Is the “Factor Wheel” Rolling Again?

Published August 3, 2023

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.

Big wheel keep on turning
Proud Mary keep on burning
And we’re rolling, rolling
Rolling on the river

(John Fogerty and Credence Clearwater Revival, 1969, with an iconic cover by Ike & Tina Turner, 1971)

I last wrote about risk factor diversification this past March, and it is time to revisit this important topic.

As a reminder, most investors are familiar with the visual of an asset class “performance quilt,” which highlights the importance of asset class diversification.

																2008 - 2022	
2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD	Ann.	Vol.
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%	REITs 41.3%	Comdty. 16.1%	Large Cap 16.9%	Large Cap 8.8%	REITs 23.4%
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%	Large Cap 28.7%	Cash 1.5%	DM Equity 12.1%	Small Cap 7.2%	Small Cap 23.2%
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. 27.1%	High Yield -12.7%	Small Cap 8.1%	REITs 6.6%	EM Equity 23.0%
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 14.8%	Fixed Income -13.0%	Asset Alloc. 7.8%	Asset Alloc. 6.1%	Comdty. 20.2%
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%	Asset Alloc. 13.5%	Asset Alloc. -13.9%	High Yield 5.2%	High Yield 5.4%	DM Equity 20.0%
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%	DM Equity 11.8%	DM Equity -14.0%	EM Equity 5.1%	Fixed Income 2.7%	Large Cap 17.7%
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 1.0%	Large Cap -18.1%	REITs 3.0%	DM Equity 2.3%	High Yield 13.0%
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%	EM Equity -19.7%	Cash 2.3%	EM Equity 1.0%	Asset Alloc. 12.4%
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%	Fixed Income -1.5%	Small Cap -20.4%	Fixed Income 2.1%	Cash 0.6%	Fixed Income 4.2%
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%	EM Equity -2.2%	REITs -24.9%	Comdty. -7.8%	Comdty. -2.6%	Cash 0.4%

Sources: 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 US Aggregate, REITs: NAREIT Equity REIT Index, Cash: Bloomberg 1-3m 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 US Aggregate, 5% in the Bloomberg 1-3m 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 12/31/08 to 12/31/21. 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. J.P. Morgan "Guide to the Markets," U.S. data is as of 6/30/23.

