Factor, Factor, Gimme the News

Published May 27, 2021

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.

Doctor Doctor, gimme the news
I got a bad case of lovin' you
No pill's gonna cure my ill
I got a bad case of lovin' you

(From "Bad Case of Loving You (Doctor, Doctor)", by Robert Palmer, 1979)

We last visited the topic of factor diversification roughly a year ago. Most investors are seemingly very familiar with the visual of an asset class "performance quilt," which highlights the importance of asset class diversification.

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD	2006 - 2020 Ann.	2006 - 2020 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%	Small Cap 12.7%	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 8.3%	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%	Comdty. 6.9%	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%	Large Cap 6.2%	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 3.6%	EM Equity 6.9%	Comdty. 18.8%
Asset Alloc. 15.[illegible]%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 2[illegible].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. 3.3%	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%	EM Equity 2.3%	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%	High Yield -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 -3.4%	Comdty. -4.0%	Cash 0.8%

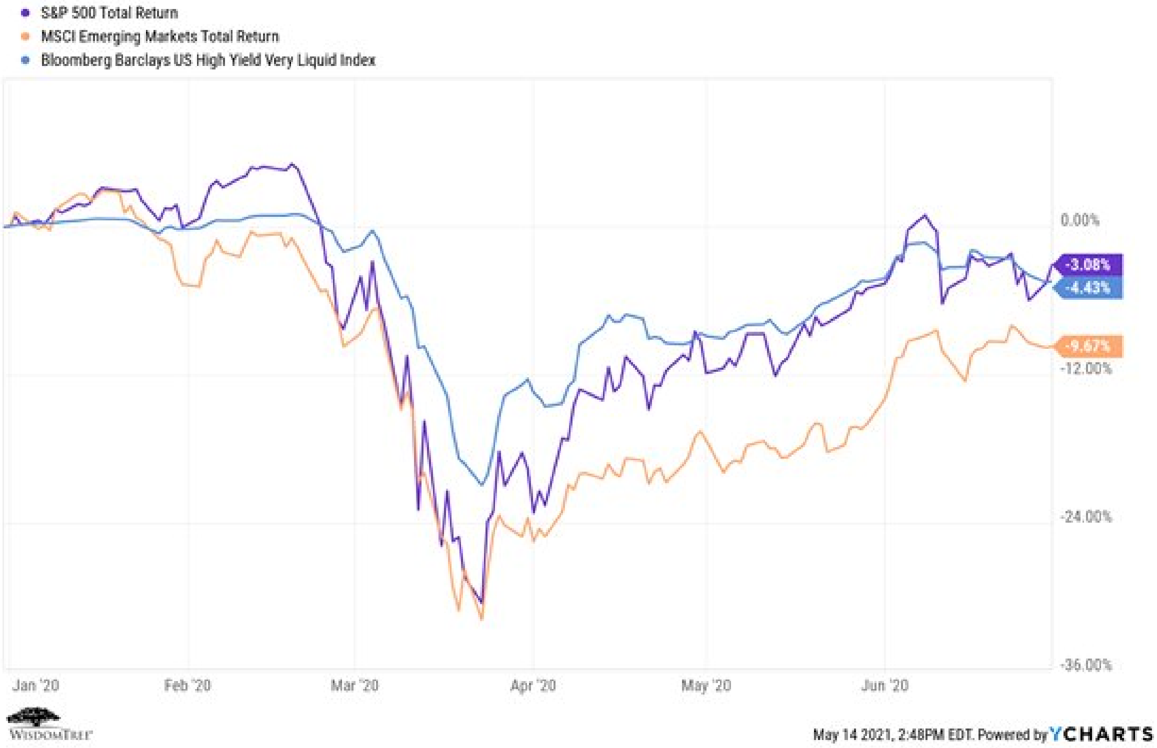
Sources: J.P. Morgan Asset Management Guide to the Markets, 3/31/21, Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management. Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Commodity: Bloomberg Commodity, High Yield: Bloomberg Barclays Global High Yield, Fixed Income: Bloomberg Barclays U.S. Aggregate Bond, REITs: NAREIT All Equity REITs, Cash: Bloomberg Barclays 1-3 Month U.S. 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 Barclays U.S. Aggregate Bond, 5% in the Bloomberg Barclays 1-3 Month U.S. Treasury, 5% in the Bloomberg Barclays Global High Yield, 5% in the Bloomberg Commodity and 5% in the NAREIT All Equity REITs. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period from 12/31/05–12/31/20. 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.

