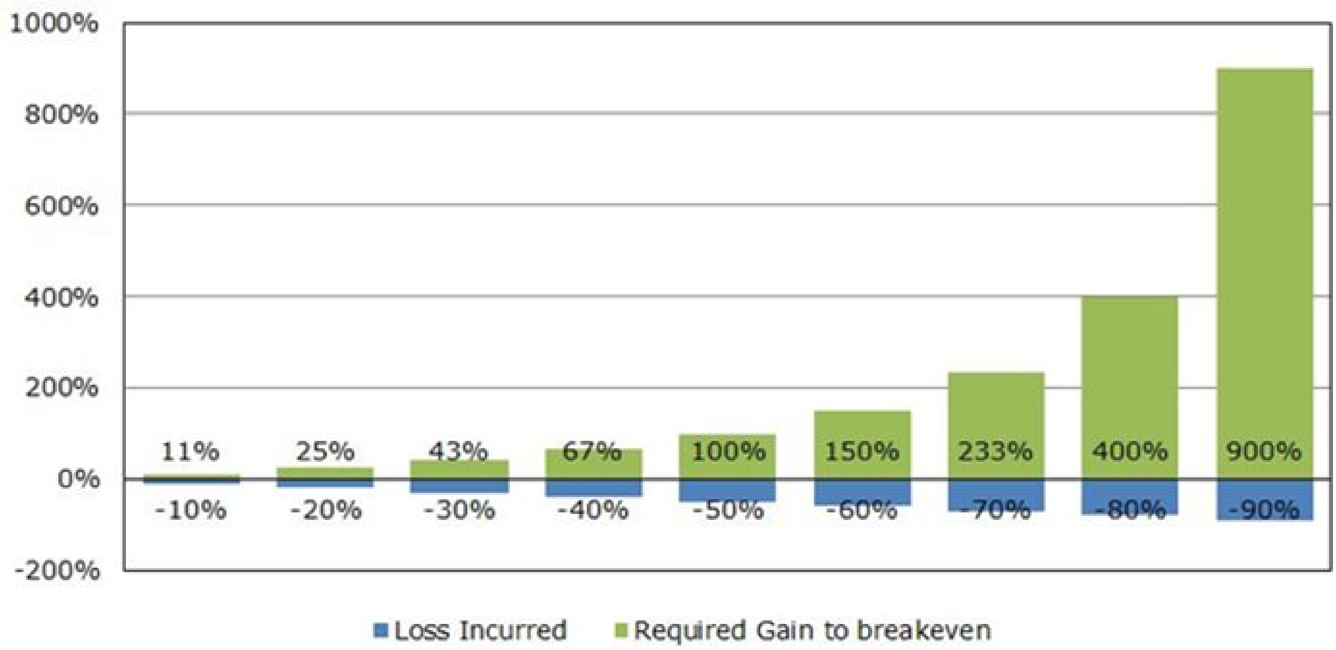
If you are a regular reader of WisdomTree blog posts, you know how seriously we take factor diversification in the construction of our Model Portfolios.

Almost everyone understands and agrees on the importance of ***asset allocation***—that is, diversifying a portfolio across multiple asset classes to improve the consistency and risk-adjusted performance potential of the portfolio. And many are very familiar with the “asset class quilt chart,” which illustrates just how difficult it can be to predict which asset classes will perform best and how diversifying may offer a more consistent performance.

																2006 - 2020	
2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**YTD**	**Ann.**	**Vol.**
REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	Large Cap 31.5%	Small Cap 20.0%	Comdty. 29.1%	Large Cap 9.9%	EM Equity 23.3%
EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	REITs 28.7%	EM Equity 18.7%	REITs 21.6%	Small Cap 8.9%	REITs 23.1%
DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 25.5%	Large Cap 18.4%	Large Cap 15.9%	High Yield 7.5%	Small Cap 22.6%
Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 22.7%	Asset Alloc. 10.6%	Small Cap 12.4%	REITs 7.1%	DM Equity 19.1%
Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 19.5%	DM Equity 8.3%	DM Equity 8.8%	EM Equity 6.9%	Comdty. 18.8%
Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	EM Equity 18.9%	Fixed Income 7.5%	Asset Alloc. 8.7%	Asset Alloc. 6.7%	Large Cap 16.7%
High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	High Yield 12.6%	High Yield 7.0%	High Yield 1.7%	DM Equity 5.0%	High Yield 12.2%
Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 8.7%	Cash 0.5%	Cash 0.0%	Fixed Income 4.5%	Asset Alloc. 11.8%
Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 7.7%	Comdty. -3.1%	EM Equity -1.0%	Cash 1.2%	Fixed Income 3.2%
Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 2.2%	REITs -5.1%	Fixed Income -1.6%	Comdty. -4.0%	Cash 0.8%

