
QUALITY STREET

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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.

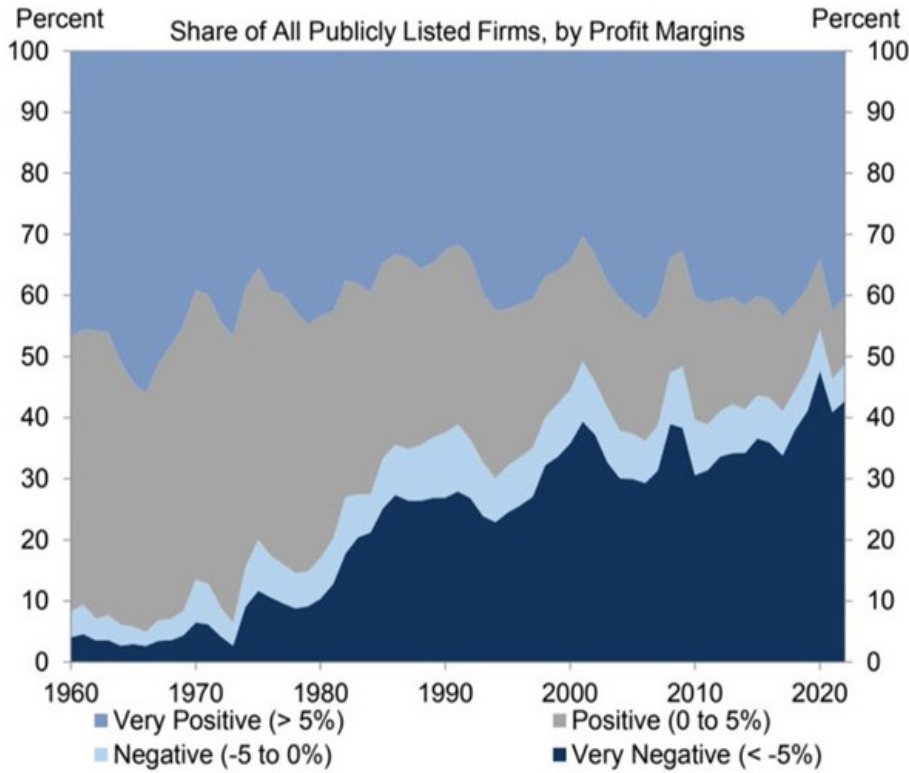
*I have heard of playing around with numbers
But one is all I need
She can't be beat; she makes me complete
On Quality Street*

(From "Quality Street" by Van Morrison, 1991)

We last focused on the "quality" factor back in May with ["Quality Is Job One."](#) Given the current market environment, it feels like it is time to revisit it.

At first thought, some might wonder what we mean by "current market environment." The economy is proving to be more resilient than many expected, inflation is coming down, the [Fed](#) appears to be at or near the end of its [rate hike](#) cycle and, at least in the initial stages, Q3 earnings are in line with expectations. So, in the immortal words of Alfred E. Neuman, the perpetual "cover boy" for *MAD* magazine, "What, me worry?"

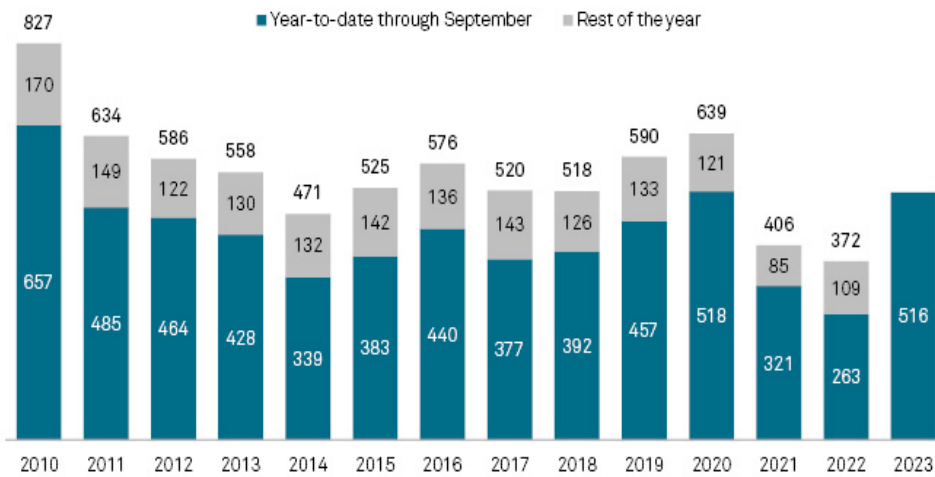
But let's dig a little deeper. First, this chart shows the declining profit margins of almost half of all publicly listed U.S. companies.



