A TALE OF TWO MARKET REGIMES

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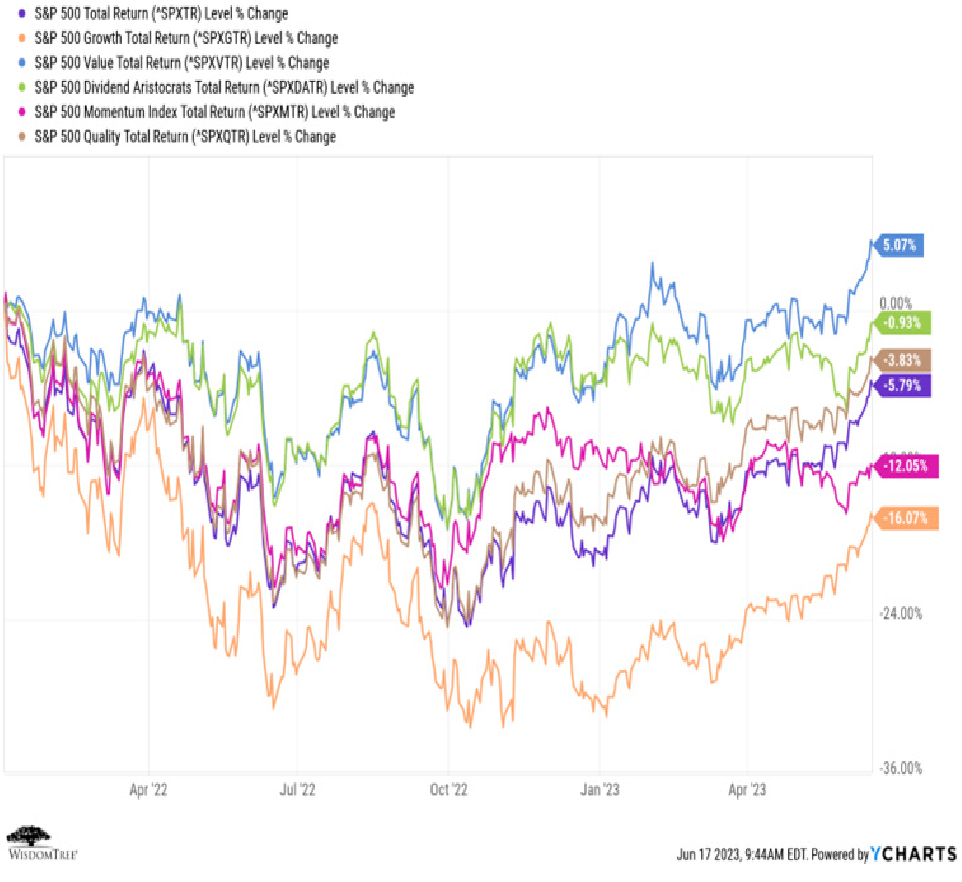
This article is relevant to financial professionals who are considering offering model portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness…"

