WISDOMTREE MULTIFACTOR: NOT THE LOW VOLATILITY YOU'RE USED TO…

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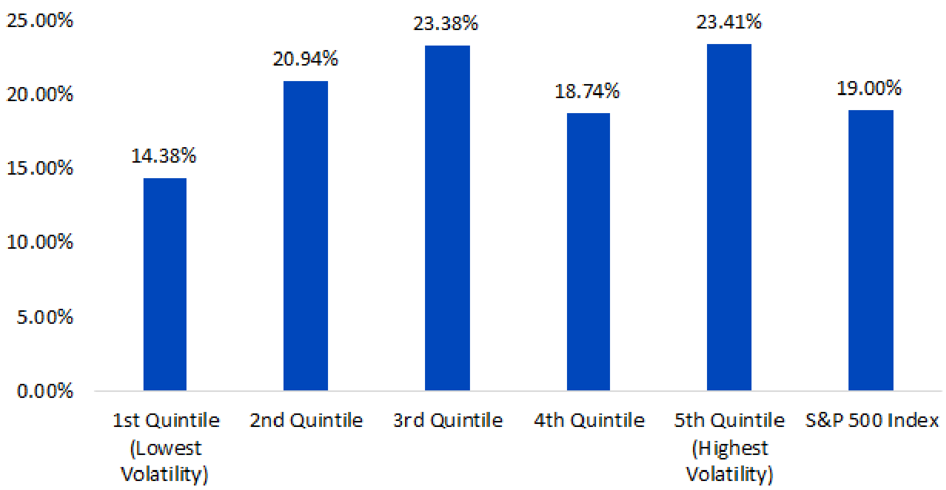
We recently wrote about why our multifactor strategies favor using the low-correlation factor instead of the low-volatility factor as part of our alpha-seeking stock selection composite multifactor scoring. In that piece we laid out two reasons for this. The first was that low volatility as a standalone factor did not generate absolute excess returns versus the market over the last 50-plus years. The second is that, historically, the low-volatility factor has been extremely sensitive to interest rates, generally underperforming in rising rate environments.

Since the inception of WisdomTree's U.S. Multifactor Index (WTUSMF) just over 14 months ago, the yield on the 10-year U.S. government Treasury has increased 60 basis points (bps).[1] As can be seen in the chart below, over this same period, the S&P 500 Index returned 19% annualized, led by its highest-volatility stocks, while low volatility has underperformed, in line with what we've seen in past rising interest rate periods.

S&P 500 Volatility Quintile Returns

Low Volatility Underperforms with Rising Rates



Sources: WisdomTree, FactSet, 6/30/17–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

WTUSMF's Implicit Tilt to Low Volatility

Despite not using low volatility as an alpha-seeking factor, we are aware of its prowess in risk-adjusted terms and therefore use it as part of our strategy's weighting mechanism. Also, given some of our factor definitions, like risk-adjusted returns for mo mentum, the composite multifactor score rewards lower-volatility companies and implicitly tilts the strategy toward this factor. (For more on our multifactor methodology, please refer to this piece.)

WisdomTree U.S. Multifactor Index vs. S&P 500 Index (06/30/2017–08/31/2018)– Volatility Quintile Attribution									
Category	Attribution Components				Average Category Weights			Category Performance	
	Allocation	Stock Selection	Interaction	Total Attribution	WT Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
1st Quintile (Lowest Volatility)	-0.67%	1.25%	0.58%	1.16%	44.30%	33.56%	10.75%	17.55%	14.38%
2nd Quintile	-0.11%	1.76%	-0.26%	1.40%	24.56%	29.25%	-4.69%	24.43%	20.94%
3rd Quintile	0.07%	0.03%	-0.05%	0.05%	14.77%	18.13%	-3.36%	24.19%	23.38%
4th Quintile	-0.09%	-0.46%	0.49%	-0.05%	8.75%	12.13%	-3.38%	18.65%	18.74%
5th Quintile (Highest Volatility)	-0.14%	0.74%	0.11%	0.71%	7.62%	6.93%	0.69%	29.85%	23.41%
Total	**-0.93%**	**3.33%**	**0.87%**	**3.27%**				**22.27%**	**19.00%**

Sources: WisdomTree, FactSet, 6/30/17–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Stock Selection Value Added Within Lowest-Volatility Quintile

The table above shows the performance attribution of WTUSMF versus the S&P 500 Index in terms of volatility quintiles. It is interesting to see how, since its inception, WTUSMF has been over-weight the lowest-volatility quintile while being under-weight the rest.

The WTUSMF has outperformed the S&P 500, despite having its highest allocation and greatest over-weight in what was the worst performing segment for the S&P 500. Strong stock selection is evident throughout four of the five volatility quintiles, combining for 333 basis points of outperformance.

Typical single-factor low-volatility portfolios tend to naively over-weight the lowest-volatility stocks in the investment universe, resulting in significant deviations in active weight while not providing differentiated stock selection. As a result of their methodology, these pure low-volatility portfolios magnify their interest rate sensitivity, and their performance becomes heavily dependent on the path of rates, as they have no other means of factor diversification.

Conclusion

WisdomTree implements a composite multifactor blending approach targeting value-added stock selection. Although we do not explicitly target low volatility as an alpha-seeking factor, our methodology results in an implicit tilt toward it. This implicit tilt allows the stock selection benefits inherent in our methodology to persist and thus give alpha potential regardless of the path in interest rates.

[1]Source: Bloomberg, 6/30/17–8/31/18.

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You cannot invest directly in an index.

DEFINITIONS

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Basis point : 1/100th of 1 percent.

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.

Risk-adjusted basis : When calculating the return, we refines the return by measuring how much risk is involved in producing that return.

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.

Composite Factor Score (CFS) : Taking individual measurements of factor exposures, and combining them into a single measure meant to represent multifactor exposure for a certain asset. For example, in the case of the WisdomTree U.S. Multifactor Index, the composite factor score aims to measure factor exposures to Value, Quality, Momentum and Low Correlation as they relate to a single asset..

Quintile : One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.