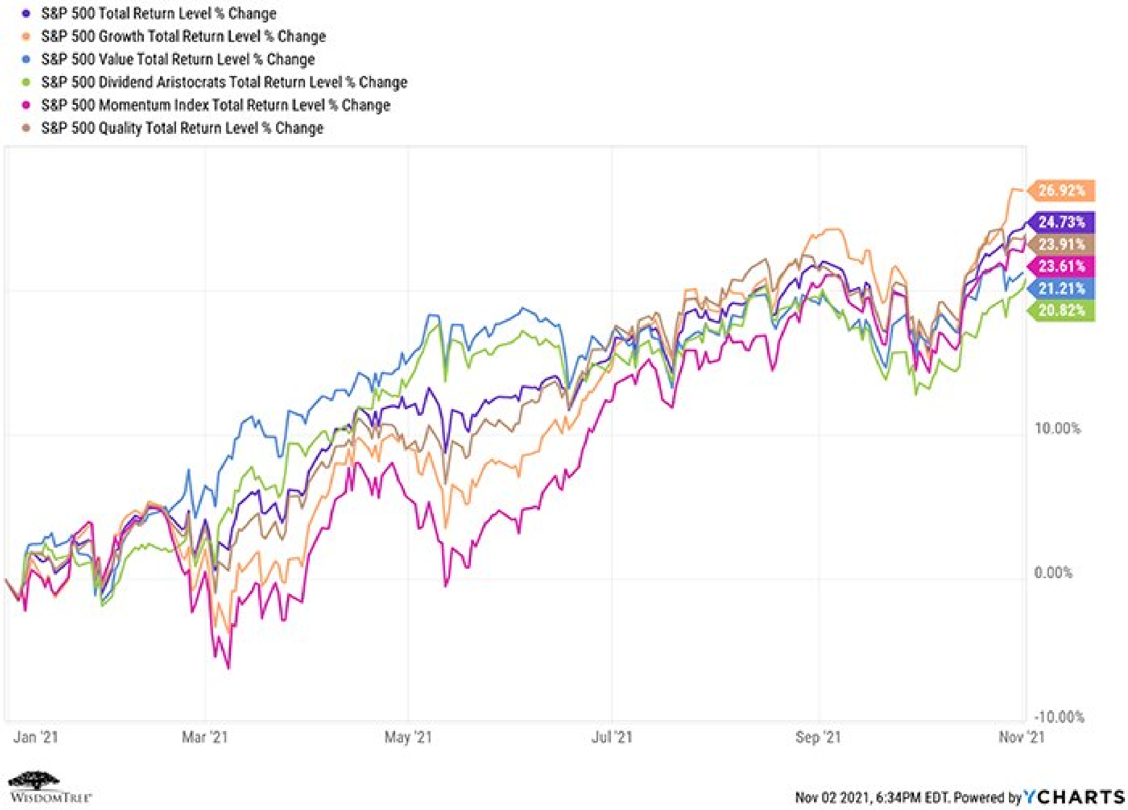
Sources: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor’s, J.P. Morgan Asset Management. Large Cap: S&P 500, Small Cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Commodity: Bloomberg Commodity Index, High Yield: Bloomberg Global HY Index, Fixed Income: Bloomberg U.S. Aggregate, REITs: NAREIT Equity REIT Index, Cash: Bloomberg 1–3 Month Treasury. The “Asset Allocation” portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg U.S. Aggregate, 5% in the Bloomberg 1–3 Month Treasury, 5% in the Bloomberg Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period from 12/31/05 to 12/31/20. All data represents total return for stated period. The “Asset Allocation” portfolio is for illustrative purposes only. Past performance is not indicative of future returns. You cannot invest in an index. Guide to the Markets – U.S. Data is as of September 30, 2021.

Why does consistency of performance matter? Let's remind ourselves of the ***power of compounding***—if you don't lose as much in down markets, you don't need to gain as much in up markets to still come out ahead.



