WHICH SMART BETA STRATEGIES WORKED IN 2016?

Luciano Siracusano — Chief Investment Strategist
01/24/2017

In 2016, billions of dollars flowed into so-called smart beta exchange-traded funds (ETFs)—funds that select stocks based on their exposure to individual factors such as low volatility, momentum or quality. Billions more flowed into funds tracking indexes incorporating several of these factors simultaneously—so-called multifactor funds.

So, how did these smart beta factors do relative to the S&P 500 Index? On balance, results were so-so: it was very much of a mixed year for many of the U.S. smart beta strategies.

If you use the MSCI single-factor indexes as your proxy, momentum, quality and minimum volatility all underperformed the S&P 500 Index. Of the major factors, only value and size outperformed. The MSCI USA Enhanced Value Index returned 15.9% and the Russell 2000 Index, a proxy for small-cap stocks, generated a 21.3% return, both handily beating the nearly 12% total return posted by the S&P 500, a proxy for the broad U.S. equity market.

Category	Index	Inception Date	Avg Annual Total Return as of 12/31/2016					
			1-Yr	3-Yr	5-Yr	10-Yr	Since 2/1/07	Since 6/1/06
Multi-factor	MSCI U.S.A Diversified Multiple-factor	2/17/2015	13.67%	N/A	N/A	N/A	N/A	N/A
Multi-factor	MSCI U.S.A Small Cap Diversified Multiple-factor	2/17/2015	23.12%	N/A	N/A	N/A	N/A	N/A
Factor	MSCI U.S.A Enhanced Value	12/12/2014	15.94%	N/A	N/A	N/A	N/A	N/A
Factor	MSCI U.S.A Minimum Volatility	6/2/2008	10.67%	10.86%	13.66%	N/A	N/A	N/A
Factor	MSCI U.S.A Sector Neutral Quality	12/12/2014	9.37%	N/A	N/A	N/A	N/A	N/A
Factor	MSCI U.S.A Momentum	2/15/2013	5.13%	9.64%	N/A	N/A	N/A	N/A
Multi-factor	Goldman Sachs ActiveBeta U.S. Large Cap Equity	8/19/2015	8.77%	N/A	N/A	N/A	N/A	N/A
U.S. Market	S&P 500	3/4/1957	11.96%	8.87%	14.66%	6.95%	6.84%	7.77%

Sources: Bloomberg, FactSet, as of 12/31/16. Past performance is not indicative of future results. You cannot invest directly in an index.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index.
Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

For definitions of indexes in the chart, visit our glossary.

In the large-cap multifactor category, the MSCI USA Diversified Multiple-Factor Index beat the S&P 500 by 171 basis points (bps) in 2016. However, the Goldman Sachs ActiveBeta U.S. Large Cap Equity Index disappointed, underperforming the S&P 500 by more than 3 percentage points. In the small-cap segment, the MSCI USA Small Cap Diversified Multiple-Factor Index fared better, generating returns that exceeded those of the Russell 2000 by 181 bps.

Success hinged on which smart beta factor one tilted toward, and in some cases, which *smart beta index* one used within a specific category. Although evaluating any smart beta strategy requires years of real-time performance, these 2016 results raise an interesting question: Is there an easier way to tap into the potential smart beta offers without taking on as much stock selection risk that typically accompanies these narrower smart beta strategies?

Based on a decade of real-time results, WisdomTree believes the answer is yes.

In 2016, for example, WisdomTree was eight for eight: each and every one of WisdomTree's core U.S. equity indexes beat the S&P 500 Index. Put another way, if one had simply owned each of the major size segments of the U.S. equity market dividend-weighted or earnings-weighted, one would have generated excess returns relative to owning the entire U.S. market capitalization-weighted.

Category	Index	Inception Date	Avg Annual Total Return as of 12/31/2016					
			1-Yr	3-Yr	5-Yr	10-Yr	Since 2/1/07	Since 6/1/06
U.S. Broad	WT Dividend	6/1/2006	16.98%	9.82%	14.07%	7.05%	6.94%	7.98%
U.S. Broad	WT Earnings	2/1/2007	15.30%	8.55%	14.73%	N/A	7.35%	N/A
U.S. Broad	Russell 3000		12.74%	8.43%	14.67%	7.07%	6.93%	7.84%
U.S. Large	WT LargeCap Dividend	6/1/2006	15.73%	9.43%	13.63%	6.64%	6.54%	7.63%
U.S. Large	WT Earnings 500	2/1/2007	14.19%	8.61%	14.53%	N/A	7.04%	N/A
U.S. Large	S&P 500		11.96%	8.87%	14.66%	6.95%	6.84%	7.77%
U.S. Mid	WT MidCap Dividend	6/1/2006	20.82%	11.56%	16.33%	8.56%	8.31%	9.34%
U.S. Mid	WT MidCap Earnings	2/1/2007	20.07%	7.67%	15.68%	N/A	9.59%	N/A
U.S. Mid	S&P 400		20.74%	9.04%	15.33%	9.16%	8.84%	9.21%
U.S. Small	WT SmallCap Dividend	6/1/2006	31.40%	10.22%	16.72%	7.56%	7.51%	8.54%
U.S. Small	WT SmallCap Earnings	2/1/2007	30.17%	7.45%	15.87%	N/A	8.70%	N/A
U.S. Small	Russell 2000		21.31%	6.74%	14.46%	7.07%	6.95%	7.63%

Sources: WisdomTree, Bloomberg, FactSet, as of 12/31/16. Past performance is not indicative of future results. You cannot invest directly in an index.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

For definitions of indexes in the chart, visit our glossary.