But, as regular readers know, we believe **risk factor diversification** is equally as important as asset class diversification. And risk factor performance can be as difficult to forecast as asset class performance.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2008 - 2022	
															Ann.	Vol.
Min. Vol. -25.7%	Value 38.8%	Small Cap 26.9%	High Div. 14.3%	Cyclical 20.1%	Value 43.2%	Value 17.7%	Momen. 9.3%	Small Cap 21.3%	Momen. 37.8%	Min. Vol. 1.5%	Cyclical 36.3%	Momen. 29.6%	Value 29.2%	Defens. 5.3%	Min. Vol. 9.5%	Small Cap 23.2%
Defens. -26.7%	Cyclical 36.9%	Multi-Factor 18.3%	Min. Vol. 12.9%	Value 16.8%	Small Cap 38.8%	Min. Vol. 16.5%	Min. Vol. 5.6%	High Div. 16.3%	Cyclical 27.3%	Momen. -1.6%	Quality 34.4%	Cyclical 27.8%	Cyclical 27.6%	High Div. -3.8%	Momen. 9.2%	Value 21.4%
High Div. -27.6%	Multi-Factor 29.8%	Momen. 18.2%	Defens. 10.1%	Small Cap 16.3%	Multi-Factor 37.4%	High Div. 14.9%	Quality 4.6%	Value 15.9%	Quality 22.5%	High Div. -2.3%	Momen. 28.1%	Small Cap 20.0%	Quality 27.2%	Min. Vol. -9.2%	Quality 9.2%	Cyclical 20.9%
Quality -31.2%	Small Cap 27.2%	Cyclical 17.9%	Quality 7.8%	Multi-Factor 15.7%	Cyclical 35.0%	Multi-Factor 14.8%	Cyclical 2.6%	Cyclical 14.0%	Value 22.2%	Defens. -2.9%	Min. Vol. 28.0%	Quality 17.1%	Multi-Factor 25.1%	Value -14.0%	High Div. 9.1%	Momen. 19.0%
Small Cap -33.8%	Quality 24.9%	High Div. 15.9%	Multi-Factor 7.3%	Momen. 15.1%	Momen. 34.8%	Momen. 14.7%	High Div. 0.7%	Multi-Factor 13.7%	Multi-Factor 21.8%	Cyclical -5.3%	Value 27.7%	Multi-Factor 11.4%	Defens. 25.0%	Multi-Factor -15.5%	Cyclical 8.9%	Multi-Factor 18.5%
Value -36.9%	High Div. 18.4%	Min. Vol. 14.7%	Momen. 6.1%	Quality 12.8%	Quality 34.3%	Cyclical 13.6%	Multi-Factor 0.4%	Min. Vol. 10.7%	High Div. 19.5%	Quality -5.6%	Multi-Factor 26.6%	Min. Vol. 5.8%	High Div. 21.9%	Momen. -17.4%	Multi-Factor 8.5%	Quality 17.0%
Multi-Factor -39.3%	Min. Vol. 18.4%	Quality 14.2%	Value -2.7%	Min. Vol. 11.2%	High Div. 28.9%	Defens. 13.0%	Defens. -0.9%	Quality 9.4%	Min. Vol. 19.2%	Multi-Factor -9.7%	Small Cap 25.5%	Defens. 5.2%	Min. Vol. 21.0%	Quality -20.3%	Defens. 8.3%	High Div. 15.7%
Momen. -40.9%	Momen. 17.6%	Value 12.7%	Cyclical -3.4%	Defens. 10.7%	Defens. 28.9%	Quality 10.7%	Small Cap -4.4%	Defens. 7.7%	Small Cap 14.6%	Small Cap -11.0%	High Div. 22.5%	High Div. 1.7%	Small Cap 14.8%	Small Cap -20.4%	Value 8.0%	Defens. 14.5%
Cyclical -44.8%	Defens. 16.5%	Defens. 12.0%	Small Cap -4.2%	High Div. 10.6%	Min. Vol. 25.3%	Small Cap 4.9%	Value -6.4%	Momen. 5.1%	Defens. 12.3%	Value -11.1%	Defens. 21.4%	Value -0.2%	Momen. 12.9%	Cyclical -27.2%	Small Cap 7.2%	Min. Vol. 13.9%