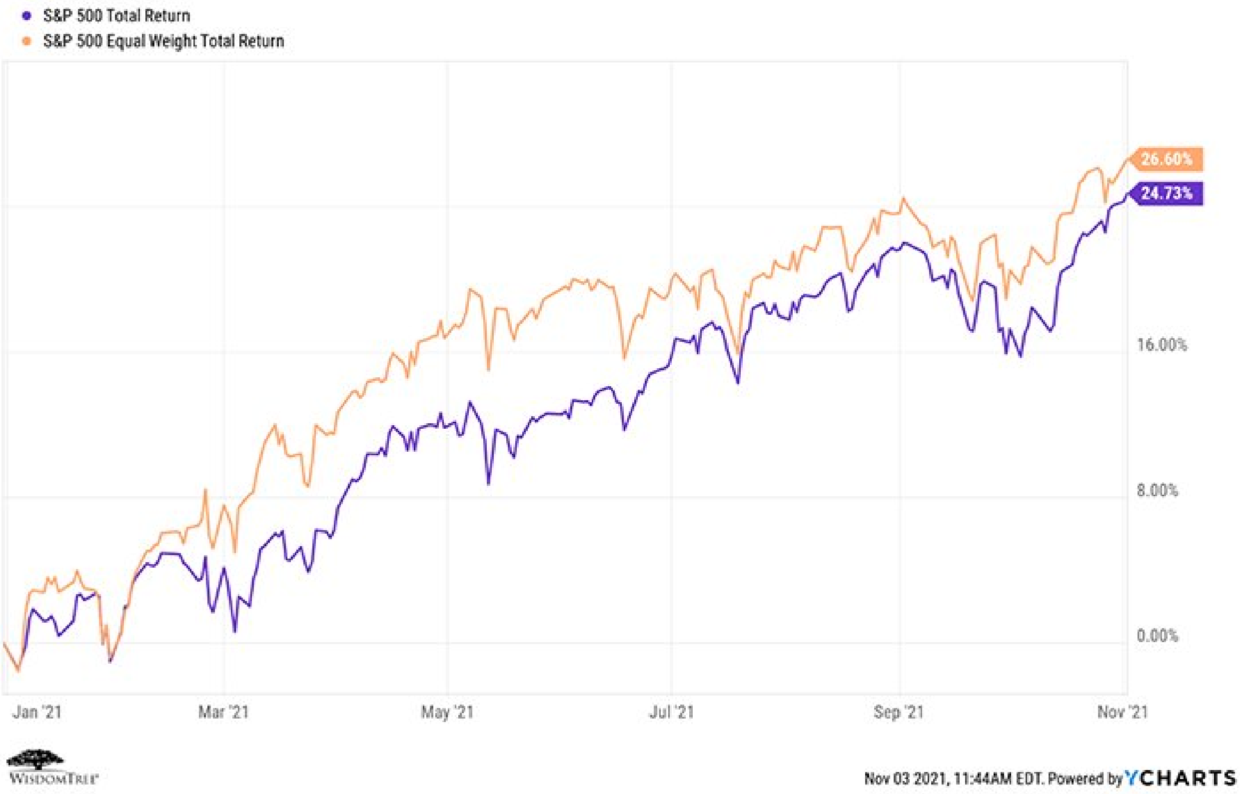
Source: BizNews, 9/30/14.

At WisdomTree, we take diversification one level further and diversify across ***risk factors*** as well as across asset classes. Take a look at the performances of multiple risk factors over the course of this year within the S&P 500 Index—note that there is an almost 7% return dispersion between them.



Source: YCharts, data year to date ("YTD") through 11/1/21. You cannot invest in an index, and past performance does not guarantee future performance.

Another factor that doesn't show up in the above chart is the "size" factor; that is, the performance of smaller-cap stocks versus larger-cap stocks. Using the S&P 500 Equal Weight Index as a proxy, we can see the outperformance of smaller-cap stocks over the course of this year.



Source: YCharts, data YTD through 11/2/21. You cannot invest in an index, and past performance does not guarantee future results.

It is also worth noting that factor performance is not necessarily consistent across asset classes. While value and quality are middle-of-the-pack performers YTD in large-cap stocks, where growth has dominated, they are performing much better in mid- and small-cap stocks, while growth has lagged (using the S&P 600 Index as the proxy for SMID-cap stocks).

Source: YCharts, data YTD through 11/2/21. You cannot invest in an index, and past performance does not guarantee future results.

As one final example, take a look at the YTD performance differential between broad market and small-cap emerging markets ("EM") stocks.

Source: YCharts, data YTD through 11/2/21. You cannot invest in an index, and past performance does not guarantee future results.