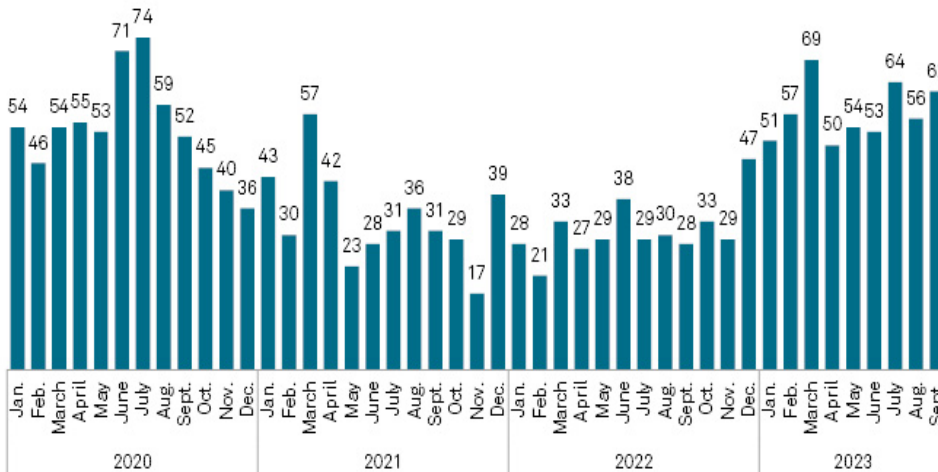
Source: Michael A. Arout and Goldman Sachs, 10/10/23.

Second, we see a steady increase in bankruptcies so far in 2023—the highest level since the COVID-19 pandemic of 2020.

US bankruptcy filings by year



US bankruptcy filings by month



Data compiled Oct. 3, 2023.

Includes S&P Global Market Intelligence-covered U.S. companies that announced a bankruptcy between Jan. 1, 2020, and Sept. 30, 2023.

S&P Global Market Intelligence's bankruptcy coverage is limited to public companies or private companies with public debt where either assets or liabilities at the time of the bankruptcy filing are greater than or equal to \$2 million, or private companies where either assets or liabilities at the time of the bankruptcy filing are greater than or equal to \$10 million.

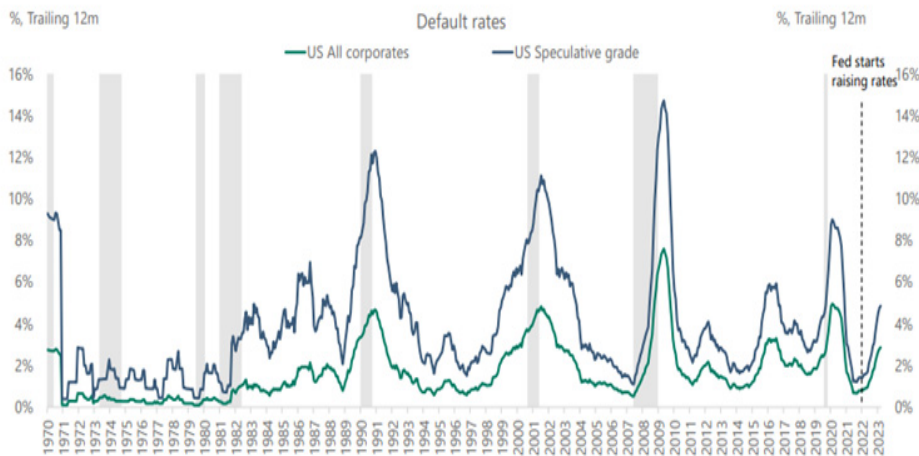
Source: S&P Global Market Intelligence.

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Source: S&P Global Market Intelligence, through 9/30/23.

We could go on but will share just a few more charts, this time from the [bond market](#), which is showing a steady increase in default rates.

