Quality Is Job One

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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.

"Quality Is Job One"

(Iconic advertising slogan for the Ford Motor Company for most of the 1980–90s)

In this blog post, we focus on the quality risk factor. Why? Two reasons: (1) it permeates and forms the anchor of many WisdomTree products and Model Portfolios; and (2) we believe it will become increasingly important as we sail through the uncertain seas of the remainder of 2023 and beyond.

First, let's define terms. "Quality" has its roots in the well-known DuPont analysis, which defines quality firms as those with better relative earnings, cash flow and balance sheets (ROE, ROA and leverage, respectively). At WisdomTree, we extend that line of thought to include companies with better dividend sustainability and pricing power (i.e., the ability to withstand margin pressures in times of economic distress).

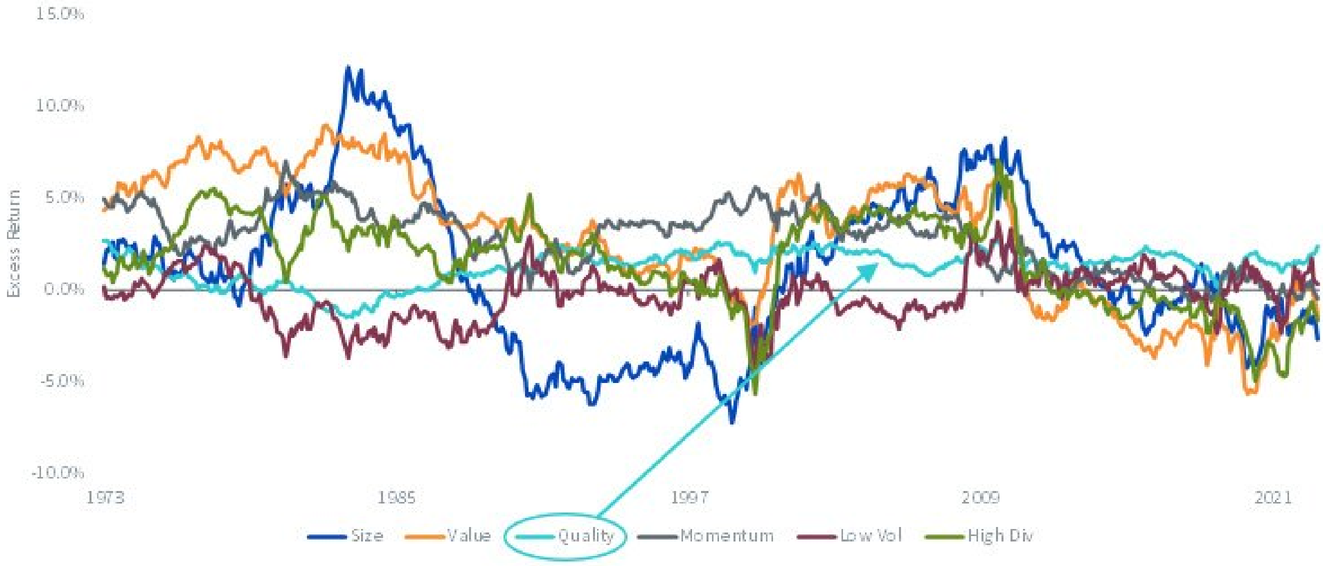
We measure this through our proprietary Composite Risk Score, which seeks to find the highest quality securities in many of the Indexes we manage. (Remember, we are a "self-indexing" firm—we do not license most of our Indexes from third parties, but create and manage them ourselves, and then wrap ETFs around them, thereby giving us control over which securities go into those ETFs.)

Why Does Quality Matter?

Historical analysis suggests that quality is the most consistent performer of the various equity risk factors. It is rarely the best or worst performing factor, but is the most consistent, which is why it anchors many of our products and most of our Model Portfolios.

The following chart is busy, but focus on the teal line, which represents the historical performance of the quality factor.