But what we believe is equally as important as asset class diversification is risk factor diversification. One way to think about asset classes is that they are simply convenient and investable bundles of different risk factors. This is one explanation for why asset allocation doesn't provide as much downside protection during market disruptions as many advisors and end clients expect.

Consider the simplistic example of U.S. large-cap stocks, emerging market stocks and high-yield bonds. Three very different asset classes, to be sure. But here is how they all performed during the worst of the global financial crisis.

Source: YCharts, data 7//1/08–7/1/09. You cannot invest in an index, and past performance does not guarantee future results.

Looks pretty similar. How about during the early days of the COVID-19 pandemic last year?

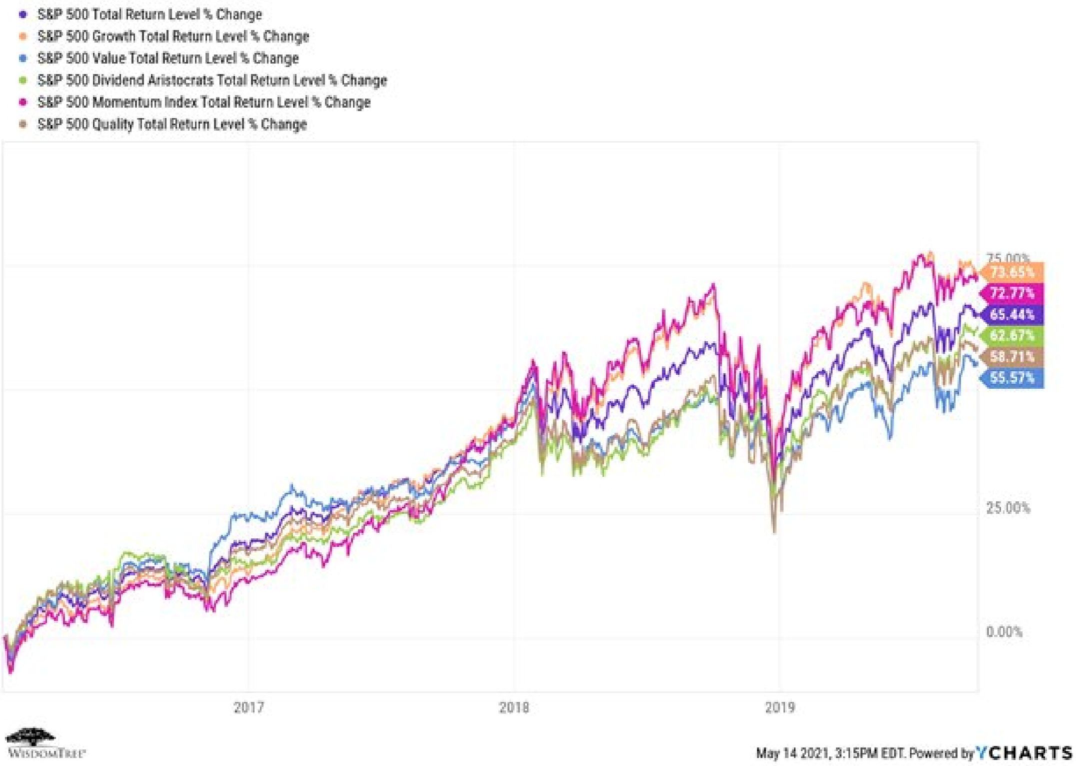


Source: YCharts, data 1/1/20–6/30/20. You cannot invest in an index, and past performance does not guarantee future results.

