...WAIT, VALUE MANAGERS DID WHAT?!

Joseph Tenaglia – Director, Model Portfolios
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One of the most anticipated annual reports in the fund industry is the SPIVA U.S. Scorecard by S&P. It measures how active funds perform relative to their benchmarks.

The 2019 update came out this month. Even though a heck of a lot has changed since the end of the year, we can learn a lot from the results.

Not a Ton of Surprises, Except for...

Many of the results come as no surprise to industry watchers.

Nearly 70% of intermediate investment-grade bond funds outperformed their benchmark index. This makes sense given how investment-grade credit (commonly over-weighted in many core bond funds) sharply outperformed in 2019.

U.S. large-cap growth managers, many of whom over-weight the big tech companies, also had a strong showing—again expected, as the tech sector was up 50%.

As for those with the weakest showings, the juggernaut won once again: 70% of large-cap core managers lagged the S&P 500. It was the 12th consecutive year that the majority of funds in the category trailed the Index.

With that said, there are always a few surprises. Perhaps the biggest this year was that a jarring **97% of large value funds lagged the benchmark in 2019—the worst showing of any style box in any year since at least 2001.**

The poor performance of large value funds is not new. No U.S. equity style box has a worse average hit rate over the last 1-, 3-, 5- and 10-year periods. There are currently no time frames where even one out of every five active managers beat the Index. It's the only category with such consistently poor results.

Percent of Managers Outperformed by Benchmark

	1-Year		
	Value	Core	Growth
Large-Cap	97%	70%	33%
Mid-Cap	65%	41%	9%
Small-Cap	80%	41%	14%

	3-Year		
	Value	Core	Growth
Large-Cap	82%	84%	42%
Mid-Cap	78%	60%	19%
Small-Cap	83%	75%	22%

	5-Year		
	Value	Core	Growth
Large-Cap	89%	94%	60%
Mid-Cap	89%	82%	51%
Small-Cap	92%	91%	68%

	10-Year		
	Value	Core	Growth
Large-Cap	92%	97%	89%
Mid-Cap	88%	92%	78%
Small-Cap	97%	97%	82%

Sources: 2019 SPIVA U.S. Scorecard, S&P Dow Jones Indices, as of 12/31/19. Past performance is not indicative of future results.

Value Does Not Have to Mean Junk

Large value's struggle was not alone, as value funds of all sizes have underperformed. Over each trailing time frame and in every market cap segment, growth managers have done better than their value counterparts.

The struggles of value investing have been written about ad nauseum in recent years; the compounded underperformance by value funds relative to already-underperforming benchmarks has been less scrutinized. Why are so many funds trailing an index that is trailing on its own?

One potential reason is because few value managers are implementing quality within their approaches. Many value strategies compare themselves to the Russell family of value indexes, where the only value metric utilized is the price-to-book ratio (P/B). In our view, this is a flawed and outdated calculation that does not effectively capture the worth of many of today's business models.

The SPIVA report analyzes fund performance against S&P indexes, which in addition to P/B also uses price-to-earnings (P/E) and price-to-sales (P/S) ratios. This is a step up, especially considering the initial profitability requirement of the parent S&P 500 Index.

But we don't view these simple valuation ratios as sufficient. Instead, we prefer to look at value through the lens of dividends, both in screening and weighting.

Why? Because there can be a lot of landmines in value investing—after all, there is usually a reason that inexpensive companies are inexpensive—and dividends are an organic way to inject quality into a value strategy.

Restricting holdings to dividend payers and giving the largest weight to companies with the cash flow to support the largest dividends further tilts the portfolio toward the highest-quality subset of value.

Consider our U.S. LargeCap Dividend Fund (DLN), a rules-based passive ETF.

A factor regression of DLN against both the S&P and Russell value indexes shows that, while all three have strong exposure to the value factor, only DLN has even a positive exposure to profitability, while Russell and S&P both load negative to the main proxy for quality.

