Risk Factors Are Rotating Back into Focus

Published July 8, 2022

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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.

Regular readers of the WisdomTree blogs know that we write frequently about risk factor diversification. As we approach the halfway point of what has been a very turbulent 2022, 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.

																2007 - 2021	
2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD	Ann.	Vol.
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%	REITs 41.3%	Comdty. 25.5%	Large Cap 10.6%	REITs 23.2%
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%	Large Cap 28.7%	Cash 0.0%	Small Cap 8.7%	EM Equity 22.9%
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. 27.1%	Asset Alloc. -3.9%	REITs 7.5%	Small Cap 22.5%
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 14.8%	Large Cap -4.6%	High Yield 6.6%	Comdty. 19.1%
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%	Asset Alloc. 13.5%	REITs -5.3%	Asset Alloc. 5.7%	DM Equity 18.9%
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%	DM Equity 11.8%	High Yield -5.7%	EM Equity 4.8%	Large Cap 16.9%
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 1.0%	DM Equity -5.8%	DM Equity 4.1%	High Yield 12.2%
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 -5.9%	Fixed Income 4.1%	Asset Alloc. 11.7%
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%	Fixed Income -1.5%	EM Equity -6.9%	Cash 0.8%	Fixed Income 3.3%
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%	EM Equity -2.2%	Small Cap -7.5%	Comdty. -2.6%	Cash 0.7%

Sources: Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management. You cannot invest in an index. Past performance does not guarantee future results. 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 1-3m Treasury. The "Asset Allocation" portfolio assumes the following weights: 25% S&P 500, 10% Russell 2000, 15% MSCI EAFE, 5% MSCI EME, 25% Bloomberg U.S. Aggregate, 5% Bloomberg 1-3m Treasury, 5% Bloomberg Global High Yield Index, 5% Bloomberg Commodity Index and 5% NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period 12/31/06–12/31/21. All data represents total return for stated period. The "Asset Allocation" portfolio is for illustrative purposes only. JP Morgan Guide to the Markets – U.S. Data as of 3/31/22.

For definitions of terms in the image above, please visit the glossary.

But 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.

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022 YTD
Momentum (-1.6%)	Value (46.32%)	Correlation (24.04%)	Quality (15.8%)	Low Vol (19.36%)	Quality (10.93%)	Low Vol (-23.16%)	Value (58.13%)	Quality (25.67%)	Low Vol (12.31%)	Quality (18.82%)	Value (44.52%)	Low Vol (17.2%)	Momentum (7.46%)	Value (19.44%)	Quality (25.42%)	Low Vol (-1.27%)	Size (28.03%)	Correlation (25.54%)	Value (28.57%)	Correlation (5.09%)
Low Vol (-2.56%)	Correlation (34.08%)	Multifactor (21.43%)	Value (15.24%)	Momentum (17.42%)	Correlation (7.33%)	Momentum (-25.75%)	Quality (38.07%)	Value (20.57%)	Momentum (12.08%)	Value (17.73%)	Size (35.77%)	Multifactor (16.54%)	Low Vol (5.32%)	Quality (13.23%)	Size (22.21%)	Momentum (-2.14%)	Quality (27.97%)	Size (15.11%)	Low Vol (23.91%)	Multifactor (4.19%)
Multifactor (-2.87%)	Quality (32.91%)	Value (19.65%)	Correlation (15.0%)	Value (17.36%)	Size (7.18%)	Multifactor (-32.59%)	Correlation (32.81%)	Correlation (20.12%)	Multifactor (10.85%)	Size (16.7%)	Correlation (34.81%)	Correlation (15.55%)	Quality (1.5%)	Low Vol (13.06%)	Value (19.1%)	Correlation (-3.67%)	Value (27.75%)	Quality (13.77%)	Quality (21.77%)	Momentum (1.71%)
Correlation (-7.41%)	Multifactor (30.97%)	Low Vol (18.53%)	Multifactor (14.05%)	Multifactor (15.42%)	Multifactor (5.85%)	Quality (-35.08%)	Size (32.79%)	Momentum (17.56%)	Correlation (4.41%)	Multifactor (15.67%)	Quality (33.78%)	Momentum (15.32%)	Size (0.66%)	Size (11.59%)	Momentum (18.77%)	Multifactor (-4.01%)	Low Vol (27.45%)	Momentum (8.65%)	Size (21.47%)	Low Vol (0.96%)
Quality (-8.27%)	Size (30.15%)	Quality (17.46%)	Size (7.59%)	Size (13.39%)	Momentum (5.59%)	Size (-36.67%)	Multifactor (24.59%)	Multifactor (17.38%)	Quality (3.4%)	Correlation (15.52%)	Multifactor (32.23%)	Size (14.29%)	Multifactor (0.55%)	Momentum (9.95%)	Multifactor (17.32%)	Size (-4.38%)	Momentum (26.01%)	Multifactor (4.24%)	Momentum (19.73%)	Value (-0.38%)
Value (-15.47%)	Low Vol (27.01%)	Momentum (17.02%)	Momentum (5.59%)	Quality (12.57%)	Low Vol (1.14%)	Value (-38.47%)	Low Vol (20.2%)	Low Vol (15.94%)	Size (1.05%)	Momentum (13.15%)	Momentum (27.99%)	Value (13.58%)	Value (-5.9%)	Multifactor (7.97%)	Low Vol (17.24%)	Quality (-6.65%)	Correlation (23.15%)	Low Vol (0.94%)	Multifactor (19.6%)	Quality (-3.45%)
Size (-22.11%)	Momentum (25.57%)	Size (13.16%)	Low Vol (5.07%)	Correlation (11.24%)	Value (0.27%)	Correlation (-41.0%)	Momentum (15.13%)	Size (14.5%)	Value (-1.34%)	Low Vol (12.9%)	Low Vol (23.72%)	Quality (13.52%)	Correlation (-7.79%)	Correlation (7.59%)	Correlation (13.51%)	Value (-13.2%)	Multifactor (20.11%)	Value (-0.23%)	Correlation (6.96%)	Size (-4%)