Again, very similar. Why is that? Because all three very different asset classes are highly exposed to the equity risk factor. Three different asset classes, but with very similar factor exposures.

That's why all WisdomTree Model Portfolios are diversified at both the asset class AND risk factor levels. We believe this helps deliver a better level of diversification and, therefore, more consistent performance over full market cycles.

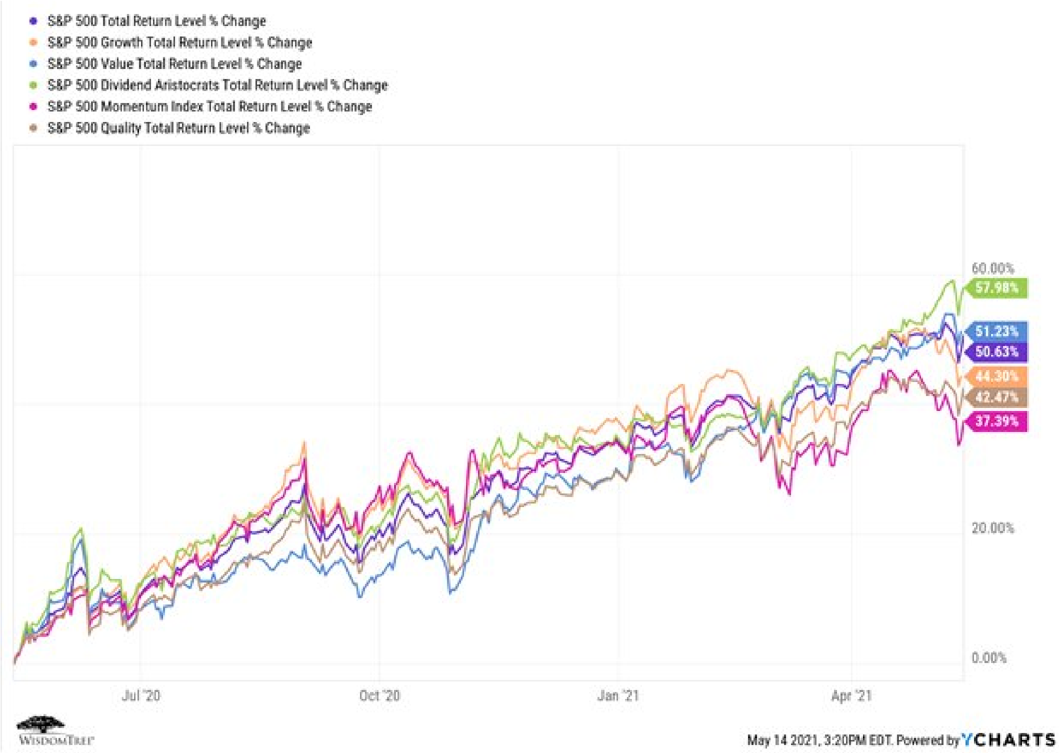
Take a look at the factor dominance under two different environments. First, let's look at January 1, 2015, until September 30, 2019.



Source: YCharts, data 1/1/15–9/30/19. You cannot invest in an index, and past performance does not guarantee future results.

It seems to be all growth and momentum, all the time. Value, quality and dividends were in the caboose of the train.

Compare that to the past 12 months. It appears dividends and value have driven performance, while growth and momentum have moved to the rear of the bus.



Source: YCharts, data 5/13/20–5/13/21. You cannot invest in an index, and past performance does not guarantee future results.

The point we're trying to make is that it is just as difficult to predict factor rotation as it is asset class rotation. We're not sure anyone predicted the massive factor rotation back toward small caps and value that occurred after the Pfizer vaccine announcement came out last November (though, given that many WisdomTree products have a value or size "tilt" to them, we certainly have enjoyed it). Value stocks in particular have roared back.