A Tale of Two Cities by Charles Dickens

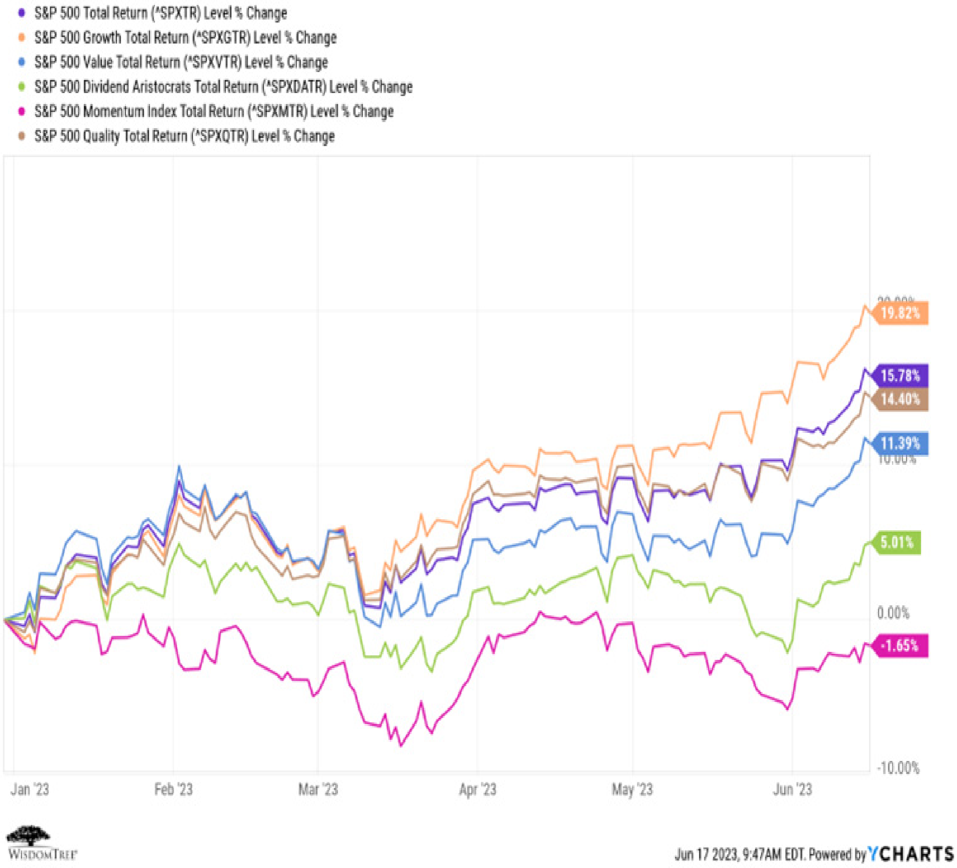
Let's begin our "tale of two market regimes" by comparing risk factor performances for the S&P 500 index for calendar year 2022…



Source: YCharts, 2022. You cannot invest in an index and past performance does not guarantee future results.

For definitions of terms in the chart above, please visit the glossary.

…with YTD performances in 2023:



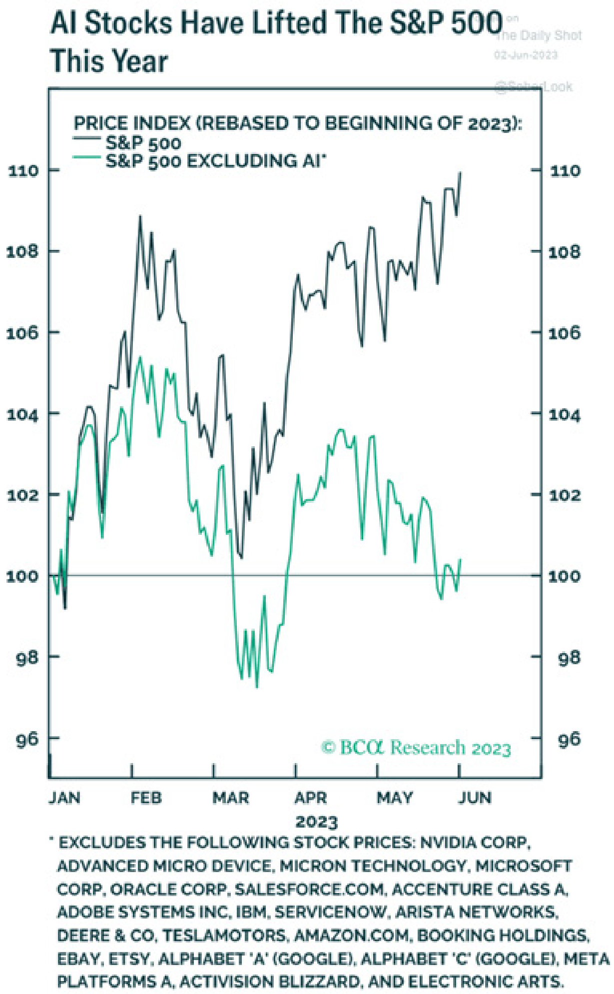
Source: YCharts, 1/1/23–6/16/23. You cannot invest in an index and past performance does not guarantee future results.

The contrast is stark. In 2022, the leading (in fact, dominant) factors were value, dividends and quality, with a massive 21% differential between value (+5%) and growth (-16%).