Sources: WisdomTree and Bloomberg, as of 05/31/22. 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, 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. Past performance does not guarantee future results.

For definitions of terms in the image above, please visit the glossary.

Year-to-Date Review

The first half of 2022 was unusual in the sense that bonds did not provide the hedge to equity risk they historically have.

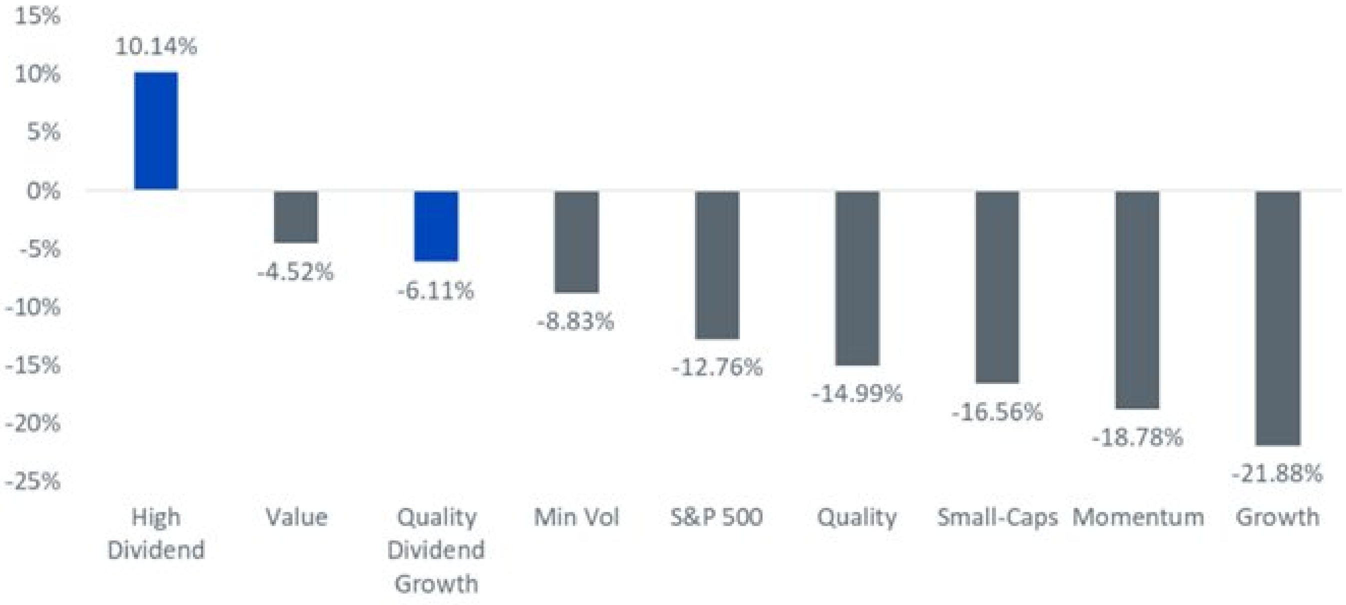
Source: YCharts, year-to-date data through 06/21/22. You cannot invest in an index, and past performance does not guarantee future results.

