

# Why WisdomTree Is Going Active with Our Multifactor ETFs

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WisdomTree aspires to be at the forefront of innovative ways for marrying the benefits of the exchange-traded fund (ETF) structure with goals that are associated with active managers, such as outperforming market cap-weighted indexes over the long run.

In 2017, WisdomTree launched a domestic multifactor strategy to target factors well researched in the academic literature. We believe our bottom-up method for combining factors helps maximize the potential for higher absolute and risk-adjusted returns in a unique fashion—and the real-time performance of this strategy has been quite good among all the multifactor approaches, [as we wrote about our one-year anniversary here](#).

WisdomTree is expanding this strategy and providing investors access to its multifactor approach with two new *active* ETFs: the [WisdomTree International Multifactor Fund \(DWMF\)](#) and the [WisdomTree Emerging Markets Multifactor Fund \(EMMF\)](#).

## Going Beyond Beta for Alpha

The very first ETFs—and the majority of those that followed—were based on market capitalization-weighted indexes. Broad market indexing and ETFs have gained a large and growing share of the asset management marketplace due to investors' desire to lower the costs of investing. In addition, studies continually have found it difficult for traditional active managers to overcome the higher fees they charge.

Believing in a passive, low-cost approach, WisdomTree launched a suite of fundamentally weighted Indexes and ETFs in 2006 that were designed to address a central drawback of market cap-weighted indexing: that traditional cap weighting incorporates no sense of rebalancing back to relative value and thus becomes unduly exposed to all major asset pricing bubbles.

Alongside the consistent drive toward index investing, there has also been a growing adoption of factor-based portfolio strategies. The research in the academic community has centered its focus on value, quality, low volatility, momentum and size factors.

In WisdomTree's original factor ETFs from 2006, we provided exposure to four of the five well-regarded factors, with the exception of momentum. Factor analysis would illustrate that our small-cap dividend ETF provides exposure to small caps (size), value, quality and low beta (low volatility). These original WisdomTree factor ETFs were set up to be broad-based, scalable solutions with low levels of tracking error versus more traditional market capitalization-weighted benchmarks.

While WisdomTree believes broad beta benchmarks—both market capitalization weighted and fundamentally weighted—will continue to gain share at the expense of expensive active management, we also think there is a place in portfolios for higher alpha-seeking investment strategies that are priced reasonably and at relatively low fees compared with traditional active management.

### Modern Alpha Strategies

In a quest to build our higher tracking error and more-active strategies, WisdomTree believes it is important to balance the risks that come with more-active mandates. Some of these risks include:

- **Balance of Factors:** Are you over-weight in certain factors that become meaningfully out of favor for a long stretch of time? For instance, WisdomTree believes in the long-run efficacy of the value factor, yet in the past decade, value indexes have lagged growth indexes in nearly every market globally, with Japan as one of the only notable exceptions. A strategy that just tilts to value, therefore, has had a meaningful headwind over this period.
- **Sector and Country Bets:** Are you meaningfully under-weight or over-weight in certain sectors or countries that are a result of your factor tilts? For instance, minimum volatility and high dividend indexes have an inherent over-weight in bond proxy sectors such as Utilities, Telecom and Real Estate. A country like China and its tech sector has experienced some of the highest growth in emerging markets, and as a result has had among the lowest earnings yields. A value index may be chronically under-weight in a country like China.
- **Balance Benefits of a Diversified Factor Approach:** In a strategy designed to add alpha, one must take meaningful stock selection risk. Employing factor diversification to improve the merits of stock selection signals was a key element shaping WisdomTree's thinking on a more "active" methodology.
- **Currency Management Overlay:** WisdomTree has worked with Record Currency Management (Record) to use its currency research and currency signals to dynamically hedge currency exposures within international equity strategies. In international investing, currencies can contribute a significant proportion of overall returns and volatility, making exposure to currency an important factor driving international results.

### Unique, Multifactor Active ETFs

WisdomTree's multifactor strategies not only will seek significant tilts away from pure market cap weighting with 1) more concentrated stock selection rules, and 2) a flatter "factor" and risk-based weighting methodology more akin to equal weighting, but there will also be an active overlay from the purely model-based output.

**The active overlay:** WisdomTree seeks to apply risk analysis of our raw factor model. When certain factor bets creep into the model portfolio that make the balance of risks tilt too much in one factor's direction, we can adjust the portfolio to be more balanced across our factors.

Our research shows there are times when a pure indexing approach can lead to unbalanced factor or sector concentration risk—even when indexes are designed to equally weight a diverse set of factors.

And as WisdomTree gets more active in spirit of our underlying investment strategies, we believe it is important to utilize the type of risk controls active management shops employ.

In an upcoming blog post, we will discuss the specific factors we are targeting in our new multifactor active equity strategies and the research underpinning our multifactor process.

### **The Future for Active ETFs**

Active equity strategies are an exciting new frontier for ETFs. So far, successful active strategies really have been confined to some of the well-known fixed income managers whose brands ported well into fully transparent ETFs. But WisdomTree believes there is value that active strategies can provide. Many active investment managers could likely improve their performance by marrying a more systematic discipline to their subjective decision-making.

WisdomTree believes our active ETFs are examples for a new breed of “modern alpha” seeking strategies and we are excited for much more to come in this space.

## Important Risks Related to this Article

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