Factor Regression for DLN vs. Value Indexes

Fund / Index	Market	Size	Value	Profitability	Investment
DLN	0.93	-0.24	0.21	0.14	0.12
S&P 500 Value	1.00	-0.14	0.27	-0.06	0.16
Russell 1000 Value	0.98	-0.10	0.23	-0.01	0.16

Sources: WisdomTree, Zephyr StyleADVISOR, Ken French Data Library, from 7/1/06–2/29/20. Larger positive numbers mean greater exposure to each specific factor and negative numbers mean a lack of exposure to each specific factor. Reflects latest date of available data. Weights subject to change. Past performance is no guarantee of future results. An investor cannot invest directly in an index.

For definitions of terms in the table, please visit out glossary.

Active Managers, the Easter Bunny and Santa Claus

Back to the SPIVA report. To paraphrase Led Zeppelin, if 2019 was the good times, 2020 has been the bad times, and we have all certainly had our share.

This begs the timely question: What happens in down markets?

There is a common narrative that active managers may lag in bull markets but will do much better once the downturn arrives. This theory has mixed results. Looking at 2008, 2011, 2015 and 2018 (the four worst years for U.S. markets since the tech bubble), no more than 35% of all active U.S. equity managers outperformed in any of those years. There were some highlights, including in the much-maligned large value category: active did relatively well in 2008 (keyword: relatively), as PMs wisely avoided the toxic banks; 75% of funds outperformed that year. But the other three down years were essentially a coin flip for large value, with an average of just 46% of managers outperforming during these times.

Fast forward to today. The trend of mixed returns from active funds in down markets hasn't changed in Q1 2020. Only 33% of large value managers beat the S&P 500 Value Index in Q1, with the average fund lagging by 1.7%.[1] Case in point: the largest actively

managed large value mutual fund lagged the SP 500 Value Index by nearly 4% on the downside in Q1.[2]

I believe Ben Johnson, director of global ETF research for Morningstar, said it best:

> The idea that active managers as a group will on average outperform the market during bear markets belongs in the same category as the Easter Bunny and Santa Claus…It's something we all want to believe in, and to some degree take comfort in, but ultimately, it's fiction.[3]

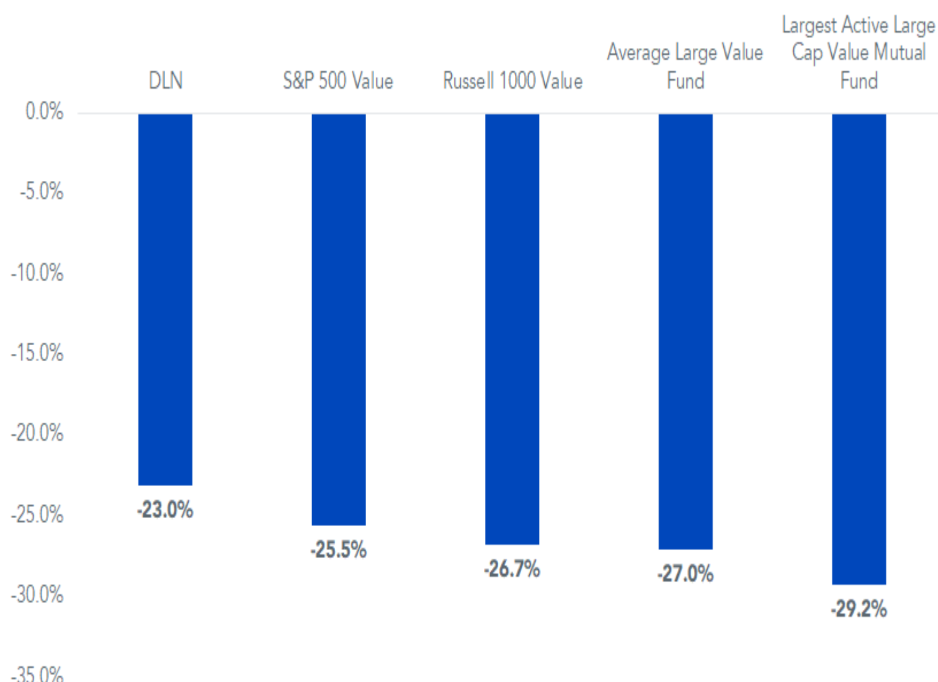
If Not Active, What Does Well in Down Markets?