Rolling 10-Year Excess Return vs. Market



Sources: WisdomTree, Kenneth French Data Library, as of 03/31/23, and represents the latest available data. Using French's definitions: Value = HI 30 portfolio, Size = Lo 30 portfolio, Quality = HI 30 portfolio, Low Vol = BIG LoVar portfolio and High Div = HI 30 portfolio.

We see that over the past two years (inclusive of the awful 2022), quality added significant value in large-cap stocks…

Sources: Ycharts, 2-year data through 05/08/23. You cannot invest in an index and past performance does not guarantee future results.

…and in small- and mid-cap stocks (using the S&P 600 and Russell 2000 indexes as proxies. The S&P 600 is considered a higher quality index because it excludes a higher percentage of negative earners).

Source: Ycharts, 2-year data through 05/08/23. You cannot invest in an index and past performance does not guarantee future results.

Longer term, we see that quality has outperformed outside the U.S. as well. Here we first compare the quality characteristics of our own DNL ETF, which is our Global ex-U.S. Quality Dividend Growth product and which filters its security selection through our composite risk score, versus its benchmark MSCI AC World ex-US Index, using the primary DuPont analysis metrics.

QUALITY METRICS as of 3/31/2023 *select a characteristic to view historical data*	DNL	MXWDU
Return on Assets (ROA%)	8.65%	1.78%
Return on Equity (ROE%)	25.74%	12.79%
Return on Sales %	15.81%	13.65%
Leverage	2.97	7.20

Sources: The WisdomTree Fund Comparison Tool, data through 03/31/23. DNL is an investable product, but MXWDU is an index. You cannot invest in an index and past performance does not guarantee future results. The performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end performance, please call 866.909.WISE (9473) or visit the Fund's website.

And now we compare performance over the past 10 years.

Source: The WisdomTree Fund Comparison Tool, 10-year data through 05/08/23. IQDG is an investable product, but MXWDU is an index. You cannot invest in an index and past performance does not guarantee future results.

What about Fixed Income?

In a market environment marked by a slowing economy and rising interest rates, quality can be as important in fixed income as it is in equities. We apply quality filters to our security selection for both our U.S. Corporate Bond Fund (WFIG) and our U.S. High Yield Corporate Bond Fund (WFHY).

The quality screens for WFIG include free cash flow over debt service, leverage ratio, and return on invested capital (ROIC). We then eliminate the lowest scoring 20% of issuers based on those metrics, by sector.

Despite these quality screens, investors have sacrificed little total return over a common performance period versus broad market U.S. corporate bond ETFs.

Source: The WisdomTree Fund Comparison Tool, common date performance from 4/26/16–5/08/23. WFIG has an expense ratio of 0.18% and is a corporate bond ETF that seeks to track, before fees and expenses, the WisdomTree U.S. Corporate Bond Index, which is a rule-based alternatively weighted index designed to capture the performance of selected issuers in the U.S. investment-grade corporate bond market that are deemed to have attractive fundamental and income characteristics. SPBO has an expense ratio of 0.03% and is a U.S. corporate bond ETF offered by State Street, and seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the Bloomberg U.S. Corporate Bond Index. USIG has an expense ratio of 0.04%, and is a U.S. Corporate Bond ETF offered by iShares, and seeks to track the investment results, before fees and expenses, of the ICE BofA U.S. Corporate Index. SPBO and USIG were chosen for comparison due to their similar investment strategies. Past performance does not guarantee future results.

