The Last Good Deal in Town

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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.

Not that you need to be reminded, but 2022 has been one heck of a difficult market to navigate.

Stock markets are off to their worst start in decades. Bonds have failed as diversifiers. Inflation is at a 40-year high. Mortgage rates are skyrocketing. The Fed has been forced to slam on the brakes. Economic growth is diving. Confidence is cratering.

Other than that, Mrs. Lincoln, how was the play?

Unfortunately, we believe two of 2022's unwelcomed guests may be here for a while: inflation and volatility.

Inflation is no longer limited to just a narrow subset of consumer goods that have been impacted by supply chain disruptions—although some of these persist. Used car prices once represented nearly a third of the increase in annual inflation, but that has broadened out. Today, dozens of subcomponents are seeing rapid price growth (consider that the median component annual CPI now sits just under 6%). Even if inflation prints come down from their current nosebleed levels, the future floor has been lifted.

It looks like volatility is here to stay as well. Markets were complacent in 2021, and for good reason: stocks just kept rising without much disruption. Loose financial conditions and solid earnings helped drive animal spirits, and the VIX averaged just 19 for the year.

Fast-forward to today: policy is sharply tighter, sentiment is poor and the VIX has spent more than twice as much time above 30 as it has below 20 . Unless we can already see the light at the end of the recessionary tunnel, it's likely that both implied and realized volatility will stay elevated from here.

The Portfolio Playbook for Inflation and Volatility

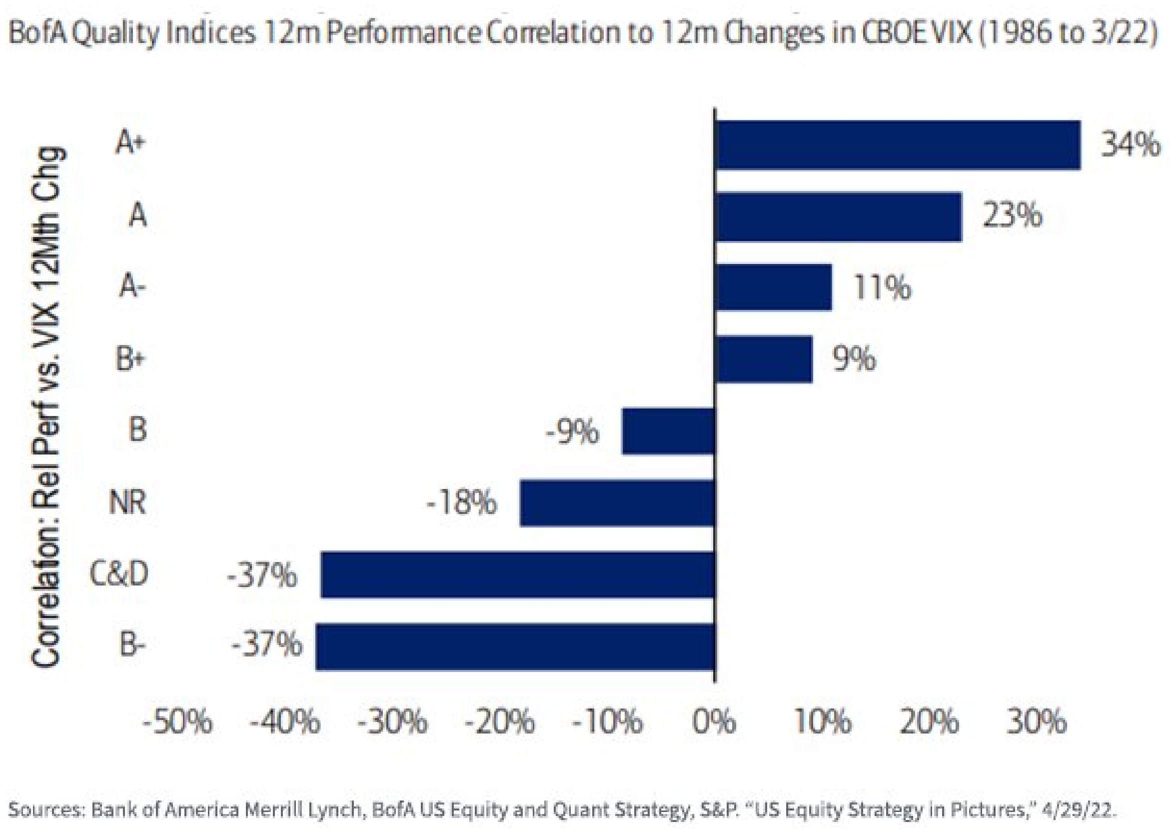
How should investors position their portfolios in this environment?