A default cycle has started



Sources: Moody's Analytics and Torsten Slok, Chief Economist of Apollo Global Management, as of October 2023.

Also, while many companies did a respectable job of terming out their debt when rates were exceptionally low, both investment-grade and [high-yield](#) bonds face sizable “maturity walls” over the next 12–36 months (meaning they will need to refinance in a much higher [interest rate](#) environment).

Let’s be clear. We are not taking on the character of “Chicken Little” and proclaiming “the sky is falling.” We simply want to illustrate that, much like a duck on a pond, everything may look smooth and serene on the surface, but underneath the water, there is more action going on than meets the eye. Said differently, we see more fragility in the market environment than the headline numbers may suggest.

Which brings us back to the [quality](#) factor.

Let’s define terms. “Quality” has its roots in the well-known [DuPont Analysis](#), which defines quality as firms with better relative [margins](#), earnings, [cash flow](#) and [balance sheets](#) ([ROE](#), [ROA](#) and [leverage](#), respectively). At WisdomTree, we extend that line of thought to include [companies with better dividend sustainability and pricing power](#) (i.e., the ability to withstand margin pressures in times of economic distress).

We measure this through our proprietary [“composite risk score,”](#) which seeks to find the highest-quality securities in many of the Indexes we manage.

Remember, WisdomTree is a “self-indexing” firm—we do not license most of our Indexes from third parties but create and manage them ourselves and then wrap ETFs around them, thereby giving us control over the screening filters and which securities go into those ETFs.

Why Does Quality Matter?

Let’s examine [DGRW](#), our Morningstar five-star* [large-cap](#) quality [dividend growth](#) strategy. First, let’s look at its quality metrics relative to the [S&P 500 Index](#).

**Overall rating. Large Blend (1,286 funds) as of 9/30/2023. Based on risk-adjusted returns.*

QUALITY METRICS as of 9/30/2023		500	DGRW
<i>select a characteristic to view historical data</i>			
Return on Assets (ROA%)		4.00%	4.10%
Return on Equity (ROE%)		17.35%	23.94%
Return on Sales %		14.73%	15.15%

Source: WisdomTree, as of 9/30/23. Past performance does not guarantee future results.

For definitions of terms in the table above, please visit the [glossary](#).

We see that over the past three years (including the awful 2022), [DGRW](#) added value versus the broader market index.



Source: YCharts, three-year data through 10/20/23. DGRW is an investable product, but the S&P 500 is an index. You cannot invest in an index. Past performance does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and the principal value of an investment will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than their original cost.

For the most recent month-end and standardized performance, click [here](#).

We see a similar story in small-cap stocks.

Using [DGRS](#), our small-cap quality dividend growth strategy, as a comparison, we see quality metrics versus the [Russell 2000 Index](#)..

QUALITY METRICS as of 9/30/2023		DGRS	RU2000
<i>select a characteristic to view historical data</i>			
Return on Assets (ROA%)		3.64%	1.15%
Return on Equity (ROE%)		15.31%	5.72%
Return on Sales %		9.35%	8.12%

Source: WisdomTree, as of 9/30/23. DGRS is an investable product, but the Russell 2000 is an index. You cannot invest in an index, and past performance does not guarantee future results.

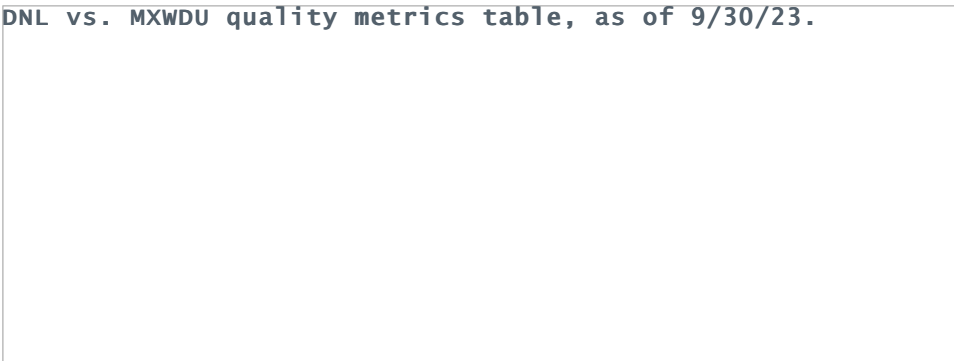
...as well as attractive performance.