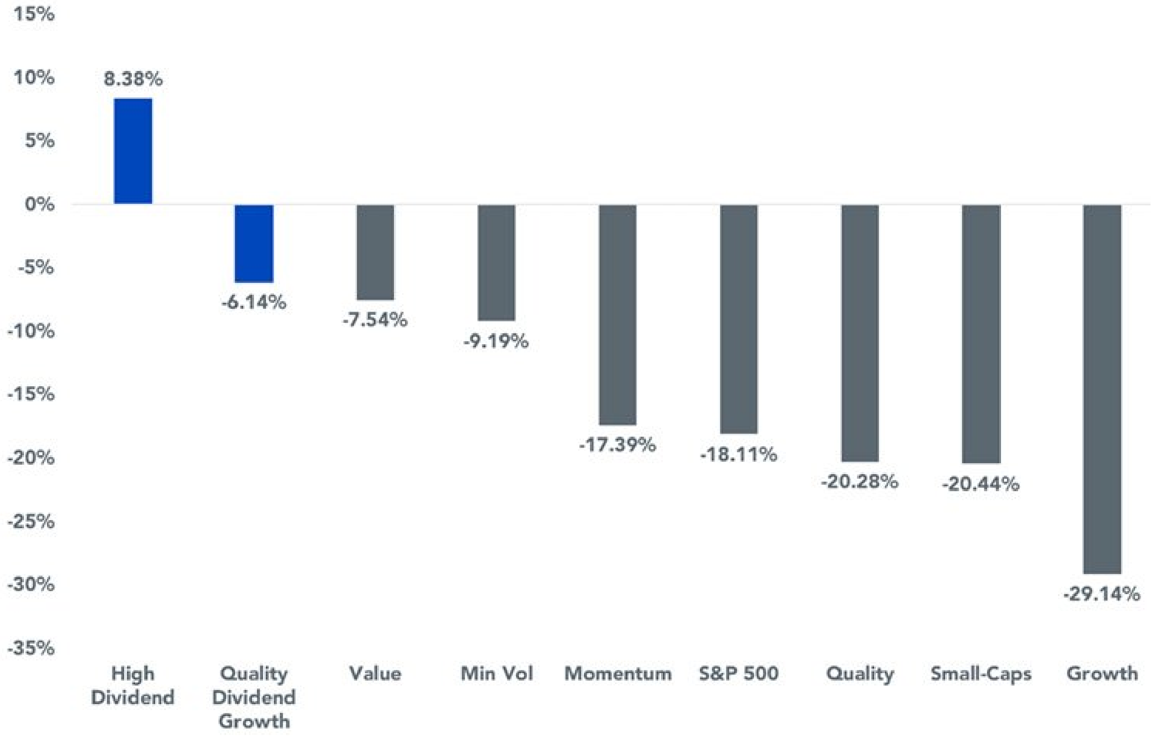
Sources: FactSet, MSCI, Russell, Standard & Poor's, J.P. Morgan Asset Management. The MSCI High Dividend Yield Index aims to offer a higher-than-average dividend yield relative to the parent index that passes dividend sustainability and persistence screens. The MSCI Minimum Volatility Index optimizes the MSCI USA Index using an estimated security co-variance matrix to produce low absolute volatility for a given set of constraints. The MSCI Defensive Sectors Index includes Consumer Staples, Energy, Health Care and Utilities. The MSCI Cyclical Sectors Index contains Consumer Discretionary, Communication Services, Financials, Industrials, Information Technology and Materials. Securities in the MSCI Momentum Index are selected based on a momentum value of 12-month and 6-month price performance. Constituents of the MSCI Sector Neutral Quality Index are selected based on stronger quality characteristics than their peers within the same GICS sector by using three main variables: high return on equity, low leverage and low earnings variability. Constituents of the MSCI Enhanced Value Index are based on three variables: price-to-book value, price-to-forward earnings and enterprise value-to-cash flow from operations. The Russell 2000 is used for Small Cap. The MSCI USA Diversified Multiple Factor Index aims to maximize exposure to four factors: Value, Momentum, Quality and Size. Annualized volatility is calculated as the standard deviation of quarterly returns multiplied by the square root of four. J.P. Morgan "Guide to the Markets," U.S. data is as of 12/31/22.

2023 YTD Risk Factor Review

2022 witnessed one of the greatest factor rotations in history, as growth fell to earth and value roared back to life.

