CHECKING IN ON RISK FACTOR DIVERSIFICATION

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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.

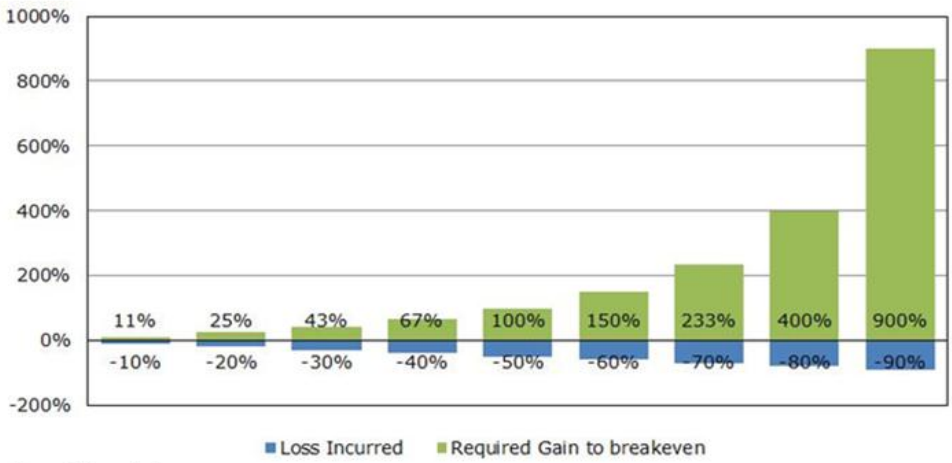
If you are a regular reader of WisdomTree blog posts, you know how seriously we take [factor diversification]() in the construction of our Model Portfolios.

Almost everyone understands and agrees on the importance of ***asset allocation***—that is, diversifying a portfolio across multiple asset classes to improve the consistency and risk-adjusted performance potential of the portfolio. And many are very familiar with the “asset class quilt chart,” which illustrates just how difficult it can be to predict which asset classes will perform best and how diversifying may offer a more consistent performance.

																2006 - 2020	
2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD	Ann.	Vol.
REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	Large Cap 31.5%	Small Cap 20.0%	Comdty. 29.1%	Large Cap 9.9%	EM Equity 23.3%
EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	REITs 28.7%	EM Equity 18.7%	REITs 21.6%	Small Cap 8.9%	REITs 23.1%
DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 25.5%	Large Cap 18.4%	Large Cap 15.9%	High Yield 7.5%	Small Cap 22.6%
Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 22.7%	Asset Alloc. 10.6%	Small Cap 12.4%	REITs 7.1%	DM Equity 19.1%
Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 19.5%	DM Equity 8.3%	DM Equity 8.8%	EM Equity 6.9%	Comdty. 18.8%
Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	EM Equity 18.9%	Fixed Income 7.5%	Asset Alloc. 8.7%	Asset Alloc. 6.7%	Large Cap 16.7%
High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	High Yield 12.6%	High Yield 7.0%	High Yield 1.7%	DM Equity 5.0%	High Yield 12.2%
Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 8.7%	Cash 0.5%	Cash 0.0%	Fixed Income 4.5%	Asset Alloc. 11.8%
Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 7.7%	Comdty. -3.1%	EM Equity -1.0%	Cash 1.2%	Fixed Income 3.2%
Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 2.2%	REITs -5.1%	Fixed Income -1.6%	Comdty. -4.0%	Cash 0.8%