For definitions of terms in the image above, please visit the glossary.

Certain equity risk factors, specifically **dividends** and **value**, were more effective hedges to broad market equity risk.

Conversely, the rising interest rate environment over the first half caused havoc with growth stocks (i.e., stocks whose cash flows are expected further out in the future and so whose “discounted cash flow” valuations are therefore more sensitive to rising rates).

U.S. Factor Return YTD, as of 5/31/22



Source: WisdomTree, FactSet, Russell, MSCI, S&P. 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.

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Within small-cap stocks, we also see that **quality** was an important risk mitigator (using the S&P 600 versus the Russell 2000 indexes as proxies for the quality factor, as the S&P 600 index excludes far more negative earnings companies than the Russell 2000 index).

Source: YCharts, year-to-date data through 06/22/22. You cannot invest in an index, and past performance does not guarantee future results.

As a final factor to examine, let's look at **size**. Within U.S. large-cap stocks, we see year-to-date (YTD) outperformance by the smaller-cap stocks within the index (using the S&P 500 equal-weighted index as a proxy for those smaller-cap stocks).

Source: YCharts, year-to-date data through 06/22/22. You cannot invest in an index, and past performance does not guarantee future results.

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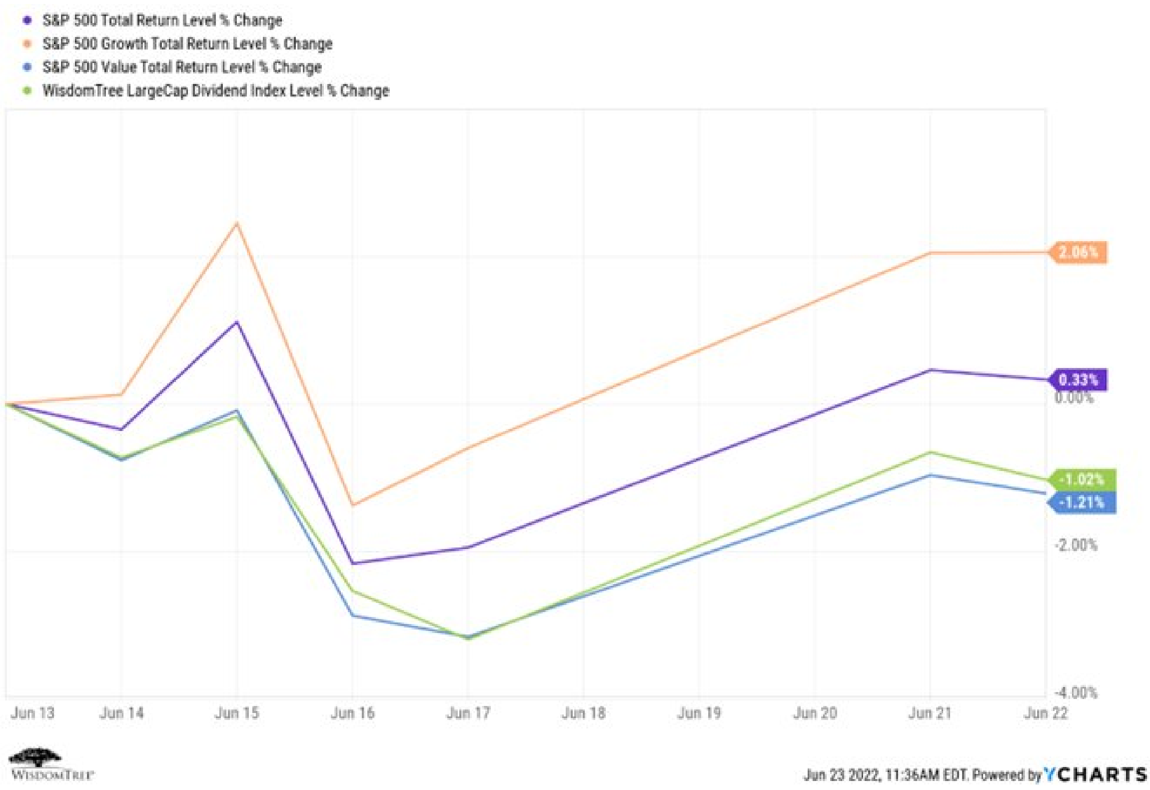
But, at a broader level, U.S. large-cap stocks outperformed U.S. small-cap stocks.

Source: YCharts, YTD data through 06/22/22. You cannot invest in an index, and past performance does not guarantee future results.