When considering what may outperform in a down market, framing the question of active versus passive misses the point. Instead of focusing on a fund's structure, investors should think about the underlying investment philosophy.

While active funds have a spotty record of doing well in downturns, one approach that has shown to consistently do well in these types of environments is dividends.

During the down years of 2008, 2011, 2015 and 2018, DLN outperformed the S&P 500 Value Index each year, with an average outperformance at NAV of 4.6% per year. And once again proving its worth in real time, DLN outperformed at NAV by 2.5% in Q1. It's a small sample size, and outperformance does not imply positive results, but it's also indicative of the longer trend of top-quartile performance against large-cap value mutual funds, ETFs and benchmarks.

Returns in Q1 2020



Sources: BofA US Quantitative Strategy, Zephyr StyleADVISOR, YCharts, as of 3/31/20.

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 redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed 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.

For standardized performance of DLN, please click here.

We've been writing about the potential for a value outperformance cycle for quite some time, and if we do see a market rebound after the Q1 drawdown, we would expect value to

lead the charge. Further, there are now new tax loss harvesting opportunities in the category that have not been available in quite some time. Investors expecting a value resurgence or those unhappy with their existing allocation may be wise to look at DLN—a 5-star Morningstar Overall Rated (as of March 31, 2020) Fund that historically has been a consistent outperformer in a category that has shockingly few of them.

DLN Percentile Rank in Peer Group - Large Cap Value ETFs and Mutual Funds					
YTD	1-Year	3-Year	5-Year	10-Year	Since Inception
17	9	7	4	1	13

Source: Morningstar Direct, from 7/1/06–3/31/20. Number of funds in Large Cap Value category: 1224 (YTD), 1197 (1-year), 1158 (3-year), 1068 (5-year), 929 (10-year), 835 (since inception).

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For each fund with at least a three-year history, Morningstar calculates a Morningstar RatingTM metric each month by subtracting the return on a 90-day U.S. Treasury Bill from the fund's load-adjusted return for the same period and then adjusting this excess return for risk. The top 10% of the funds in each broad asset class receive five stars, the next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars and the bottom 10% receive one star. The Overall Morningstar RatingTM for a fund is derived from a weighted average of the performance figures associated with its 3-, 5- and 10-year (if applicable) Morningstar RatingTM metrics. WisdomTree U.S. LargeCap Dividend Fund was rated against the following numbers of U.S.-domiciled large cap value funds over the following time periods: 1,107 funds in the last 3 years, 957 funds in the last 5 years, and 703 funds in the last 10 years. With respect to these large-cap value funds, WisdomTree U.S. LargeCap Dividend Fund received a Morningstar RatingTM of five stars, five stars and five stars for the 3-, 5- and 10-year periods, respectively. Past performance is no guarantee of future results.

[1]Lipper Analytical Services; BofA US Quantitative Strategy, 4/3/20.

[2]YCharts, as of 3/31/20.

[3]FundFire, "Active Managers Did Poorly Last Year. Can Volatility Save Them?", 4/8/20.

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You cannot invest directly in an index.

DEFINITIONS

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term “large market capitalization”. Market capitalization is calculated by multiplying the number of a company’s shares outstanding by its stock price per share.

Style : Morningstar defines its style box along two axes—large, mid-cap and small, as well as value, blend and growth. If two strategies are in the same style box, it does not mean that they hold the exact same portfolios, but it means that it might be harder to generate significantly different returns, as compared to strategies in different style boxes.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Price-to-book ratio : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Price-to-sales (P/S) ratio : share price divided by per share revenue.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Dividend : A portion of corporate profits paid out to shareholders.

Cash flows : a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Bullish : a position that benefits when asset prices rise.

Tech Bubble : Market collapse between 1999-2001 that was led by technology stock.

Tax Loss Harvesting : Selling securities at a loss to offset a capital gains tax liability. Tax gain/loss harvesting is typically used to limit the recognition of short-term capital gains, which are normally taxed at higher federal income tax rates than long-term capital gains.