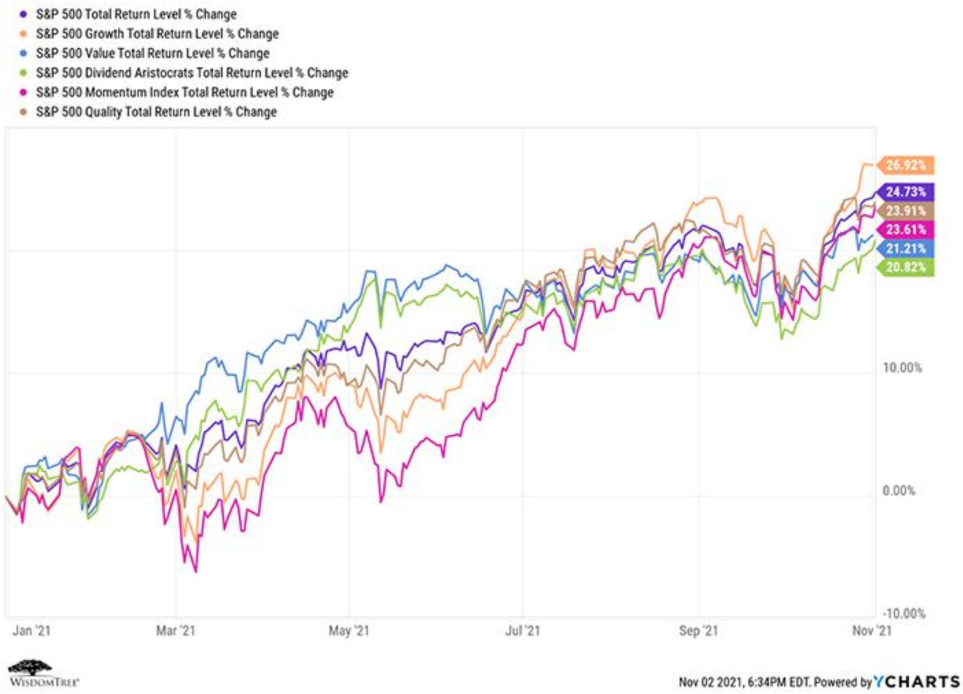
Sources: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management. Large Cap: S&P 500, Small Cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Commodity: Bloomberg Commodity Index, High Yield: Bloomberg Global HY Index, Fixed Income: Bloomberg U.S. Aggregate, REITs: NAREIT Equity REIT Index, Cash: Bloomberg 1–3 Month Treasury. The “Asset Allocation” portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg U.S. Aggregate, 5% in the Bloomberg 1–3 Month Treasury, 5% in the Bloomberg Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period from 12/31/05 to 12/31/20. All data represents total return for stated period. The “Asset Allocation” portfolio is for illustrative purposes only. Past performance is not indicative of future returns. You cannot invest in an index. Guide to the Markets – U.S. Data is as of September 30, 2021.

Why does consistency of performance matter? Let’s remind ourselves of the ***power of compounding***—if you don’t lose as much in down markets, you don’t need to gain as much in up markets to still come out ahead.



Source: BizNews, 9/30/14.

At WisdomTree, we take diversification one level further and diversify across ***risk factors*** as well as across asset classes. Take a look at the performances of multiple risk factors over the course of this year within the [S&P 500 Index](#)—note that there is an almost 7% return dispersion between them.