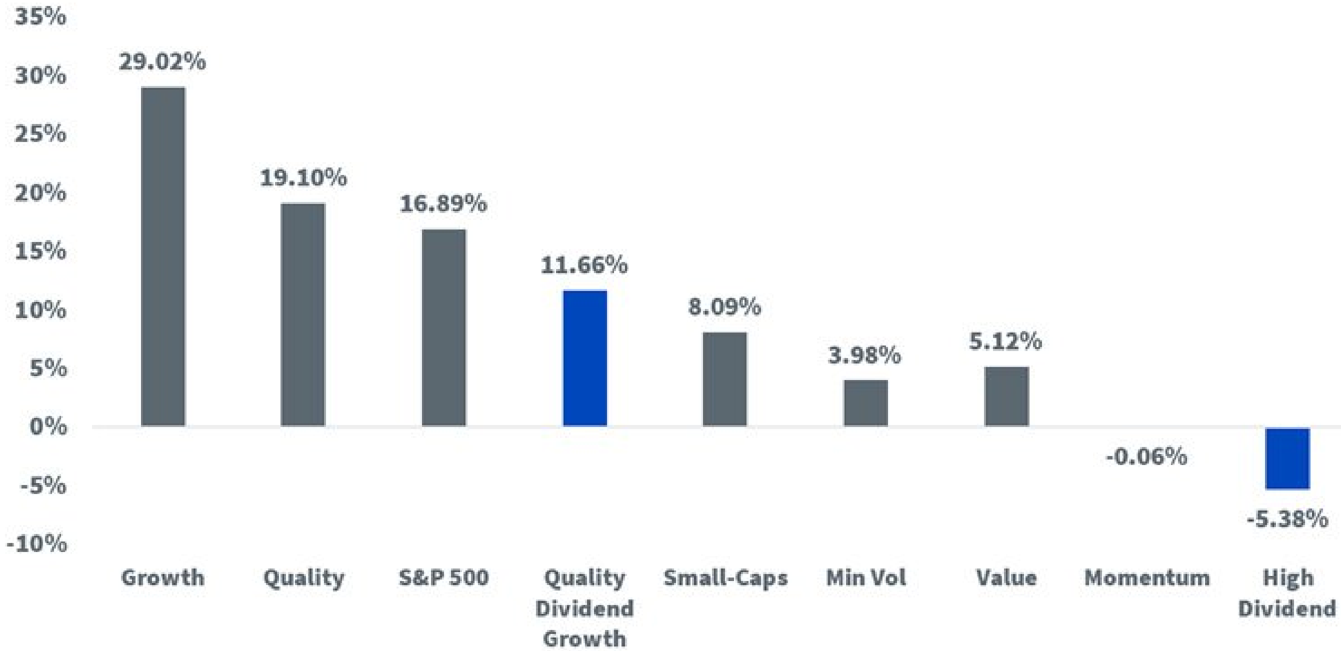
That "factor rotation" completely reversed itself in the first six months of 2023 (here, we use the S&P 500 Index as a proxy for the broader markets), as the market was dominated by a small handful of artificial intelligence (AI)-themed mega-cap tech stocks.