For definitions of terms in the chart, please visit the glossary.

We particularly love this last chart because we believe we are somewhat unique in that we make explicit allocations to non-U.S. small-cap stocks within many of our Model Portfolios, at both the EAFE and EM levels. [EAFE small caps have also outperformed this year, but the differential is not nearly as extreme as with EM.]

The point of the story is that, just like with asset classes, it is almost impossible to outguess the market with respect to which risk factors will outperform or for how long when they do. We prepare a "risk factor performance quilt" every month to highlight this point.

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021 YTD
Momentum (-1.6%)	Value (46.32%)	Correlation (24.04%)	Quality (15.8%)	LowVol (19.36%)	Quality (10.93%)	LowVol (-23.16%)	Value (58.13%)	Quality (25.67%)	LowVol (12.31%)	Quality (18.82%)	Value (44.52%)	LowVol (17.2%)	Momentum (7.46%)	Value (19.44%)	Quality (25.42%)	LowVol (-1.27%)	Size (28.03%)	Correlation (25.54%)	Value (23.65%)
LowVol (-2.56%)	WTUSMFU (38.38%)	Multifactor (21.43%)	Value (15.24%)	Momentum (17.42%)	Correlation (7.33%)	Momentum (-25.75%)	WTUSMFU (40.14%)	WTUSMFU (23.23%)	Momentum (12.08%)	Value (17.73%)	Size (35.77%)	Multifactor (16.54%)	LowVol (5.32%)	WTUSMFU (13.9%)	Size (22.21%)	Momentum (-2.14%)	Quality (27.97%)	WTUSMFU (15.73%)	Quality (18.97%)
Multifactor (-2.87%)	Correlation (34.08%)	Value (19.65%)	Correlation (15.0%)	Value (17.36%)	Size (7.18%)	Multifactor (-32.59%)	Quality (38.07%)	Value (20.57%)	Multifactor (10.85%)	WTUSMFU (17.2%)	WTUSMFU (35.31%)	Correlation (15.55%)	Quality (1.5%)	Quality (13.23%)	WTUSMFU (19.63%)	Correlation (-3.67%)	Value (27.75%)	Size (15.11%)	Size (18.49%)
Correlation (-7.41%)	Quality (32.91%)	LowVol (18.53%)	Multifactor (14.05%)	Multifactor (15.42%)	Multifactor (5.85%)	Quality (-35.08%)	Correlation (32.81%)	Correlation (20.12%)	Correlation (4.41%)	Size (16.7%)	Correlation (34.81%)	Momentum (15.32%)	Size (0.66%)	LowVol (13.06%)	Value (19.1%)	Multifactor (-4.01%)	LowVol (27.45%)	Quality (13.77%)	LowVol (15.46%)
Quality (-8.27%)	Multifactor (30.97%)	Quality (17.46%)	WTUSMFU (11.18%)	WTUSMFU (14.6%)	WTUSMFU (5.77%)	Size (-36.67%)	Size (32.79%)	Momentum (17.56%)	Quality (3.4%)	Multifactor (15.67%)	Quality (33.78%)	Size (14.29%)	Multifactor (0.55%)	Size (11.59%)	Momentum (18.77%)	Size (-4.38%)	WTUSMFU (27.1%)	Momentum (8.65%)	Multifactor (14.18%)
Value (-15.47%)	Size (30.15%)	WTUSMFU (17.44%)	Size (7.59%)	Size (13.39%)	Momentum (5.59%)	Value (-38.47%)	Multifactor (24.59%)	Multifactor (17.38%)	Size (1.05%)	Correlation (15.52%)	Multifactor (32.23%)	Value (13.58%)	WTUSMFU (-1.31%)	Momentum (9.95%)	Multifactor (17.32%)	Quality (-6.65%)	Momentum (26.01%)	Multifactor (4.24%)	Momentum (13.85%)
WTUSMFU (-17.97%)	LowVol (27.01%)	Momentum (17.02%)	Momentum (5.59%)	Quality (12.57%)	LowVol (1.14%)	WTUSMFU (-38.85%)	LowVol (20.2%)	LowVol (15.94%)	WTUSMFU (0.13%)	Momentum (13.15%)	Momentum (27.99%)	Quality (13.52%)	Value (-5.9%)	Multifactor (7.97%)	LowVol (17.24%)	WTUSMFU (-7.85%)	Correlation (23.15%)	LowVol (0.94%)	WTUSMFU (11.21%)
Size (-22.11%)	Momentum (25.57%)	Size (13.16%)	LowVol (5.07%)	Correlation (11.24%)	Value (0.27%)	Correlation (-41.0%)	Momentum (15.13%)	Size (14.5%)	Value (-1.34%)	LowVol (12.9%)	LowVol (23.72%)	WTUSMFU (12.72%)	Correlation (-7.79%)	Correlation (7.59%)	Correlation (13.51%)	Value (-13.2%)	Multifactor (20.11%)	Value (-0.23%)	Correlation (6.33%)