Over decades of research, Professor Jeremy Siegel has shown that stocks have historically been the ultimate inflation hedge—especially those that paid dividends, as dividend growth consistently outpaced annual inflation.

Within equities, we think it is best to anchor portfolios around the quality factor.

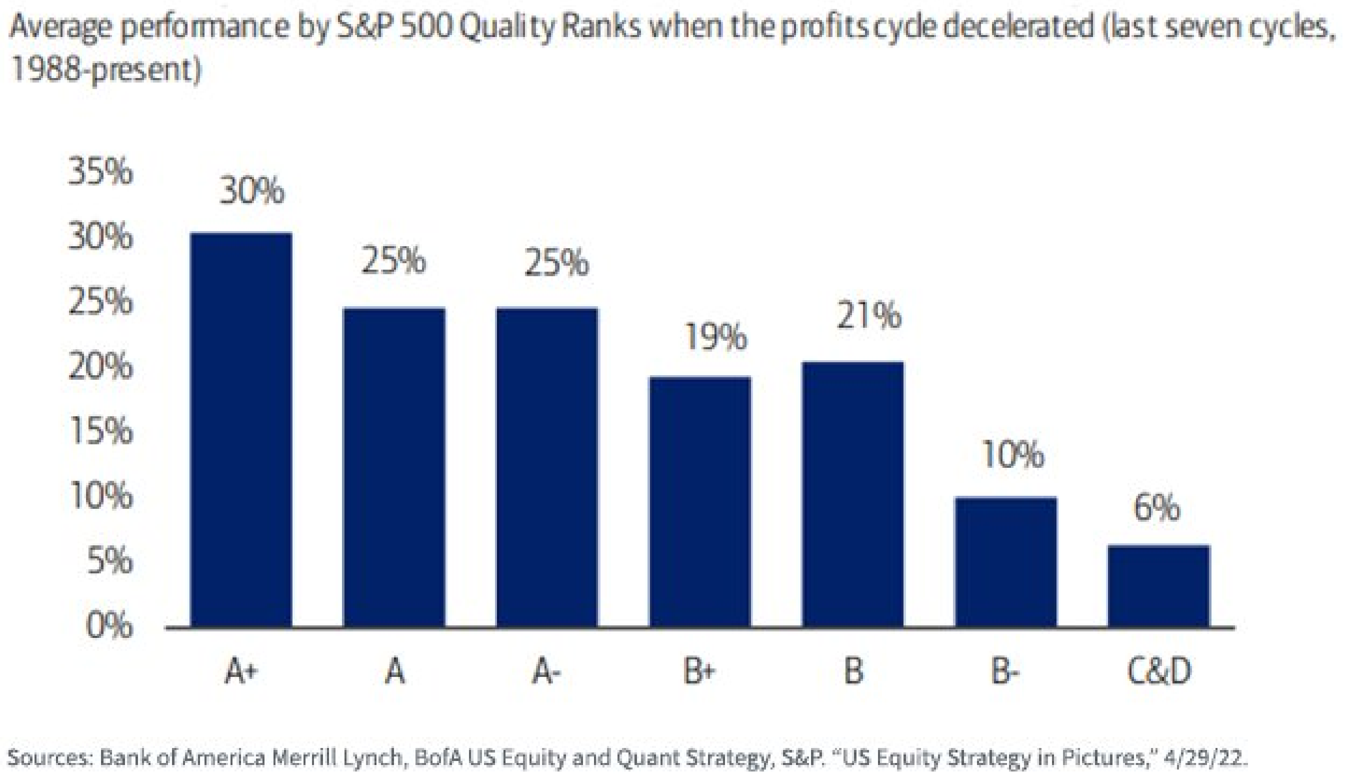
According to Bank of America Merrill Lynch, the highest-quality stocks have historically outperformed when volatility rises. Additionally, these companies have also done the best when profit cycles were decelerating—arguably the same part of the market cycle we find ourselves in today.

