IS USMF THE ETF INDUSTRY'S NEXT FIVE-TOOL PLAYER?

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In yesterday's blog post, we discussed the background and rationale for launching the Wi sdomTree U.S. Multifactor Index—WisdomTree's latest innovation in the quest for alpha wi th a diversified factor-investing process. WisdomTree's U.S. Multifactor Index, which is tracked by the WisdomTree U.S. Multifactor Fund (USMF), is designed to provide greater potential for outperformance over standard beta indexes due to its greater stock selection risk and tracking error against beta, inherent in both its unique stock selection and its proprietary weighting methodology.

Innovations in this indexing approach include:

- **Unique blending of fundamental and technical factors** to create proprietary stock selection and weighting model.
    - WisdomTree's fundamental factor screens: value and quality.
    - WisdomTree technical factor screens: momentum and low correlation
- **Active Selection:** WisdomTree selects stocks from a universe of the 800 largest market capitalization stocks in the United States. From this universe, WisdomTree selects the top 200 stocks with the highest combined factor score.
- **Risk and Return Weighting:** WisdomTree utilizes not just a stock's factor score—its alpha signal—as part of the weighting process, but also its volatility level. Weighting by half of a stock's factor score and half of its volatility score creates a risk-adjusted weighting system.
- **Sector Neutrality:** One of the key potential risks WisdomTree identified in factor investment strategies is how many such strategies wind up with large sector bets compared to the market. These sector bets may help or hurt over given market cycles, potentially causing the performance of one such strategy to have more to do with its sector exposures than its factor exposures. WisdomTree, in looking to add value through a diversified factor selection model, wanted to minimize the risk of diluting our alpha signals because of mismatched sector weights relative to the market.

Risk Reduction Methodology

One of the innovations in the WisdomTree factor approach was to incorporate a two-pronged volatility reduction strategy. Given that low volatility approaches have added to risk-adjusted returns over time, but not necessarily to absolute returns, we chose not to include it in our alpha-focused stock selection process.

Instead, WisdomTree incorporated a volatility-oriented weighting methodology to be applied to those stocks shown to have diversified factor alpha from exposure to value, quality, momentum and low correlation signals. We believe increasing exposure to lower-correlated parts of the market enhances diversification, and our research leads us to believe it can lower the overall volatility of our multifactor, alpha-driven strategy.

The WisdomTree multifactor methodology thus selects and weights constituents in an *alpha*-oriented manner, while also tilting those weights based on the overall volatility of each component—a Sharpe ratio weighting concept. Finally, because we depart from market cap weighting in weighting via our factor score and volatility scores, the Index naturally tilts toward more mid-cap exposure, thus giving the WisdomTree U.S. Multifactor Index exposure to the size factor.

The WisdomTree U.S. Multifactor Index can be summarized with this flow diagram:

Source: WisdomTree.

Diversifying Factor-Specific Risk

A key benefit of using a multifactor stock selection methodology is the potential to diversify factor-specific risk. A natural question is: Why did we choose to score individual stocks based on our factor definitions rather than equally weighting the stocks selected for our distinct factor portfolios?

Our research found that by picking stocks based on one factor at a time, we diluted the alpha potential of various factor exposures when they were combined. To use a baseball analogy, rather than selecting the starting everyday lineup based on a players' ability to excel in an individual area, we choose instead to search for "five-tool players"—those who can hit, hit with power, run, field and throw, in other words, the next Joe DiMaggio, Willie Mays or Roberto Clemente. Striking this balance helped us select 200 stocks that tapped into multiple factors, resulting in a basket more likely to outperform in various environments. We also believe that factors interact in ways one might not expect. For example, sometimes momentum acts best when applied to a value stock rather than as its own stand-alone screen. This might allow investors to avoid a value trap or hold a well-performing value stock longer, when it otherwise might have been rebalanced out of the portfolio as valuations rise.

Conclusion

Navigating today's investment landscape can be difficult. Investors face many choices: between active and passive, mutual funds and exchange-traded funds (ETFs), and now beta and smart beta. WisdomTree believes it has tools that can help investors build a core smart beta position or, with this new Index and the ETF tracking it, a strategy that can replace traditional active managers.

With our initial dividend- or earnings-weighted methodologies, we have provided investors with broad diversified market exposure but have done so with a simple and intuitive twist: weighting equity markets by income. While this approach is now characterized as "smart," it felt more like a clever way to gain beta exposure to the market, as opposed to an alpha-focused strategy centered on factor-based stock selection.

In the case of the WisdomTree U.S. Multifactor Index, we wanted to provide that same access to investors but now seek alpha more directly through focused factor exposure rather than just tilts. We did so in a sector-neutral manner, ensuring that the alpha generated comes from stock selection via factors rather than sector tilts. We included low correlation as a selection screen to potentially enhance returns and diversification, but incorporated low volatility into the weights we assign stocks at the quarterly rebalance. To us, this is the simple and intuitive solution to multifactor exposure, and one that, we hope, can serve investors when incorporated into their U.S. allocations over the long term. For investors interested in learning more about the ETF that tracks this Index, click on the WisdomTree U.S. Multifactor Fund (USMF).

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You cannot invest directly in an index.

DEFINITIONS

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Value Factor : 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 tim.

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.

Low Correlation : Characterized by assets that have a relatively lower correlation vs the market over time. This term is also associated with the Low Correlation Factor which associates these stock characteristics with excess returns vs the market over time.

Market Capitalization : 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.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

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. .

Risk-adjusted returns : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Sharpe ratio : Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.

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.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund’s weight.

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

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

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