

# HOW TO BUILD A MORE COMPLETE QUALITY PORTFOLIO IN U.S. EQUITIES

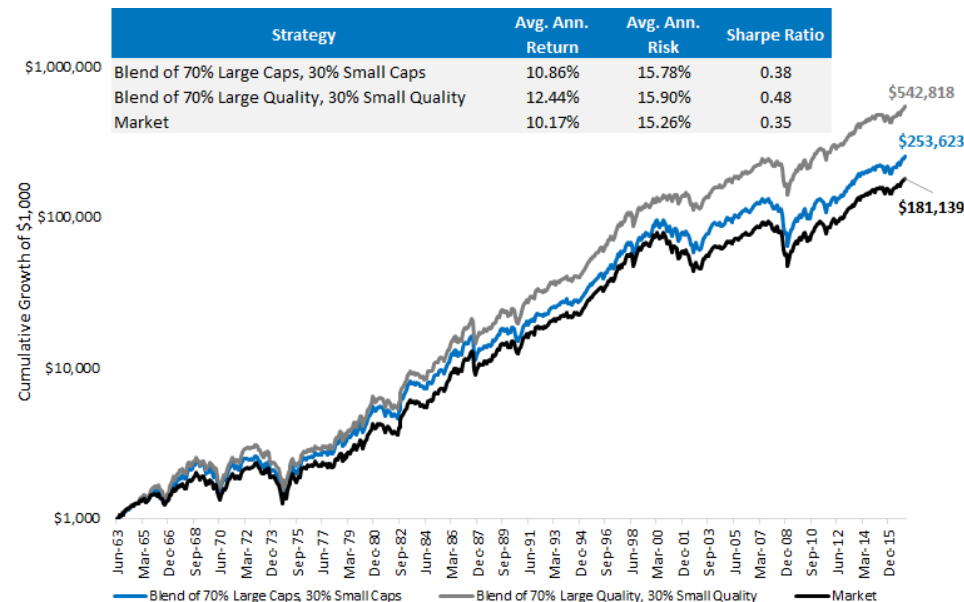
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In 2015, Cliff Asness and his colleagues released a paper with the highly provocative title “Size Matters, if You Control Your Junk.”<sup>1</sup>

We agree that taking an additional layer of focus within small-cap stocks—for example, small caps plus quality, small caps plus value or small caps plus momentum—can be very helpful, to allow for the risk/return trade-offs to be potentially more attractive.

However, it is critical to think of small caps not only as stand-alone options but also in terms of how they might sit within portfolio allocations.

## Quantifying a Quality Upgrade over the Long Term



Sources: WisdomTree, Kenneth French Data Library, with data from 6/30/1996 to 2/28/2017. Past performance is not indicative of future results. You cannot invest directly in an index. Large Caps: The largest 30% of U.S. publicly listed equities by market capitalization. Small Caps: The smallest 30% of U.S. publicly listed equities by market capitalization. Quality refers to a tilt toward companies with favorable operating profitability metrics. Market refers to all U.S. listed stocks.

## Large Caps and Small Caps vs. Large Quality and Small Quality

[Factor investing](#) has generated significant attention of late:

- **Blending Large Caps and Small Caps Outperformed the Market:** Over this very long period, going from a full, broad market strategy to a strategy of 70% large caps and 30% small caps outperformed by more than 60 [basis points \(bps\)](#) per year. However, this did also come with an incremental increase in about 60 bps of risk, leading to a slightly higher [Sharpe ratio](#).
- **Practical Application of the Factor Discussion—the “Quality Upgrade”:** Much has been made of the various investment factors, but we think one of the primary potential benefits lies in introducing tilts to a given exposure. Here, we looked at the concept of 70% large-cap quality and 30% small-cap quality, instead of merely saying 70% large cap and 30% small cap. As can be seen, there was a greater than 2%-per-year incremental increase in returns, leading to a terminal growth of \$1,000 that is more than twice as high as simply looking at the large-cap/small-cap blend alone. This was also achieved with a much more significant increase in the Sharpe ratio.

### Small Caps Offer Fertile Ground for Factor Tilts

While the five commonly discussed factor exposures are value, momentum, quality, size and low [volatility](#), we’d encourage investors to not think of them as necessarily being mutually exclusive. For instance, the concept of small value has been prevalent for many years and would imply exposure to at least two factor premiums—small caps and value.

*The real bottom line is that factor tilts within small caps afford the opportunity to challenge the traditional assumption that one needs an [active manager](#) to outperform in the “less efficient” small-cap space.*

