

Concerned about Volatility in 2016? Think about the Quality Factor

Published January 12, 2016

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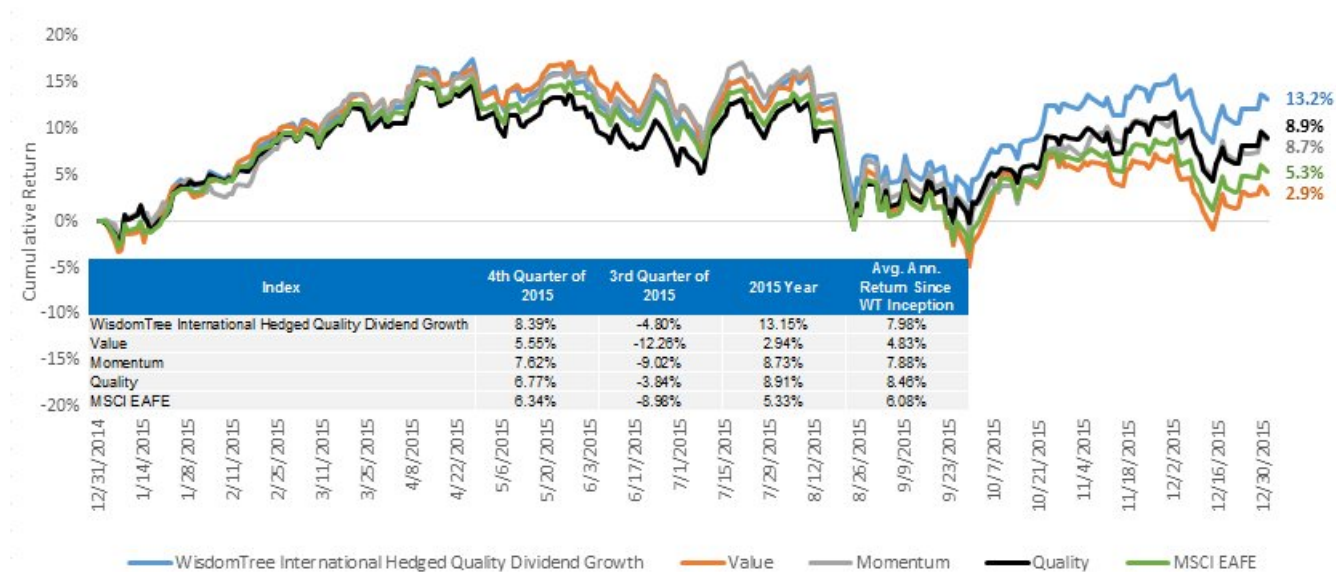
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It is that time when we are getting bombarded with various outlooks for the year ahead in the markets. There is no shortage of uncertainty:

- 2016 is a presidential election year in the United States, and there is no incumbent candidate. Historically, U.S. equity markets¹ have experienced greater turbulence during these types of election years.
- 2015 saw oil prices start at approximately \$50 per barrel and end at \$37 per barrel—a nearly 30% decline.² Political tensions between Iran and Saudi Arabia have become more intense, again creating more uncertainty about the direction of oil.
- The U.S. dollar is coming off a period of dramatic gains in the previous 12 to 18 months.³ Will that appreciation against foreign currencies slow or continue apace? These are only some of the sources of uncertainty that are influencing markets in early 2016. However, a few themes from 2015, in our opinion, could remain important in 2016:
- A stronger U.S. dollar makes imports from foreign firms into the U.S. more competitive, a favorable factor for international stocks.
- Hedging exposure to foreign currency fluctuations against the U.S. dollar remains important, as we continue to believe that currency offers a form of uncompensated risk.
- As markets deal with uncertainty, we continue to believe that higher-quality companies—particularly those with lower leverage—may be better positioned to respond to changing conditions.