Fund Name	Inception Date	Objective	Expense Ratio	Index	Principal Risks	AUM
WFIG	4/27/16	WFIG is a corporate bond ETF that seeks to track, before fees and expenses, the WisdomTree U.S. Corporate Bond Index, which is a rule-based alternatively weighted index designed to capture the performance of selected issuers in the U.S. investment-grade corporate bond market that are deemed to have attractive fundamental and income characteristics.	0.18%	WisdomTree U.S. Corporate Bond Index	There are risks associated with investing, including possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. While the Fund attempts to limit credit and counterparty exposure, the value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund's portfolio investments. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.	$8.6 M
SPBO	4/6/11	SPBO is a U.S. corporate bond ETF offered by State Street, and seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the Bloomberg U.S. Corporate Bond Index.	0.03%	Bloomberg U.S. Corporate Bond Index	In general, ETFs can be expected to move up or down in value with the value of the applicable index. Although ETF shares may be bought and sold on the exchange through any brokerage account, ETF shares are not individually redeemable from the Fund. Investors may acquire ETFs and tender them for redemption through the Fund in Creation Unit Aggregations only. Please see the prospectus for more details.	$702.62 M
USIG	1/5/07	USIG is a U.S. Corporate Bond ETF offered by iShares, and seeks to track the investment results, before fees and expenses, of the ICE BofA U.S. Corporate Index.	0.04%	ICE BofA U.S. Corporate Index	If the Fund invests in any underlying fund, certain portfolio information, including sustainability characteristics and business-involvement metrics, provided for the Fund may include information (on a look-through basis) of such underlying fund, to the extent available. Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments.	$9,255.3 M

Sources: WisdomTree, State Street Global Advisors, iShares. Data as of 8/30/23. Funds chosen for comparison based on similar investmnet objectives.

For the most recent month-end and standardized performance, current yield, and to download the fund prospectus, click the respective ticker: WFIG, SPBO, USIG.

Our WFHY product accesses the broad U.S. high-yield market, but with an important caveat—it screens out issuers with negative cash flow. The result is a far lower default rate in comparison to the broader high-yield market.

Cumulative HY Defaults (Mar '16–Feb '23)

Sources: Bloomberg, ICE, WisdomTree, as of 2/28/23. HY Corporate Market Cap is proxied by the Bloomberg U.S. Corporate High Yield Index after 3/31/20. Prior to this date, HY Corporate Market Cap is proxied by the ICE BofA U.S. High Yield Index. HY Corporate Market Cap was policed due to data availability. Past performance is not indicative of future results. You cannot invest directly in an index.

Over a common performance period, however, WFHY has not sacrificed total return relative to broader market competitors.

Source: The WisdomTree Fund Comparison Tool, common date performance from 4/27/16–5/08/23. WFHY has a gross expense ratio of 0.38%, and is a high-yield ETF that seeks to track, before fees and expenses, the WisdomTree U.S. High Yield Corporate Bond Index, which is a rule-based alternatively weighted index designed to capture the performance of selected issuers in the U.S. high-yield corporate bond market that are deemed to have attractive fundamental and income characteristics. JNK has an expense ratio of 0.40%, and is a high-yield ETF offered by State Street, and seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the Bloomberg High Yield Very Liquid Index. HYG has an expense ratio of 0.49%, and is a high-yield ETF offered by iShares, seeks to track the investment results, before fees and expenses, of the iBoxx $ Liquid High Yield Index, an index composed of U.S. dollar-denominated, high-yield corporate bonds. JNK and HYG were chosen for comparison due to their similar investment strategies. Past performance does not guarantee future results.

Fund Name	Inception Date	Objective	Expense Ratio	Index	Principal Risks	AUM
WFHY	4/27/16	WisdomTree U.S. High Yield Corporate Bond Fund* seeks to track the performance of select issuers in the U.S. non-investment grade corporate bond ("junk bond") market that are deemed to exhibit favorable fundamentals and opportunities for income.	0.38%	WisdomTree U.S. High Yield Corporate Bond Index	There are risks associated with investing, including possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. High-yield or "junk" bonds have lower credit ratings and involve a greater risk to principal. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. While the Fund attempts to limit credit and counterparty exposure, the value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund's portfolio investments. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.	$220.3 M
JNK	11/28/07	The SPDR® Bloomberg High Yield Bond ETF seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the Bloomberg High Yield Very	0.40%	Bloomberg High Yield Very Liquid Index	Investing in high yield fixed income securities, otherwise known as "junk bonds", is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.	$7,253.21 M
HYG	4/4/07	The iShares iBoxx $ High Yield Corporate Bond ETF seeks to track the investment results of an index composed of U.S. dollar-denominated, high yield corporate bonds.	0.49%	iBoxx $ Liquid High Yield Index	If the Fund invests in any underlying fund, certain portfolio information, including sustainability characteristics and business-involvement metrics, provided for the Fund may include information (on a look-through basis) of such underlying fund, to the extent available. Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments. Non-investment-grade debt securities (high-yield/junk bonds) may be subject to greater market fluctuations, risk of default or loss of income and principal than higher-rated securities.	$14.42 B