Compare that with YTD performance in 2023. There is once again a gap between value (+11.4%) and growth (+19.8%)—but in the opposite direction. Note as well that quality has hung in there (+14.4%), but dividends (+5%) lag far behind.

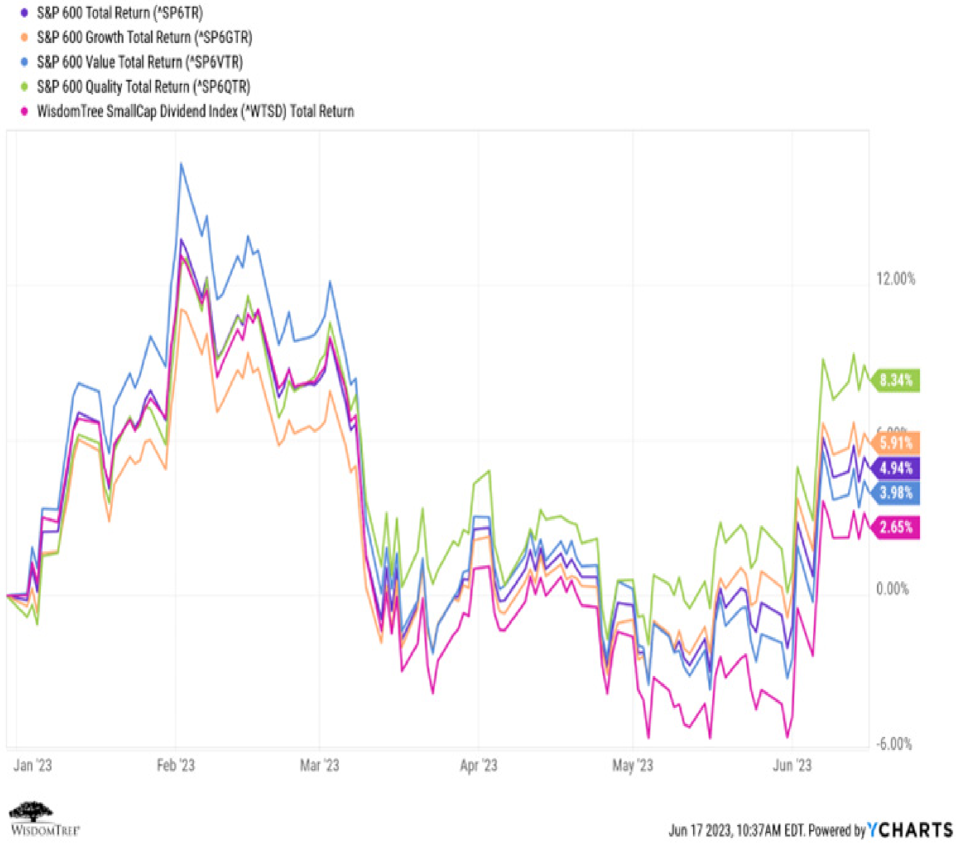
What happened? We think three things: (1) the banking crisis resulted in a decline in interest rates, which typically benefits growth stocks (by lowering the discount rate on future cash flows); (2) investor concerns over an impending recession resulted in a rotation out of value and into growth stocks (value stocks tend to be more sensitive to a decelerating economy); and (3) artificial intelligence (AI) became the ‘meme theme,’ which hugely benefitted the mega-cap tech stocks.

Take a look at the YTD performance of the S&P 500 index with and without the so-called AI-influenced stocks—almost ALL the positive performance in the S&P 500 index this year has been driven by mega-cap tech stocks.



Sources: The Daily Shot and BCA Research, as of 6/2/23. You cannot invest in an index and past performance does not guarantee future results.

The performance differentials between factors also extends to U.S. small- and mid-cap stocks. The value and dividend factors, which tend to be heavily allocated to Financials, were rocked by the regional banking crisis in March and April.



Source: YCharts, 1/1/23–6/16/23. You cannot invest in an index and past performance is no guarantee of future results.