High-Quality Stocks Have Tended to Outperform When Volatility Has Risen



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

High-Quality Stocks (A+) Have Outperformed When the Profits Cycle Has Decelerated



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The Style That Doesn't Go Out of Style

It should not come as a shock that when times get tough, companies with strong free cash flows and pricing power are best positioned.

But taking a step back from today's choppiness, ask yourself: why wouldn't investors always want to over-weight quality?

Several investment factors ebb and flow between periods of relative under- and outperformance, depending on where we are in the cycle. Value and size have historically tended to fare best in early cycle periods; momentum has tended to work best in trending mid-cycle markets.

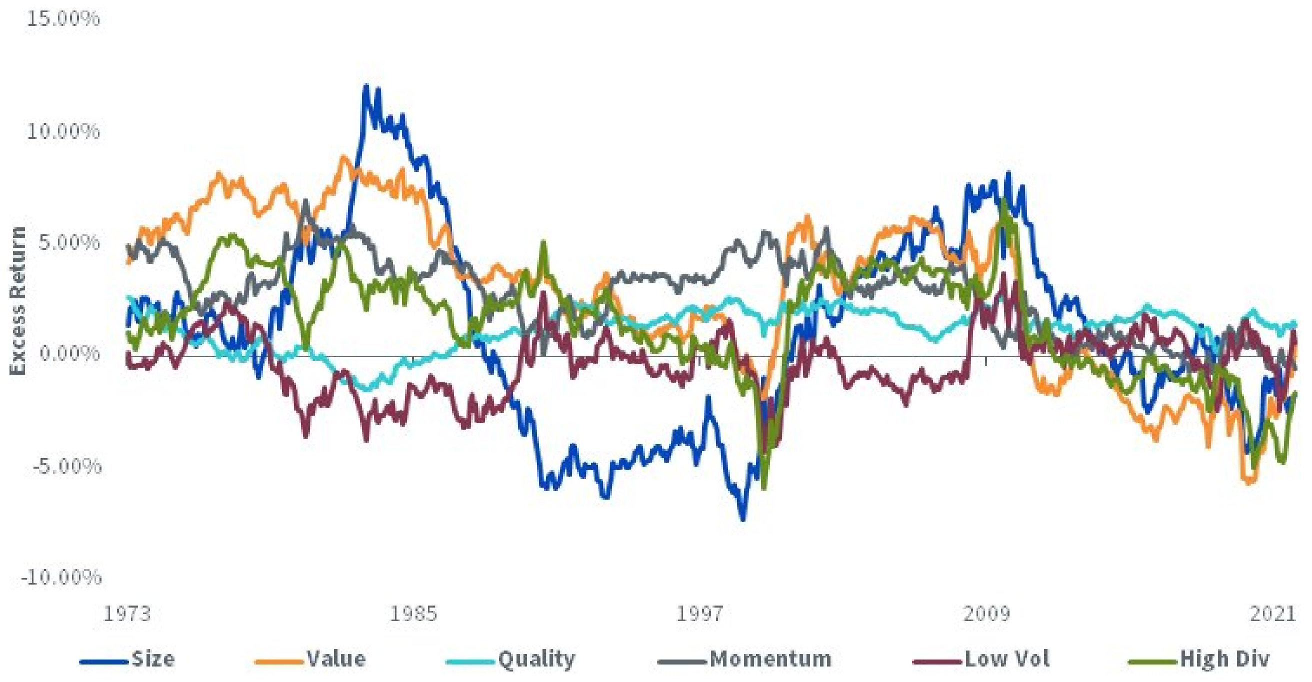
One big exception to this is quality—in our view, the most consistent of all factors.

Sure, quality will likely lag in the sharp risk-on rallies that typically mark the start of an early cycle snapback. But those types of environments don't tend to last, and neither does quality underperformance.

In fact, there hasn't been a rolling 10-year period when quality underperformed since the late 1980s.

Investors would be wise to consider quality as their portfolio anchors—not just today, but always.

Rolling 10-Year Excess Return vs. Market



Sources: WisdomTree, Ken French, data as of 5/31/22 and represents the latest date of available data. Value: Hi 30 portfolio. Size: Lo 30 portfolio. Quality: Hi 30 portfolio. Low Vol: Big lo-var portfolio. High Div: Hi 30 portfolio. Market: all CRSP firms incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ. Past performance is not indicative of future results.