Source: YCharts, data 5/13/20–5/13/21. You cannot invest in an index, and past performance is not indicative of future results.

This is why we favor factor diversification as well as asset class diversification in all our Model Portfolios. We cannot guess factor rotation, which can happen quickly, so we build portfolios with diversified factor exposure.

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021 YTD
Momentum (-11.18%)	Value (40.90%)	Correlation (17.01%)	Correlation (11.07%)	Value (20.76%)	Quality (13.04%)	Low Vol (-26.49%)	Value (45.46%)	Quality (20.13%)	Multifactor (13.97%)	Value (16.8%)	Value (34.73%)	Correlation (20.35%)	Momentum (7.49%)	Value (16.07%)	Quality (27.01%)	Low Vol (1.85%)	Quality (36.45%)	Momentum (24.89%)	Value (12.68%)
Low Vol (-11.18%)	WTUSMFU (29.50%)	Multifactor (16.92%)	Quality (10.69%)	Multifactor (18.64%)	Multifactor (9.64%)	Momentum (-26.59%)	WTUSMFU (27.20%)	WTUSMFU (15.90%)	Low Vol (11.73%)	WTUSMFU (16.17%)	WTUSMFU (32.78%)	Value (14.19%)	Correlation (2.92%)	Low Vol (11.8%)	Size (22.75%)	Momentum (0.65%)	Size (29.48%)	Quality (24.83%)	WTUSMFU (7.95%)
Multifactor (-13.72%)	Size (27.07%)	Low Vol (14.67%)	Multifactor (8.59%)	Low Vol (17.52%)	Correlation (8.43%)	Multifactor (-29.07%)	Quality (25.37%)	Value (13.89%)	Momentum (11.08%)	Size (15.85%)	Size (32.13%)	Multifactor (13.67%)	Size (2.72%)	WTUSMFU (11.73%)	WTUSMFU (21.95%)	Size (-3.07%)	WTUSMFU (29.08%)	Size (21.88%)	Low Vol (6.93%)
Quality (-16.30%)	Correlation (26.45%)	Momentum (13.18%)	Value (7.24%)	Momentum (15.75%)	Size (6.49%)	Value (-30.86%)	Size (23.27%)	Size (12.49%)	Correlation (9.94%)	Momentum (15.81%)	Correlation (29.25%)	WTUSMFU (13.14%)	Low Vol (2.06%)	Size (10.99%)	Momentum (20.54%)	Multifactor (-3.81%)	Value (28.85%)	WTUSMFU (20.81%)	Size (6.91%)
Correlation (-16.37%)	Momentum (20.20%)	Quality (12.08%)	WTUSMFU (6.40%)	Correlation (15.57%)	WTUSMFU (6.15%)	Quality (-31.94%)	Correlation (21.76%)	Correlation (12.06%)	Quality (5.48%)	Correlation (15.70%)	Momentum (27.29%)	Quality (13.14%)	WTUSMFU (1.35%)	Momentum (10.07%)	Low Vol (19.33%)	Correlation (-4.41%)	Correlation (28.06%)	Multifactor (19.51%)	Multifactor (5.51%)
WTUSMFU (-22.15%)	Quality (19.49%)	WTUSMFU (11.67%)	Size (6.45%)	WTUSMFU (15.35%)	Momentum (5.6%)	Size (-36.84%)	Low Vol (17.38%)	Momentum (11.93%)	Size (2.78%)	Quality (15.4%)	Quality (26.05%)	Size (13.06%)	Multifactor (0.67%)	Correlation (6.61%)	Multifactor (19.32%)	WTUSMFU (-4.69%)	Momentum (27.01%)	Correlation (19.16%)	Momentum (4.55%)
Value (-21.09%)	Low Vol (18.93%)	Size (9.14%)	Momentum (2.90%)	Size (14.93%)	Low Vol (1.4%)	WTUSMFU (-36.71%)	Multifactor (16.26%)	Multifactor (10.50%)	WTUSMFU (1.84%)	Low Vol (13.95%)	Low Vol (24.56%)	Low Vol (11.39%)	Quality (-0.58%)	Multifactor (6.09%)	Value (17.61%)	Quality (-7.39%)	Low Vol (25.42%)	Low Vol (11.61%)	Quality (3.77%)
Size (-21.70%)	Multifactor (16.9%)	Value (8.86%)	Low Vol (2.26%)	Quality (14.08%)	Value (0.60%)	Correlation (-36.9%)	Momentum (16.77%)	Low Vol (9.54%)	Value (0.29%)	Multifactor (12.82%)	Multifactor (24.18%)	Momentum (10.29%)	Value (-2.3%)	Quality (4.89%)	Correlation (16.53%)	Value (-9.29%)	Multifactor (23.75%)	Value (2.88%)	Correlation (1.54%)