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Something interesting in both market regimes (2022 and YTD 2023) is that the quality factor held up. We define "quality," following the classic DuPont Analysis, as companies with stronger balance sheets, earnings and cash flows. Our own analysis indicates that the quality factor is, indeed, the most consistently performing risk factor, which is why it is the anchor factor for our Model Portfolios. Focus on the teal line, below.

Rolling 10-Year Excess Return vs. Market

Sources: WisdomTree, Kenneth French Data Library. Data as of 3/31/23, and represents the latest available. Using French's definitions: Value = Hi 30 portfolio, Size = Lo 30 portfolio, Quality = Hi 30 portfolio, Low Vol = BIG LoVar portfolio and High Div = Hi 30 portfolio.

So, What Does All this Mean?

Just like asset classes, risk factors rotate in and out of favor as we move through different market regimes. This is the reason we build Model Portfolios at WisdomTree that seek diversification at both the asset class and risk factor levels.

We believe that gives us the best potential for delivering more consistent performance over full market cycles. Note below that the quality factor, highlighted in brown, mostly occupies the middle two-thirds of the quilt, supporting our belief that it is the most consistent risk factor.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD	2008 - 2022 Ann.	2008 - 2022 Vol.
Min. Vol. -25.7%	Value 38.8%	Small Cap 26.9%	High Div. 14.3%	Cyclical 20.1%	Value 43.2%	Value 17.7%	Momen. 9.3%	Small Cap 21.3%	Momen. 37.8%	Min. Vol. 1.5%	Cyclical 36.3%	Momen. 29.6%	Value 29.2%	Defens. 5.3%	Cyclical 12.6%	Min. Vol. 9.5%	Small Cap 23.2%
Defens. -26.7%	Cyclical 36.9%	Multi-Factor 18.3%	Min. Vol. 12.9%	Value 16.8%	Small Cap 38.8%	Min. Vol. 16.5%	Min. Vol. 5.6%	High Div. 16.3%	Cyclical 27.3%	Momen. -1.6%	Quality 34.4%	Cyclical 27.8%	Cyclical 27.6%	High Div. -3.8%	Quality 9.2%	Momen. 9.2%	Value 21.4%
High Div. -27.6%	Multi-Factor 29.8%	Momen. 18.2%	Defens. 10.1%	Small Cap 16.3%	Multi-Factor 37.4%	High Div. 14.9%	Quality 4.6%	Value 15.9%	Quality 22.5%	High Div. -2.3%	Momen. 28.1%	Small Cap 20.0%	Quality 27.2%	Min. Vol. -9.2%	Multi-Factor 4.6%	Quality 9.2%	Cyclical 20.9%
Quality -31.2%	Small Cap 27.2%	Cyclical 17.9%	Quality 7.5%	Multi-Factor 15.7%	Cyclical 35.0%	Multi-Factor 14.8%	Cyclical 2.6%	Cyclical 14.0%	Value 22.2%	Defens. -2.9%	Min. Vol. 28.0%	Quality 17.1%	Multi-Factor 25.1%	Value -14.0%	Small Cap 2.7%	High Div. 9.1%	Momen. 19.0%
Small Cap -33.8%	Quality 24.9%	High Div. 15.9%	Multi-Factor 7.3%	Momen. 15.1%	Momen. 34.8%	Momen. 14.7%	High Div. 0.7%	Multi-Factor 13.7%	Multi-Factor 21.5%	Cyclical -5.3%	Value 27.7%	Multi-Factor 11.4%	Defens. 25.0%	Multi-Factor -15.5%	Value 2.5%	Cyclical 8.9%	Multi-Factor 18.5%
Value -36.9%	High Div. 18.4%	Min. Vol. 14.7%	Momen. 6.1%	Quality 12.8%	Quality 34.3%	Cyclical 13.6%	Multi-Factor 0.4%	Min. Vol. 10.7%	High Div. 19.5%	Quality -5.6%	Multi-Factor 26.6%	Min. Vol. 5.8%	High Div. 21.9%	Momen. -17.4%	Min. Vol. 1.3%	Multi-Factor 8.5%	Quality 17.0%
Multi-Factor -39.3%	Min. Vol. 18.4%	Quality 14.2%	Value -2.7%	Min. Vol. 11.2%	High Div. 28.9%	Defens. 13.0%	Defens. -0.9%	Quality 9.4%	Min. Vol. 19.2%	Multi-Factor -9.7%	Small Cap 25.5%	Defens. 5.2%	Min. Vol. 21.0%	Quality -20.3%	High Div. -0.7%	Defens. 8.3%	High Div. 15.7%
Momen. -40.9%	Momen. 17.6%	Value 12.7%	Cyclical -3.4%	Defens. 10.7%	Defens. 28.9%	Quality 10.7%	Small Cap -4.4%	Defens. 7.7%	Small Cap 14.6%	Small Cap -11.0%	High Div. 22.6%	High Div. 1.7%	Small Cap 14.8%	Small Cap -20.4%	Defens. -3.0%	Value 8.0%	Defens. 14.5%
Cyclical -44.8%	Defens. 16.5%	Defens. 12.0%	Small Cap -4.2%	High Div. 10.6%	Min. Vol. 25.3%	Small Cap 4.9%	Value -6.4%	Momen. 5.1%	Defens. 12.3%	Value -11.1%	Defens. 21.4%	Value -0.2%	Momen. 12.9%	Cyclical -27.2%	Momen. -4.2%	Small Cap 7.2%	Min. Vol. 13.9%