Bottom Line: For those concerned about the potential for developed international equity market volatility in the near term, we find it informative to look at a recent market “stress test” period, the third quarter of 2015, in which “quality” distinctly outperformed other smart beta factors like momentum and value.⁴

How the Quality Factor Outperformed in 2015



Sources: Bloomberg, MSCI. Average annual return since WisdomTree inception is from 12/2/13 to 12/31/15, which covers the period of live performance for the WisdomTree International Hedged Quality Dividend Growth Index. Value refers to the MSCI EAFE Enhanced Value Index. Momentum refers to the MSCI EAFE Momentum Index. Quality refers to the MSCI EAFE Quality Index. Returns for the MSCI Indexes are measured in local currency terms so as not to be impacted by fluctuations of developed international currencies against the U.S. dollar. Past performance is not indicative of future results. You cannot invest directly in an index.

• **Zooming in on the 2015 “Stress Test”:** As has been the case historically in markets, the road to outperformance is typically paved by limiting downside moves during tough market environments. In the third quarter of 2015, the MSCI EAFE Index was down nearly 9%. Both the [WisdomTree International Hedged Quality Dividend Growth](#) and the MSCI EAFE Quality Indexes were down substantially less. On the other hand, the value and momentum-focused slices of the MSCI EAFE Index underperformed the broader market (the MSCI EAFE Index) during this period.

• **What Does the Longer-Term Data Tell Us?** While the December 2, 2013, inception date of the WisdomTree International Hedged Quality Dividend Growth Index inhibits much in the way of long-term analysis, the MSCI EAFE Quality Index does in fact have data extending back to December 1, 1975. Over this period, through December 31, 2015, we saw that there were 71 rolling three-month periods in which the MSCI EAFE Index was down more than 5.0%. During those periods, the MSCI EAFE Quality Index outperformed the MSCI EAFE Index, on average, by about 2.5%. Interestingly, during periods in which the MSCI EAFE Index was not down by more than 5.0%, the performance of the two Indexes was quite similar. The third quarter of 2015 was no exception, and we believe this indicates longer-term potential to see outperformance of the quality factor during particularly tough markets.⁵

• **“Quality” Can Mean Different Things to Different Indexes** The WisdomTree International Hedged Quality Dividend Growth Index does not focus on the quality factor in quite the same way as the MSCI EAFE Quality Index does, but we can see that in 2015 both of these Indexes outperformed the broad market, and both went down less than the broad market in the third quarter. But for the full year, the WisdomTree Index distinctly outperformed. What factors were most responsible for this difference?

• **Sectors:** The WisdomTree International Hedged Quality Dividend Growth Index was, on average, more

than 20% under-weight to the Financials sector for 2015 compared to the MSCI EAFE Index, and the Financials that were included substantially outperformed those in the MSCI EAFE Index. This Index was also more than 3% under-weight to the Energy sector, which was a helpful under-weight. • **Regions:** We saw approximately 10% to 15% better performance among United Kingdom and eurozone stocks in the WisdomTree International Hedged Quality Dividend Growth Index compared to the MSCI EAFE Index stocks in those regions. Those are also two of the largest regional exposures in the Indexes, totaling about 50% weight. **What to Expect in 2016** There is no way to know what 2016 will bring in the way of performance, but, as we mentioned, some of the key drivers behind the WisdomTree International Hedged Quality Dividend Growth Index's strong 2015 remain in place, and if markets do get volatile, historical analysis does in fact suggest that in tough markets the quality factor has the potential to outperform.

1Refers to U.S. companies listed on U.S. stock exchanges. Source: Professor Jeremy Siegel, "Stocks for the Long Run," updated to 2015. 2Source: Bloomberg, with oil price specified as the price per barrel of West Texas Intermediate Crude oil on dates 12/31/14 and 12/31/15. 3Source: Bloomberg, with U.S. dollar specified as the Federal Reserve U.S. Trade-Weighted Major Currencies U.S. Dollar Index. 4Source: MSCI. Comparison is among the MSCI EAFE Momentum, the MSCI EAFE Quality and the MSCI EAFE Enhanced Value Indexes, with returns all measured in local currency for period 6/30/15– 9/30/15. 5Source: MSCI, with data from 12/1/1975 to 12/31/2015.

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