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WisdomTree's Approach to Quality

Within the WisdomTree ETF product lineup, most equity ETFs track an index that implements a composite risk score, which helps boost the overall quality profile of each Fund.

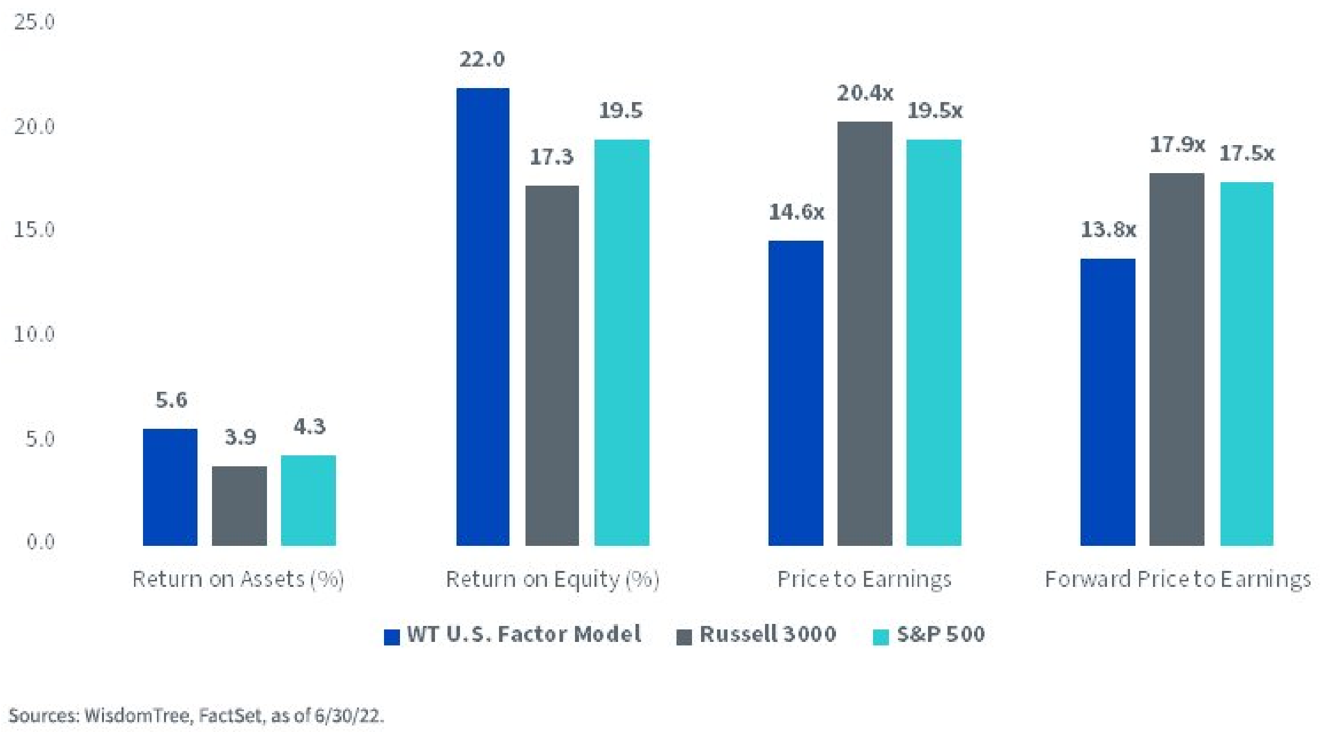
One flagship product that we believe epitomizes this is the WisdomTree U.S. Quality Dividend Growth Fund (DGRW), which has premium quality metrics, such as ROE and ROA, when compared to the S&P 500. The impact of this quality tilt has never been more evident than in 2022, when the Fund has outperformed the S&P 500 by 7.8% through June .

Similar to our ETFs, the WisdomTree Model Portfolios also have an emphasis on quality. In our opinion, perhaps no model better embodies the high-quality ethos than the WisdomTree U.S. Factor Model.

It should come as no surprise that DGRW is an anchor position in the model.

Not only does the model have sharply higher quality metrics than the overall market, but it also currently trades at a significant discount from a valuation standpoint.

In these days of high inflation, it's hard to find many things that offer a good bang for your buck. We believe that right now, the U.S. Factor Model may be one of the last good deals in town.



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You cannot invest directly in an index.

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