As we show in the table above:
- **Broad Market:** In the broad market, the dividend-weighted WisdomTree Dividend Index beat the Russell 3000 Index in 2016 by 424 bps. Its companion index, the WisdomTree Earnings Index, which weights all the profitable companies in the U.S. by the earnings they've generated in the prior year, beat the Russell 3000 by 256 bps.
- **Large Cap:** The WisdomTree Earnings 500 Index outperformed the S&P 500 by 223 bps, while the WisdomTree LargeCap Dividend Index beat the S&P 500 Index by 377 bps. Moreover, both WisdomTree Indexes beat the above-mentioned multifactor large-cap strategies offered from MSCI and Goldman Sachs.
- **Mid-Cap:** Both the WisdomTree MidCap Dividend Index and the WisdomTree MidCap Earnings Index generated returns in excess of 20%, outperforming the S&P 500 by more than 8 percentage points.
- **Small Cap:** And in the small-cap space, both the WisdomTree SmallCap Dividend Index and the WisdomTree SmallCap Earnings Index generated 2016 returns in excess of 30%, handily outpacing the 21% return posted by the Russell 2000, and the 23% return tallied by the MSCI multifactor small-cap strategy. Now, that's smart beta!

Although many have overlooked the WisdomTree strategies as ways to implement smart beta strategies in the core of their portfolios, the WisdomTree ETFs tracking these proprietary indexes have all been trading in the marketplace for the past 10 years, generating a compelling track record in the process.

Because the WisdomTree Indexes rebalance annually back to a measure of relative value, once a year they trade away from the price-driven, momentum-fueled movement of cap-weighted benchmarks. This gives WisdomTree a chance to tap into return premiums like value and quality, and in the case of our mid- and small-cap funds, size, in a disciplined, repeatable way, while providing broad exposures to traditional asset classes. Thus, WisdomTree provides the type of "multifactor" exposure investors are looking for. Because it's never easy to predict which smart beta factor will outperform in a given year, it is probably best to get some exposure to most or all of them through a more diversified approach. Now, with real-time results coming in, it's becoming easier to evaluate some of the newer strategies against those, like WisdomTree's, that have been tested in real time over full market cycles.

Conclusion

All eight of WisdomTree's core, size-segmented U.S. dividend-weighted and earnings-weighted equity Indexes beat the S&P 500 Index in 2016. In the process, they also beat many of the newer "factor-based" entrants into the smart beta indexing space. But 2016 is just part of a larger story. Since their respective real-time inceptions, spanning the last 10 years, seven of WisdomTree's eight core U.S. Indexes have also outperformed their comparable capitalization-weighted peer. At a time when investors are attempting to complement beta exposures or replace active managers by combining single-factor strategies—or adopting multifactor strategies—WisdomTree is one of the few "smart beta" providers with a proven performance record.

Important Risks Related to this Article

Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

DEFINITIONS

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Momentum Factor : 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.

Quality Factor : Excess returns achieved by companies exhibiting higher quality or profitability vs the market. Typically measured using operating profitability, return on equity and/or return on assets. .

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

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.

Size Factor : the average returns of small portfolios minus the average returns of the large portfolios after adjusting for growth or value tendencies.

MSCI USA Enhanced Value Index : Large and Mid-cap stocks exhibiting higher value characteristics relative to peers within their respective GICS sector. Value measured by Price-to-Book Value, Price-to-Forward Earnings and Enterprise Value-to-Cash flow from Operation.

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

MSCI USA Diversified Multiple-Factor Index : The index aims to maximize exposure to the Value, Momentum Quality and Low Size Factors while maintain a similar risk profile to its parent index, the MSCI USA Index. .

Basis point : 1/100th of 1 percent.

Goldman Sachs ActiveBeta U.S. Large Cap Equity : Capturing common sources of active equity returns such as value (price-to-market value), momentum (performance history), quality (profitability relative to total assets) and volatility (consistency of returns). Rebalances quarterly. .

MSCI USA Small Cap Diversified Multiple-Factor Index : The index aims to maximize exposure to the Value, Momentum Quality and Low Size Factors while maintain a similar risk profile to its parent index, the MSCI USA Small Cap Inde.

Dividend weighted : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

Earnings-weighted : Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

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.

<u>**Russell 3000 Index**</u> : Measures the performance of the 3,000 largest U.S. companies based on total market capitalization.

<u>**Rebalance**</u> : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.