Here is the 2022 factor performance…



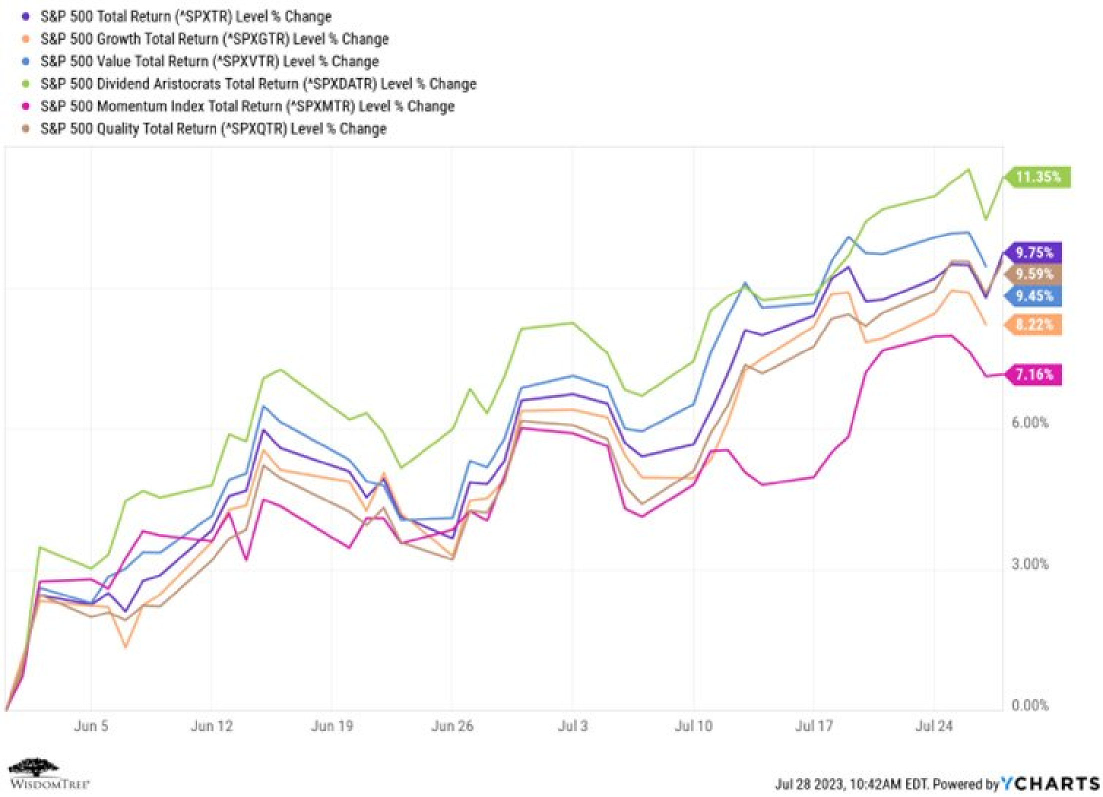
Sources: WisdomTree, FactSet, Russell, MSCI, S&P, data as of 12/31/22. You cannot invest directly in an index. Past performance is not indicative of future returns. High Dividend: WisdomTree U.S. High Dividend Index. Quality Dividend Growth: WisdomTree U.S. Quality Dividend Growth Index. Value: Russell 1000 Value Index. Small-Caps: Russell 2000 Index. Min Vol: MSCI USA Minimum Volatility Index. Quality: MSCI USA Sector-Neutral Quality Index. Momentum: MSCI USA Momentum Index. Growth: Russell 1000 Growth Index.

…in comparison to the same factor performances YTD through June 30, 2023:



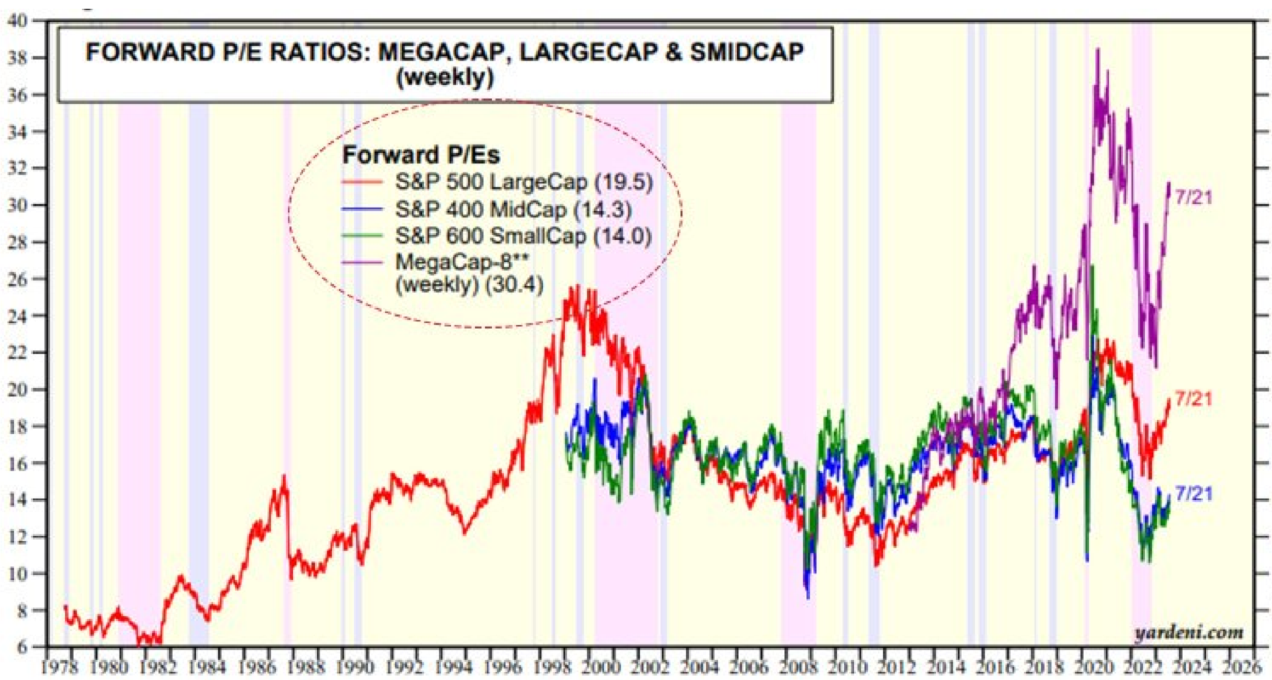
Sources: WisdomTree, FactSet, Russell, MSCI, S&P, data through 6/30/23. You cannot invest directly in an index. Past performance is not indicative of future returns. High Dividend: WisdomTree U.S. High Dividend Index. Quality Dividend Growth: WisdomTree U.S. Quality Dividend Growth Index. Value: Russell 1000 Value Index. Small-Caps: Russell 2000 Index. Min Vol: MSCI USA Minimum Volatility Index. Quality: MSCI USA Sector-Neutral Quality Index. Momentum: MSCI USA Momentum Index. Growth: Russell 1000 Growth Index.

BUT look at how those factors have “re-rotated” over the past 4–6 weeks—dividends, value and quality have moved back to the “top of the charts” while growth has fallen back.



Source: YCharts, from 6/1/23–7/27/23. You cannot invest in an index, and past performance is no guarantee of future results.

Why has this happened? Has “AI” fallen out of favor? We think most definitely not. We think the answer comes down to valuations. Here is a comparison of the forward-looking P/E ratios of the “MegaCap-8” (Alphabet [Google], Apple, Amazon, Meta [Facebook], Microsoft, Netflix, Nvidia and Tesla) versus the rest of the market.



* Weekly stock price index divided by 52-week forward consensus expected operating earnings per share.
** MegaCap-8 stocks include Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included.
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Blue shaded areas are correction declines of 10% to less than 20%. Yellow areas are bull markets. Source: I/B/E/S data by Refinitiv and Standard & Poor's.

Source: Yardeni Research, as of 7/27/23. You cannot invest in an index, and past performance does not guarantee future results.

We think investors are simply beginning to wonder if the future earnings potential of those "MegaCap-8" stocks can support such frothy valuations and are beginning to refocus on more attractively priced areas of the market (e.g., value and small cap).

And it is not simply that those other market areas are valued relatively attractively to the mega-cap growth stocks—they are also valued attractively relative to their own history.

	Current vs. 10-Year Med. P/E (ex. Neg. Earners) of Russell U.S. Size & Style Index Family			
	Size / Style	Value	Blend	Growth
1000	Large	15.3 / 16	21.5 / 19.3	33.6 / 24.6
MID	Mid	14.9 / 16.7	17.1 / 19.3	28.2 / 24
2000	Small	9 / 15.5	12.1 / 18.7	19.8 / 23.7
	Current P/E (ex. Neg Earners) as % of 10-Year Median			
	Size / Style	Value	Blend	Growth
1000	Large	95.8%	111.6%	136.3%
MID	Mid	89.4%	88.5%	117.6%
2000	Small	58.2%	64.4%	83.6%

Sources: WisdomTree, FactSet, as of 6/30/23. You cannot invest directly in an index, and past performance does not guarantee future results.