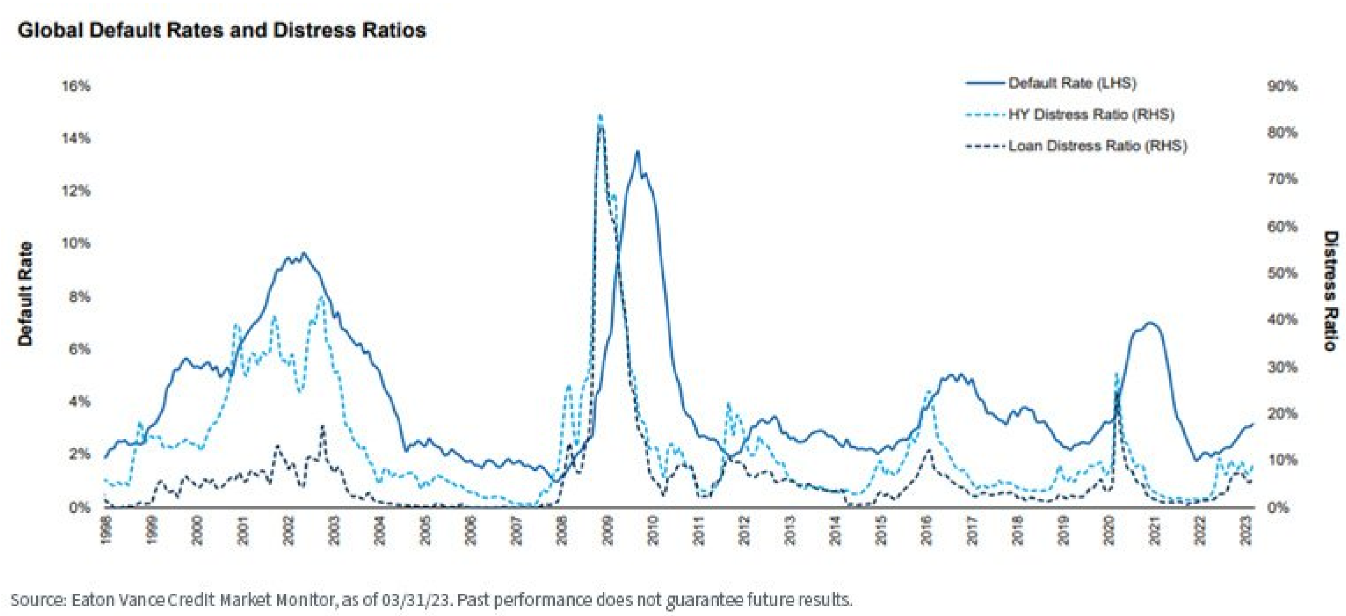
Sources: WisdomTree, State Street Global Advisors, iShares. Data as of 8/30/23. Funds chosen for comparison based on similar investmnet objectives.

For the most recent month-end and standardized performance, current yield, and to download the fund prospectus, click the respective ticker: WFHY, JNK, HYG.