Source: Bloomberg, as of 10/31/21. The starting universe for the referenced "factor portfolios" is the 800 largest companies listed in the U.S. Securities in the Low Correlation portfolio are selected based on their trailing 6- and 12-month correlation versus the broad market. Securities in the Low Volatility portfolio are selected based on their trailing 12-month standard deviation. Securities in the Momentum portfolio are selected based on their trailing 6- and 12-month risk-adjusted performance. Securities in the Quality portfolio are selected based on stronger current and historical (three-year) measures of profitability compared to their peers in the same GICS industry using four main variables: return on equity, return on assets, gross profits over assets and cash flow over assets. Securities in the Value portfolio are selected based on more attractive valuation metrics compared to their peers in the same GICS industry using six main variables: sales-to-price, book-to-price, earnings-to-price, estimated earnings-to-price, EBITDA-to-enterprise value and operating cash flow-to-price. Securities in the Size portfolio are selected based on their market capitalization compared to their peers in the starting universe. Securities in the Multifactor portfolio are selected based on a composite score calculated by equally weighting their low correlation, momentum, quality and value scores.

For definitions of terms mentioned above, please visit the glossary.

Conclusions and Model Portfolio Implications

While all WisdomTree Model Portfolios have different mandates, they all have certain common characteristics at the asset allocation and portfolio construction levels:

1. Global in nature. We are a global shop, and we believe in global diversification.

2. ETF-centric, to improve the potential for optimizing fees and taxes.

3. "Open architecture"—they include both WisdomTree and third-party products. This is not only the right thing to do from the end client perspective, but it also ensures that we can access any and all risk factor exposures we want to include in a given model.

4. The ETF structure and embedded risk factor tilts inherent in the WisdomTree product set allow us to build "core/satellite" portfolios—increasing the potential to deliver both cost and tax efficiency and also outperformance versus cap-weighted beta portfolios over full market cycles.

5. We charge no strategist fee—our revenue is derived solely from the expense ratios associated with the WisdomTree products we choose to include.

We believe in diversification and the power of compounding—we seek to deliver consistent performance regardless of market regime. We believe that diversifying at both the asset class and risk factor levels optimizes our potential for meeting that objective.

You can learn more about our Model Portfolios at our Model Adoption Center.

Important Risks Related to this Article

Neither diversification nor an asset allocation strategy assures a profit or eliminates the risk of experiencing investment losses.

For Retail Investors: WisdomTree's Model Portfolios are not intended to constitute investment advice or investment recommendations from WisdomTree. Your investment advisor may or may not implement WisdomTree's Model Portfolios in your account. The performance of your account may differ from the performance shown for a variety of reasons, including but not limited to: Your investment advisor, and not WisdomTree, is responsible for implementing trades in the accounts; differences in market conditions; client-imposed investment restrictions; the timing of client investments and withdrawals; fees payable; and/or other factors. WisdomTree is not responsible for determining the suitability or appropriateness of a strategy based on WisdomTree's Model Portfolios. WisdomTree does not have investment discretion and does not place trade orders for your account. This material has been created by WisdomTree, and the information included herein has not been verified by your investment advisor and may differ from information provided by your investment advisor. WisdomTree does not undertake to provide impartial investment advice or give advice in a fiduciary capacity. Further, WisdomTree receives revenue in the form of advisory fees for our exchange-traded Funds and management fees for our collective investment trusts.

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WisdomTree primarily uses WisdomTree Funds in the Model Portfolios unless there is no WisdomTree Fund that is consistent with the desired asset allocation or Model Portfolio strategy. As a result, WisdomTree Model Portfolios are expected to include a substantial portion of WisdomTree Funds notwithstanding that there may be a similar fund with a higher rating, lower fees and expenses or substantially better performance. Additionally, WisdomTree and its affiliates will indirectly benefit from investments made based on the Model Portfolios through fees paid by the WisdomTree Funds to WisdomTree and its affiliates for advisory, administrative and other services.