

FACTOR, FACTOR, GIMME THE NEWS

Scott Welch – Chief Investment Officer, Model Portfolios
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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.

*Doctor Doctor, gimme the news
I got a bad case of lovin' you
No pill's gonna cure my ill
I got a bad case of lovin' you*

(From "Bad Case of Loving You (Doctor, Doctor)", by Robert Palmer, 1979)

We last visited the topic of [factor diversification](#) roughly a year ago. Most investors are seemingly very familiar with the visual of an asset class "performance quilt," which highlights the importance of asset class [diversification](#).

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD	Ann.	Vol.
REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 36.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 27.8%	Cash 1.8%	Large Cap 31.5%	Small Cap 20.0%	Small Cap 12.7%	Large Cap 9.3%	EM Equity 23.3%
EM Equity 32.6%	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%	REITs 8.3%	Small Cap 9.9%	REITs 23.1%
DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.1%	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. 6.9%	High Yield 7.3%	Small Cap 22.6%
Small Cap 18.4%	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%	11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 22.7%	Asset Alloc. 18.6%	Large Cap 6.2%	REITs 7.1%	DM Equity 19.1%
Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 19.5%	DM Equity 8.3%	DM Equity 3.6%	EM Equity 6.9%	Comdty. 18.8%
Asset Alloc. 15.4%	Large Cap 5.5%	Comdty. -35.6%	Small Cap 21.5%	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%	Asset Alloc. 3.3%	Asset Alloc. 6.7%	Large Cap 16.7%
High Yield 13.7%	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%	EM Equity 2.3%	DM Equity 5.0%	High Yield 12.2%
Cash 4.8%	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 4.5%	Asset Alloc. 11.8%
Fixed Income 4.3%	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%	High Yield -1.0%	Cash 1.2%	Fixed Income 3.2%
Comdty. 2.1%	REITs -15.7%	EM Equity -33.2%	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%	Fixed Income -3.4%	Comdty. -4.0%	Cash 0.8%

Sources: J.P. Morgan Asset Management Guide to the Markets, 3/31/21, Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management. Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Commodity: Bloomberg Commodity, High Yield: Bloomberg Barclays Global High Yield, Fixed Income: Bloomberg Barclays U.S. Aggregate Bond, REITs: NAREIT All Equity REITs, Cash: Bloomberg Barclays 1-3 Month U.S. Treasury. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg Barclays U.S. Aggregate Bond, 5% in the Bloomberg Barclays 1-3 Month U.S. Treasury, 5% in the Bloomberg Barclays Global High Yield, 5% in the Bloomberg Commodity and 5% in the NAREIT All Equity REITs. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period from 12/31/05-12/31/20. All data represents total return for stated period. The Asset Allocation portfolio is for illustrative purposes only. Past performance is not indicative of future returns.

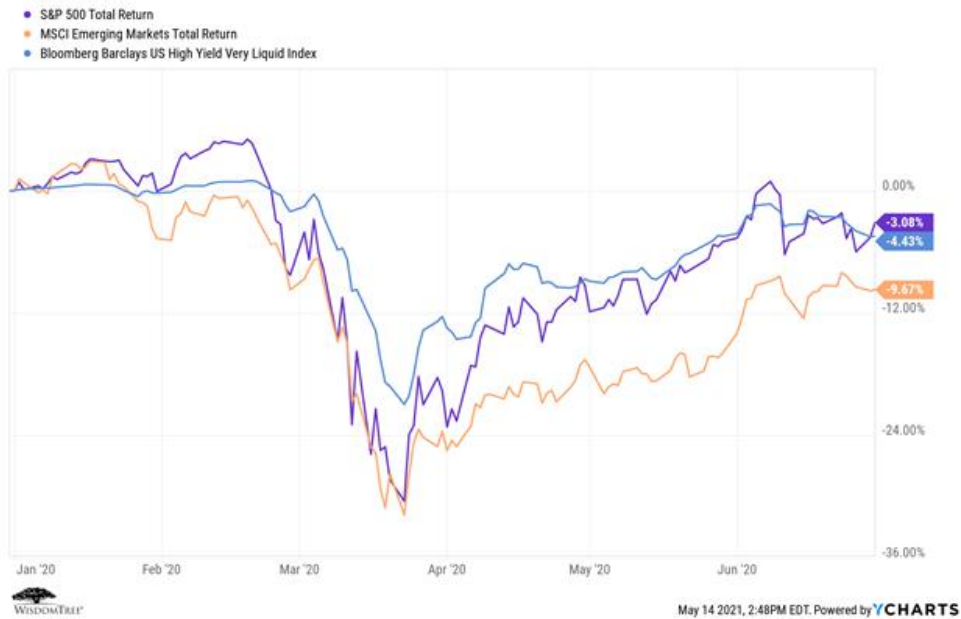
But what we believe is equally as important as asset class diversification is [risk factor](#) diversification. One way to think about asset classes is that they are simply convenient and investable bundles of different risk factors. This is one explanation for why asset allocation doesn't provide as much downside protection during market disruptions as many advisors and end clients expect.