While large-cap stocks have dominated this year, we may be beginning to see small caps “close the gap.”

Source: YCharts. Top chart YTD through 7/27/23; bottom chart one-month data through 7/27/23 . You cannot invest in an index, and past performance does not guarantee future results.

What about the Remainder of 2023?

As we move through the remainder of 2023, the open question is whether the value, size and dividend “re-rotation” will continue. If we are correct in our view that interest rates will remain range-bound and “higher for longer,” then we think the answer is yes, assuming investors “fade” (or simply capture profits from) the AI trade and refocus on fundamentals and valuations.

We further believe that quality will become increasingly important as we head into an uncertain economic environment marked by generally rising interest rates, a slowing economy and increased market volatility. We believe that investors will once again focus on companies that exhibit stronger earnings, cash flows and balance sheets and therefore have greater ability to protect their margins and dividends.

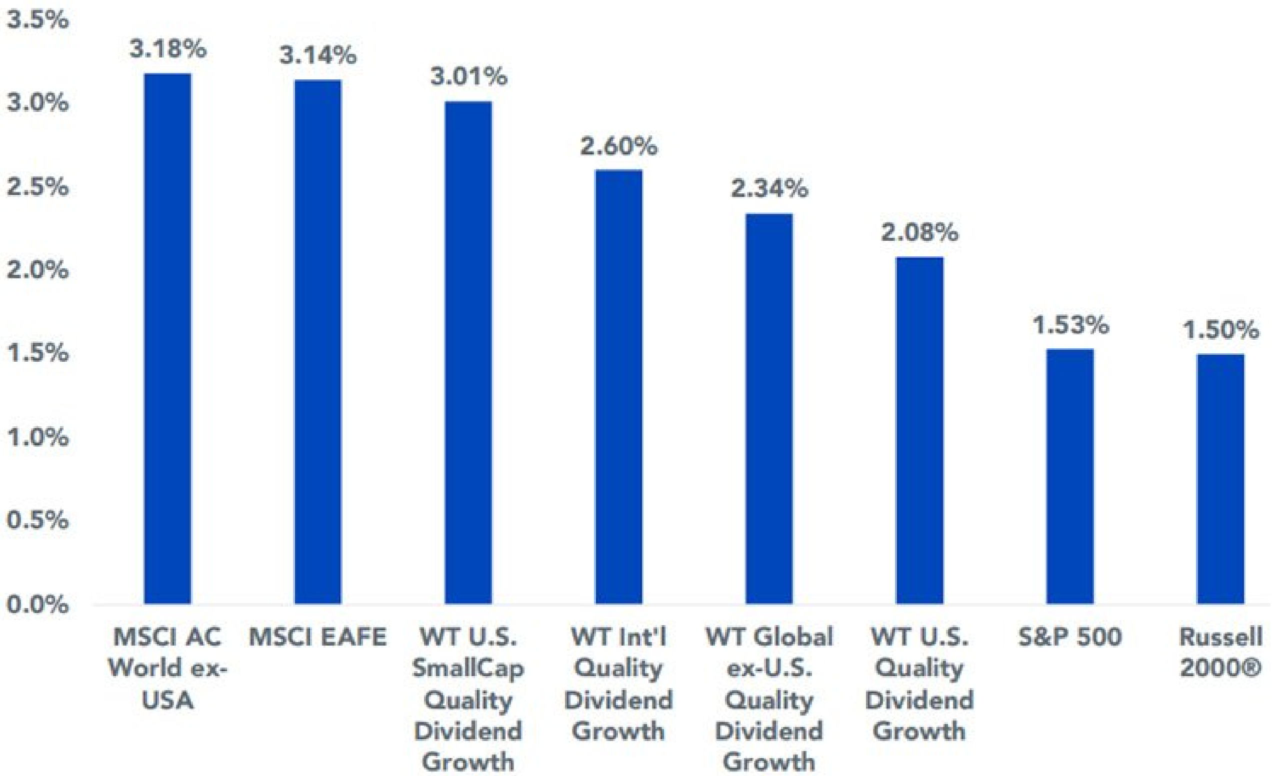
For valuation-driven (and therefore longer-term) investors, U.S. small-cap stocks continue to present an interesting opportunity. Despite the narrowing of the gap between large- and small-cap valuations, small caps remain attractively valued on a comparative basis.