Source: JP Morgan "Guide to the Markets," 3/31/23. Additional sources: FactSet, MSCI, Russell, Standard & Poor's, J.P. Morgan Asset Management. The MSCI High Dividend Yield Index aims to offer a higher-than-average dividend yield relative to the parent index that passes dividend sustainability and persistence screens. The MSCI Minimum Volatility Index optimizes the MSCI USA Index using an estimated security co-variance matrix to produce low absolute volatility for a given set of constraints. The MSCI Defensive Sectors Index includes: Consumer Staples, Energy, Health Care and Utilities. The MSCI Cyclical Sectors Index contains: Consumer Discretionary, Communication Services, Financials, Industrials, Information Technology and Materials. Securities in the MSCI Momentum Index are selected based on a momentum value of 12-month and 6-month price performance. Constituents of the MSCI Sector Neutral Quality Index are selected based on stronger quality characteristics to their peers within the same GICS sector by using three main variables: high return-on-equity, low leverage and low earnings variability. Constituents of the MSCI Enhanced Value Index are based on three variables: price-to-book value, price-to-forward earnings and enterprise value-to-cash flow from operations. The Russell 2000 is used for small cap. The MSCI USA Diversified Multiple Factor Index aims to maximize exposure to four factors: Value, Momentum, Quality and Size. Annualized volatility is calculated as the standard deviation of quarterly returns multiplied by the square root of four.

For definitions of terms in the chart above, please visit the glossary.

With respect to our market outlook, there certainly is the possibility that growth will continue to dominate factor performance over the short term. We think it will be highly dependent on Fed actions, investor sentiment and whether we decline into recession (and, if so, how badly).

From a valuation perspective, however, we believe small caps, dividends and value will regain superiority over the medium to longer term.

Growth is on a run, for sure (though somewhat narrowly within mega-cap tech stocks) but, as the market adage goes, "Trees don't grow to the sky." Or, as economist Herbert Stein famously put it, "If something can't continue, it won't." There will reach an inflection point when investors will stop paying ever-higher multiples for ever-inflating stocks.

Anyone who knows WisdomTree knows we are primarily (but not exclusively) a shop that tilts toward value, size, dividends and quality in both our product set and our Model Portfolios. We certainly have growth-focused products (e.g., QGRW and our own AI-focused product, WTAI), and we certainly seek to allocate to growth strategies (both our own and third-party) within most of our Model Portfolios, for risk factor diversification purposes.

But we maintain confidence in our ability to pursue more consistent performance with an anchor allocation to quality, surrounded by varying allocations to value, size, dividends and, yes, growth.

You never know when the next market "wave" will roll in, and we believe in being prepared to sail through whatever the market seas throw our way.

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DEFINITIONS

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.

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

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.

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.

Discount rate : The interest rate the Federal Reserve charges commercial banks and other financial institutions for short-term loans.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Artificial intelligence : machine analysis and decision-making.

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

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.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.