Consider the simplistic example of U.S. [large-cap](#) stocks, emerging market stocks and [high-yield](#) bonds. Three very different asset classes, to be sure. But here is how they all performed during the worst of the global financial crisis.



Source: YCharts, data 7/1/08–7/1/09. You cannot invest in an index, and past performance does not guarantee future results.

Looks pretty similar. How about during the early days of the COVID-19 pandemic last year?

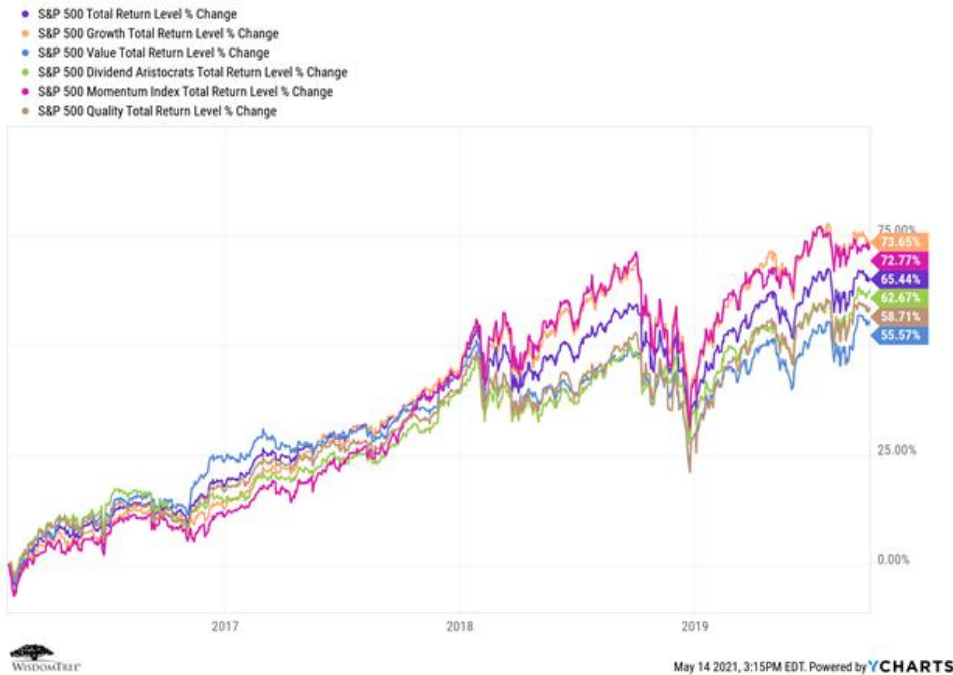


Source: YCharts, data 1/1/20–6/30/20. You cannot invest in an index, and past performance does not guarantee future results.

Again, very similar. Why is that? Because all three very different asset classes are highly exposed to the equity risk factor. Three different asset classes, but with very similar factor exposures.

That's why all WisdomTree [Model Portfolios](#) are diversified at both the asset class AND risk factor levels. We believe this helps deliver a better level of diversification and, therefore, more consistent performance over full market cycles.