For the most recent month-end and standardized performance, click [here](#).

Finally, we see that quality has outperformed outside the U.S. as well. Here we compare the quality characteristics of [DNL](#), our global ex-U.S. quality dividend growth strategy, versus its benchmark, the [MSCI ACWI ex USA Index \(MXWDU\)](#), using the primary [DuPont Analysis](#) metrics.

DNL vs. MXWDU quality metrics table, as of 9/30/23.



And now, we compare performance over the past 10 years.

DNL vs. MXWDU daily NAV performance chart, as of 9/30/23.



For the most recent month-end and standardized performance, click [here](#).

What about Fixed Income?

The more than 100-basis-point increase in the [10-Year Treasury rate](#) over the past three months is well documented and widely discussed. What is less discussed is the widening of [credit spreads](#) (especially in high yield) over that same period.

In a market environment marked by rising interest rates and widening spreads, quality can be equally as important in fixed income as it is in equities. Focusing on our high-yield strategy, [WFHY](#), it accesses the broad U.S. high-yield market with an important caveat—it screens out issuers with negative cash flow. The result is a far lower default rate in comparison to the broader high-yield market.

Cumulative high yield defaults chart, as of 9/30/23.

Default rates in the age of low interest rates were low, perhaps leading some investors to wonder why quality screens matter

A fair question, but one that may have a different answer going forward. We saw above that default rates are climbing, and many high-yield issuers face an impending “maturity wall.” We believe quality will be as important for fixed income going forward as it is for equities.

Conclusion

Here at WisdomTree, we will never apologize for anchoring many of our products and Model Portfolios to the quality risk factor. Historical performance suggests that doing so provides the potential for much more consistent performance over full market cycles.

Given what we believe will be volatile and uncertain markets over the remaining course of 2023 and beyond, we have an even higher conviction in tilting toward the quality factor.

We are more than happy to continue to walk along “quality street”.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal.

DGRW/DGRS: Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

DNL: Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not

guaranteed, and a company currently paying dividends may cease paying dividends at any time.

WFHY: Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer’s ability to make such payments will cause the price of that bond to decline. While the Fund attempts to limit credit and counterparty exposure, the value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund’s portfolio investments.

Please read the Fund’s prospectus for specific details regarding the Fund’s risk profile.

The Morningstar Rating™ for funds, or “star rating,” is calculated for managed products with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance.

The top 10% of products in each product category receive five stars, the next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars, and the bottom 10% receive one star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three- and five-year Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns.

Overall ratings shown for funds with four or five stars only.

HISTORY:

3-Year | 4 out of 5 stars - Large Blend (1,286 funds)

5-Year | 4 out of 5 stars - Large Blend (1,184 funds)

10-Year | 5 out of 5 stars - Large Blend (877 funds)

Morningstar ratings are based on risk-adjusted return. Past performance is not indicative of future results.

For the top 10 holdings of DGRW please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/dgrw>

For the top 10 holdings of DGRS please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/dgrs>

For the top 10 holdings of DNL please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/dnl>

For the top 10 holdings of WFHY please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/fixed-income/wfhy>

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.

Related Blogs

+ [Quality Is Job One](#)

Related Funds

+ [WisdomTree U.S. Quality Dividend Growth Fund](#)

- + [WisdomTree U.S. SmallCap Quality Dividend Growth Fund](#)
- + [WisdomTree Global ex-U.S. Quality Dividend Growth Fund](#)
- + [WisdomTree U.S. High Yield Corporate Bond Fund](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

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DEFINITIONS

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

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Bond market : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

High Yield : Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.

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

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.

Margins : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

Cash flows : a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new positions.

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.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term “large market capitalization”. Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Dividend growth : The growth in trailing 12-month dividends for the specified universe.

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.

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.

MSCI ACWI ex-U.S. Index: A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets excluding companies based in the United States.

DuPont Equation: At the DuPont Corporation, Donaldson Brown created the concept that Return on equity (ROE) is broken down into the interaction between profit margin, by asset turnover, and the equity multiplier. These three pieces multiplied together are equal to ROE.

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

Spread: Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.