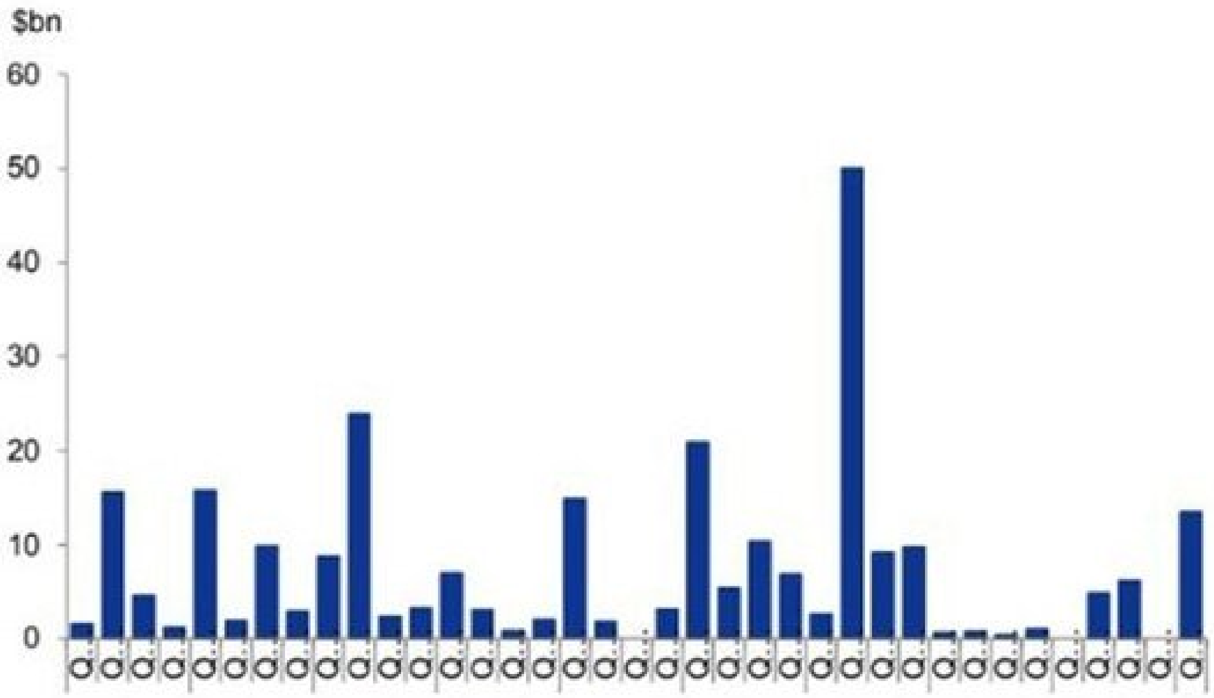
An important consideration is as follows. Default rates in the age of low interest rates were low, perhaps leading some investors to wonder why quality screens matter.

A fair question, but one that may have a different answer going forward. Consider the trend lines of default rates for both corporate and high yield bonds—still low but trending in the wrong direction.

Default Rates Remain Low, But Signs of Distress Are Increasing



Q1 Defaults have Already Surpassed the Full Year Totals of 2021 and 2022 Combined (Quarterly Volumes of Defaulted USD Corporate Debt)



Source: High-yield bond data from Goldman Sachs and Bloomberg, from an article in MarketWatch, data 03/25/23. Past performance does not guarantee future results.

Conclusions

Here at WisdomTree, we will never apologize for anchoring many of our products and Model Portfolios to the quality risk factor. Historical performance suggests that doing so provides the potential for much more consistent performance over full market cycles.

Given what we believe will be volatile and uncertain markets over the remaining course of 2023 and beyond, we have even higher conviction in tilting toward the quality factor.

As the ad slogan said, at WisdomTree, “Quality Is Job One.”

Important Risks Related to this Article

DNL: There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

WFIG & WFHY: There are risks associated with investing, including the possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. While the Funds attempt to limit credit and counterparty exposure, the value of an investment in the Funds may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Funds' portfolio investments.

Please read the Funds' prospectus for specific details regarding the Funds' risk profiles.