Source: Bloomberg, as of 4/30/21. 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 (3-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, 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.

Conclusions

All publicly available WisdomTree Model Portfolios have certain common characteristics:

1. They are global in nature;
2. They are diversified at both the asset class and risk factor levels;
3. They are ETF-focused, to optimize fees and taxes; and
4. We charge no strategist fee for them.

We are an open-architecture shop—that is, all our Models include both WisdomTree and third-party products—for many reasons: (a) it's simply the right thing to do, (b) it's what end clients assume, and advisors expect, and (c) it allows us to build more risk factor-diversified portfolios.

Asset class diversification is boring. We don't mean it's uninteresting, just that the whole point is, to use a golf expression, to keep the ball in the middle of the fairway. The power of compounding is immense—as Albert Einstein is credited with suggesting, "Compound interest is the most powerful force in the universe."

What that means is that 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.

We firmly believe risk factor diversification is a means to that end.

Important Risks Related to this Article

Neither diversification nor using an asset allocation strategy assures a profit or protects against loss.

WisdomTree Model Portfolio information is designed to be used by financial advisors solely as an educational resource, along with other potential resources advisors may consider, in providing services to their end clients. WisdomTree's Model Portfolios and related content are for information only and are not intended to provide, and should not be relied on for, tax, legal, accounting, investment or financial planning advice by WisdomTree, nor should any WisdomTree Model Portfolio information be considered or relied upon as investment advice or as a recommendation from WisdomTree, including regarding the use or suitability of any WisdomTree Model Portfolio, any particular security or any particular strategy. In providing WisdomTree Model Portfolio information, WisdomTree is not acting and has not agreed to act in an investment advisory, fiduciary or quasi-fiduciary capacity to any advisor or end client, and has no responsibility in connection therewith, and is not providing individualized investment advice to any advisor or end client, including based on or tailored to the circumstance of any advisor or end client. The Model Portfolio information is provided "as is," without warranty of any kind, express or implied. WisdomTree is not responsible for determining the securities to be purchased, held and/or sold for any advisor or end client accounts, nor is WisdomTree responsible for determining the suitability or appropriateness of a Model Portfolio or any securities included therein for any third party, including end clients.

Advisors are solely responsible for making investment recommendations and/or decisions with respect to an end client and should consider the end client's individual financial circumstances, investment time frame, risk tolerance level and investment goals in determining the appropriateness of a particular investment or strategy, without input from WisdomTree. WisdomTree does not have investment discretion and does not place trade orders for any end client accounts. Information and other marketing materials provided to you by WisdomTree concerning a Model Portfolio—including allocations, performance and other characteristics—may not be indicative of an end client's actual experience from investing in one or more of the funds included in a Model Portfolio. Using an asset allocation strategy does not ensure a profit or protect against loss, and diversification does not eliminate the risk of experiencing investment losses. There is no assurance that investing in accordance with a Model Portfolio's allocations will provide positive performance over any period. Any content or information included in or related to a WisdomTree Model Portfolio, including descriptions, allocations, data, fund details and disclosures, are subject to change and may not be altered by an advisor or other third party in any way.

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.

References to specific securities and their issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.