Taking a brief look outside the U.S., valuation- and dividend-focused investors may like what they see over a reasonable time horizon.

International Equities Forward P/E Discount to U.S.: MSCI ACWI ex-USA vs. S&P 500

Sources: WisdomTree, MSCI, S&P. Data from 12/29/00 through 6/30/23, to coincide with the inception of the MSCI ACWI ex USA Index. U.S. measured by the S&P 500 Index. Ex-U.S. measured by MSCI ACWI ex USA Index. You cannot invest in an index, and past performance does not guarantee future results.

Quality Dividend Growth Index Trailing 12-Month Dividend Yields



Sources: WisdomTree, FactSet, through 6/30/23. You cannot invest in an index, and past performance does not guarantee future results.

Conclusions

We remain comfortable with the positioning, allocations and tilts within our Model Portfolios (dividends, value, size and quality), especially since we believe in risk factor diversification and therefore allocate to the growth factor as well. The result has been that our portfolios have “held their own” in 2023 despite the mega-cap tech “headwind.”

As of 6/30/2023	Cumulative Returns			Average Annual Total Returns				
Name	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year	Since Inception
WisdomTree Core Equity Model Portfolio (NAV)	5.67%	5.30%	11.62%	14.56%	11.15%	6.83%	-	7.40%
WisdomTree Core Equity Model Portfolio (MP)	5.69%	5.33%	11.84%	14.49%	11.17%	6.82%	-	7.30%
MSCI ACWI IMI	5.83%	5.89%	13.25%	16.14%	10.97%	7.65%	-	7.67%
MSCI ACWI Diversified Multi Factor	6.13%	3.14%	8.11%	12.61%	9.35%	5.07%	-	7.27%

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when sold, may be worth more or less than their original cost.

The Model Portfolio performance results shown are theoretical and do not reflect any investor's actual experience with owning, trading or managing an actual investment. Thus, the performance shown does not reflect the impact that economic and market factors had or might have had on decision making if actual investor money had been managed and allocated per the Model Portfolio. Actual performance achieved in seeking to follow the Model Portfolio may differ from the theoretical performance shown for a number of reasons, including the timing of implementation of trades (including rebalancing trades to adjust to Model Portfolio changes), market conditions, fees and expenses (e.g., brokerage commissions, deduction of advisory or other fees or expenses charged by advisors or other third parties to investors, strategist fees and/or platform fees), contributions, withdrawals, account restrictions, tax consequences, and/or other factors, any or all of which may lower returns. While Model Portfolio performance may have performed better than the benchmark for some or all periods shown, the performance during any other period may not have, and there is no assurance that Model Portfolio performance will perform better than the benchmark in the future. Model Portfolio performance calculations assume reinvestment of dividends, are pre-tax and are net of fund expenses.

ETF shares are bought and sold at market price (not NAV) and are not individually redeemable from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

It is too early to tell if the recent “re-rotation” back toward dividends, value and size will continue, but we believe that it will over a reasonable time horizon. Ultimately, fundamentals matter, not just trends and “memes” (though sentiment and momentum can carry a factor rally far beyond its underlying fundamentals).

As a reminder, 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.

We are an **open-architecture** shop (that is, all our models include both WisdomTree and third-party products) for many reasons: (a) it's 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.

Given the difficulty in forecasting asset class and risk factor performances, we intentionally diversify our portfolio at both of those levels.

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.

For financial professionals: 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.