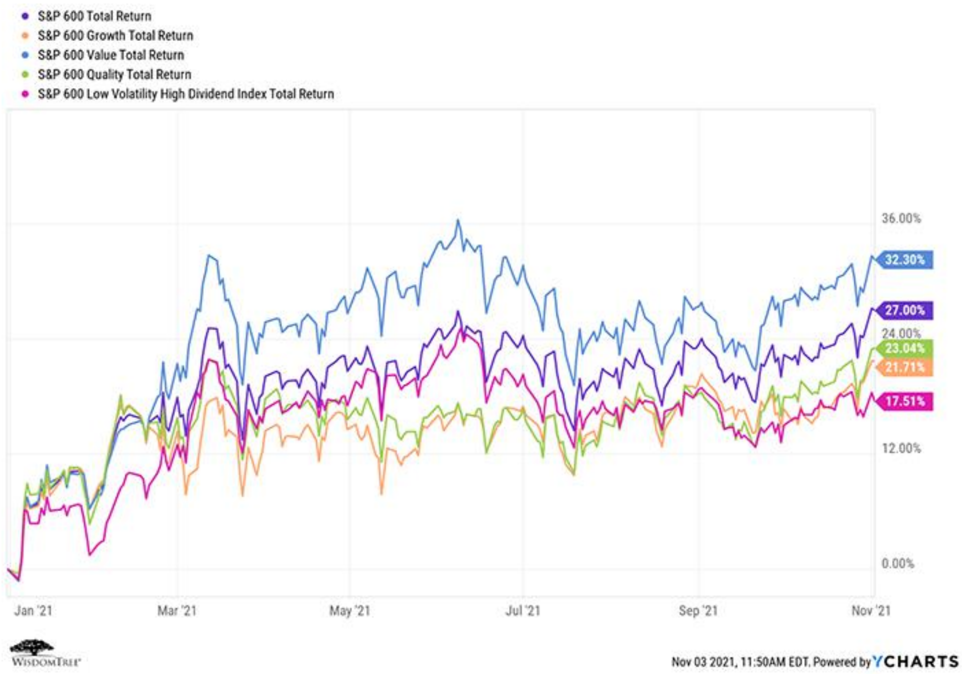


Source: YCharts, data year to date ("YTD") through 11/1/21. You cannot invest in an index, and past performance does not guarantee future performance.

Another factor that doesn't show up in the above chart is the "[size](#)" factor; that is, the performance of [smaller-cap](#) stocks versus [larger-cap](#) stocks. Using the S&P 500 Equal Weight Index as a proxy, we can see the outperformance of smaller-cap stocks over the course of this year.

Source: YCharts, data YTD through 11/2/21. You cannot invest in an index, and past performance does not guarantee future results.

It is also worth noting that factor performance is not necessarily consistent across asset classes. While value and quality are middle-of-the-pack performers YTD in large-cap stocks, where growth has dominated, they are performing much better in mid- and small-cap stocks, while growth has lagged (using the S&P 600 Index as the proxy for SMID-cap stocks).



Source: YCharts, data YTD through 11/2/21. You cannot invest in an index, and past performance does not guarantee future results.

As one final example, take a look at the YTD performance differential between broad market and small-cap emerging markets ("EM") stocks.

Source: YCharts, data YTD through 11/2/21. You cannot invest in an index, and past performance does not guarantee future results.

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

We particularly love this last chart because we believe we are somewhat unique in that we make explicit allocations to non-U.S. small-cap stocks within many of our Model Portfolios, at both the EAFE and EM levels. [EAFE small caps have also outperformed this year, but the differential is not nearly as extreme as with EM.]

The point of the story is that, just like with asset classes, it is almost impossible to outguess the market with respect to which risk factors will outperform or for how long when they do. We prepare a "risk factor performance quilt" every month to highlight this point.

For definitions of terms mentioned above, please visit the glossary.

Conclusions and Model Portfolio Implications

While all WisdomTree Model Portfolios have different mandates, they all have certain common characteristics at the asset allocation and portfolio construction levels:

1. Global in nature. We are a global shop, and we believe in global diversification.

2. ETF-centric, to improve the potential for optimizing fees and taxes.

3. "Open architecture"—they include both WisdomTree and third-party products. This is not only the right thing to do from the end client perspective, but it also ensures that we can access any and all risk factor exposures we want to include in a given model.

4. The ETF structure and embedded risk factor tilts inherent in the WisdomTree product set allow us to build "core/satellite" portfolios—increasing the potential to deliver both cost and tax efficiency and also outperformance versus cap-weighted beta portfolios over full market cycles.

5. We charge no strategist fee—our revenue is derived solely from the expense ratios associated with the WisdomTree products we choose to include.

We believe in diversification and the power of compounding—we seek to deliver consistent performance regardless of market regime. We believe that diversifying at both the asset class and risk factor levels optimizes our potential for meeting that objective.

You can learn more about our Model Portfolios at our Model Adoption Center.

Important Risks Related to this Article

Neither diversification nor an asset allocation strategy assures a profit or eliminates the risk of experiencing investment losses.

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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.

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You cannot invest directly in an index.

DEFINITIONS

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

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.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

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

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.

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.

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.

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.

S&P 600 Index : The S&P 600 is an index of small-cap stocks managed by Standard and Poor's. It tracks a broad range of small-sized companies that meet specific liquidity and stability requirements.

SMID caps : A contraction of "small and mid caps", i.e. listed companies with small and medium-sized capitalizations.

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.