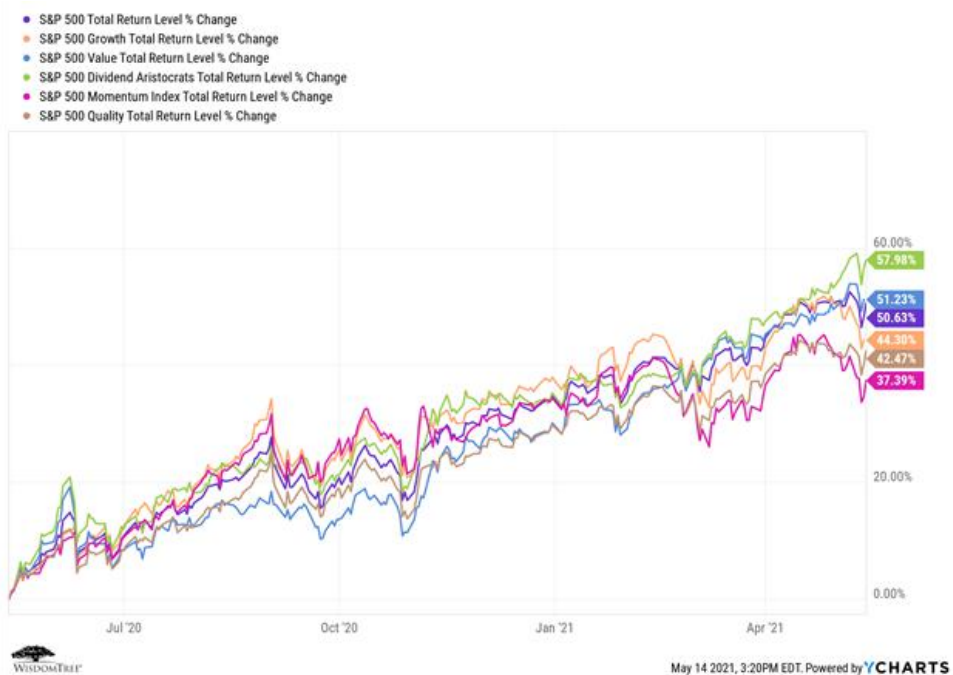
Take a look at the factor dominance under two different environments. First, let's look at January 1, 2015, until September 30, 2019.



Source: YCharts, data 1/1/15–9/30/19. You cannot invest in an index, and past performance does not guarantee future results.

It seems to be all [growth](#) and [momentum](#), all the time. [Value](#), [quality](#) and [dividends](#) were in the caboose of the train.

Compare that to the past 12 months. It appears dividends and value have driven performance, while growth and momentum have moved to the rear of the bus.



Source: YCharts, data 5/13/20–5/13/21. You cannot invest in an index, and past performance does not guarantee future results.

The point we're trying to make is that it is just as difficult to predict factor rotation as it is asset class rotation. We're not sure anyone predicted the massive factor rotation back toward [small caps](#) and value that occurred after the Pfizer vaccine announcement came out last November (though, given that many wisdomTree products have a

value or [size](#) “tilt” to them, we certainly have enjoyed it). Value stocks in particular have roared back.



Source: YCharts, data 5/13/20–5/13/21. You cannot invest in an index, and past performance is not indicative of future results.

This is why we favor factor diversification as well as asset class diversification in all our Model Portfolios. We cannot guess factor rotation, which can happen quickly, so we build portfolios with diversified factor exposure.

Figure 7_factor quilt and rotation

Conclusions

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; and
4. We charge no strategist fee for them.

We are an open-architecture shop—that is, all our Models include both WisdomTree and third-party products—for many reasons: (a) it’s simply 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.

Asset class diversification is boring. We don’t mean it’s uninteresting, just that the whole point is, to use a golf expression, to keep the ball in the middle of the fairway. The power of compounding is immense—as Albert Einstein is credited with suggesting, “Compound interest is the most powerful force in the universe.”

What that means is that if you don’t lose as much in down markets, you don’t need to gain as much in up markets to still come out ahead.

We firmly believe risk factor diversification is a means to that end.

Important Risks Related to this Article

Neither diversification nor using an asset allocation strategy assures a profit or protects against loss.

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View the online version of this article [here](#).

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DEFINITIONS

Diversification: A risk management strategy that mixes a wide variety of investments within a portfolio.

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.

High Yield: Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.

Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Momentum: Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

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 time.

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 time.

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

Small caps: new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Size: Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.