We saw similar (and more dramatic) YTD underperformances with EAFE and EM small-cap stocks in comparison to their respective large-cap indexes, though non-U.S. small-cap stocks have outperformed non-U.S. large-cap stocks over longer time horizons (e.g., 10 years).

Outlook for the Remainder of 2022

As the Fed (and other central banks) engages in more aggressive rate hike regimes, we see the market interpreting that as a signal for impending recession. The result has been a mini rally in growth stocks over the past two weeks as investors have leaned away from value-oriented sectors such as financials, utilities and especially energy.



Source: YCharts, data 6/13/22–06/22/22. You cannot invest in an index, and past performance does not guarantee future results.

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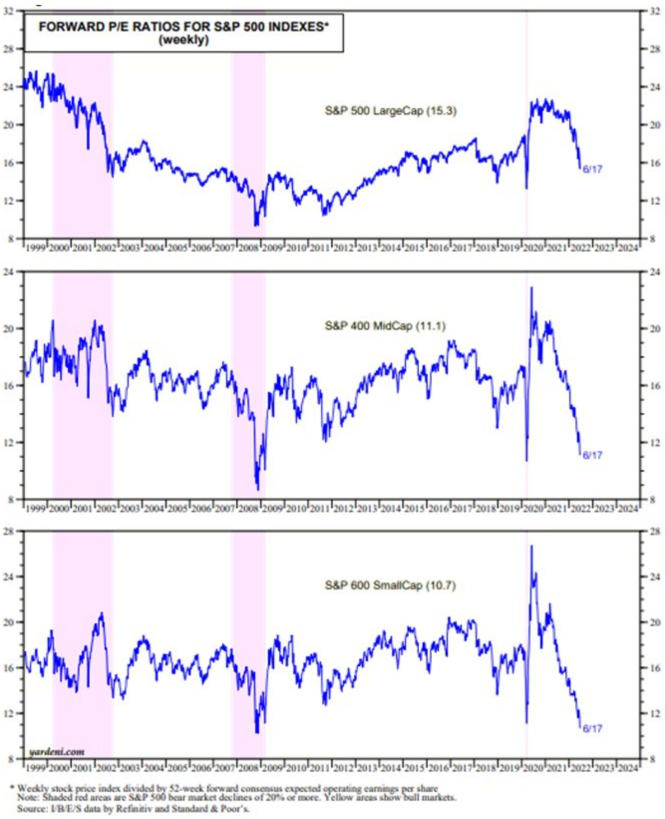
Despite this, we believe that value and dividends will outperform over the remainder of the year. We further believe that quality will become increasingly important as we head into an uncertain economic environment marked by generally rising interest rates and increased market volatility. We believe that investors will once again refocus on companies that exhibit stronger earnings, cash flows and balance sheets.

For valuation-driven (and therefore longer-term) investors, U.S. small-cap stocks present an interesting potential opportunity—the market has driven small-cap valuations down, seemingly in expectation of a sooner-than-we-expect recession.

Let's compare commonly-used valuation metrics of the S&P large cap and small cap indexes (labeled "500" and "600", respectively, in the chart below) – we see a significant discount in the small cap index numbers versus the large cap index numbers. Since what you can earn on any investment is at least partially a function of how much you pay for it today, longer-term investors may see a relative attraction to small cap stocks, despite the current market environment.

VALUATION RATIOS as of 5/31/2022 *select a characteristic to view historical data*	500	600
Price/Earnings (P/E)	19.99	15.35
Price/Earnings (P/E) Excl. Negative	19.50	12.19
Percent Negative Earn	0.87%	11.12%
Estimated Price/Earnings (P/E)	18.01	13.09
Estimated Price/Earnings (P/E) Excl. Negative	17.92	11.68
Price/Cash Flow (P/CF)	14.33	11.26
Price/Book (P/B)	4.19	1.91
Price/Sales (P/S)	2.58	0.95

A more historical perspective tells a similar story—despite the downturn so far this year, mid- and small-cap stocks remain more attractively valued than large-cap stocks.



Source: Yardeni Research, 06/22/22. You cannot invest in an index and past performance does not guarantee future results.

Conclusions

Given the factor tilts inherent in many, if not most WisdomTree strategies (dividends, value, size and quality), we remain comfortable with the positioning and allocations within our Model Portfolios. Most of our strategic models are benefitting from these factor tilts and are beating their respective benchmarks YTD.

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

As a reminder, almost 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
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.

We like the factor tilts currently embedded in our Model Portfolios, as we believe dividends, value and quality will continue to shine as we move through 2022. We also believe size may be positioned for a positive rotation.

Given our strategic investment mandates, however, we also remain diversified at both the asset class and risk factor 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.

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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.