### How WisdomTree Provides Small-Cap Quality Exposure

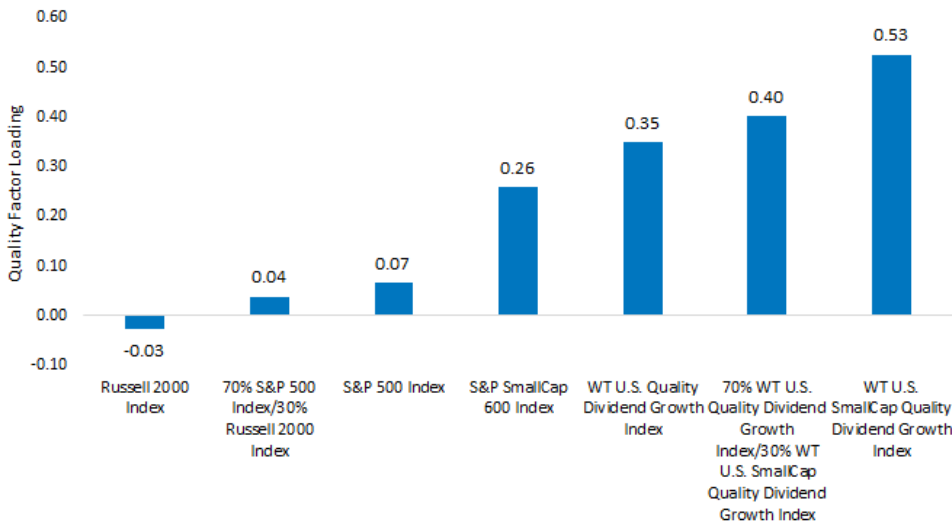
One other investment strategy often utilized focuses on the power of dividend growth over the long haul. We associate dividend growth strategies with the traditional quality factor from the academic world.

Although the first place many might look for dividend growth within U.S. equities is large-cap, blue-chip companies, many might be surprised to learn that the phenomenon can also be captured within U.S. small caps. In 2013, we developed the [WisdomTree U.S. Small Cap Quality Dividend Growth Index](#), which zeros in on U.S. small-cap companies with the potential to grow their dividends over time. An important point: we use a forward-looking methodology as opposed to past dividend history to avoid narrowing the Index. For example, as of March 31, 2017<sup>2</sup>:

- The [S&P 500 Dividend Aristocrats Index](#) requires constituents to exhibit at least 25 years of consecutive, year-over-year dividend growth, and it had 51 member stocks as of this date. The broader [S&P High Yield Dividend Aristocrats Index](#), which requires a mere 20 years of consecutive dividend growth, had 108 members.
- The [S&P MidCap 400 Dividend Aristocrats Index](#) requires constituents to exhibit at least 15 years of consecutive, year-over-year dividend growth, leading to 46 member stocks as of this date.

Do you think it's impossible to focus solely on small caps while encompassing an attentiveness to dividend growth? The WisdomTree U.S. SmallCap Quality Dividend Growth Index had 257 constituents as of March 31, 2017.<sup>3</sup> The reason for the relative broadness of exposure is that the forward-looking [earnings growth expectations](#) combined with [return on equity](#) and [return on assets](#) create a logical framework upon which potential future dividend growth may be built.

Accessing the Quality Factor in Recent Years



Sources: WisdomTree, Bloomberg, Kenneth French Data Library. Period is from 4/30/13 to 2/28/17, starting the first full month of live calculation for the WisdomTree U.S. Quality Dividend Growth Index and the WisdomTree U.S. SmallCap Quality Dividend Growth Index. Past performance is not indicative of future results. You cannot invest directly in an index.

- Factor Loading:** There are a few crucial comparisons to point out. First, there's the stepwise progression from the [Russell 2000 Index](#) (which has negative loading to quality) to the [S&P SmallCap 600 Index](#) (constituents are required to demonstrate profitability prior to initial inclusion) to the wisdomTree U.S. SmallCap Quality Dividend Growth Index, which had about twice the loading to quality as the S&P SmallCap 600 Index. Second, there is the stepwise progression from the [S&P 500 Index](#) to the [WisdomTree U.S. Quality Dividend Growth Index](#) on the large-cap side, with about five times the quality loading as the S&P 500 Index.
- Blends Exhibited Significant Differentiation:** The blend of 70% S&P 500 Index/30% Russell 2000 Index had a .04 loading to quality, whereas the blend of 70% WisdomTree U.S. Quality Dividend Growth Index/30% wisdomTree U.S. SmallCap Quality Dividend Growth Index had a loading to quality of .40, 10 times higher.

[As we discussed in this piece on the long-term returns to various small cap indexes](#), there can be a wide differentiation in returns to small-cap factor strategies. If one is looking for exposure to the "small-cap quality" factor, we find little competition for the wisdomTree U.S. SmallCap Quality Dividend Growth Index, certainly few with as high of a factor loading to it. Over the long run, we believe this factor will be rewarded, and this wisdomTree Index is unique in capturing this concept.

<sup>1</sup>Source: Chris Asness et al., "Size Matters, if You Control Your Junk," AQR, 1/15 (first draft).

<sup>2</sup>Respective index fact sheets with data as of 3/31/17 for the S&P 500 Dividend Aristocrats Index, the S&P High Yield Dividend Aristocrats Index and the S&P MidCap 400 Dividend Aristocrats Index.

<sup>3</sup>Sources: WisdomTree, FactSet.

**Important Risks Related to this Article**

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

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development.

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](#).

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You cannot invest directly in an index.

## DEFINITIONS

**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.

**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.

**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.

**Factor-based**: Strategies that focus on groups of firms thought to share common attributes, be it in terms of their fundamentals or their share price behavior.

**Basis point**: 1/100th of 1 percent.

**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.

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

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

**Earnings growth estimates**: Bloomberg analysts' long-term earnings growth expectations, which encompass the estimated growth in operating earnings per share over the company's next full business cycle, typically three to five years.

**Return on Equity (ROE)**: Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

**Return on assets (ROA)**: Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

**Russell 2000 Index**: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**S&P SmallCap 600 Index**: Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

**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.