LOOKING BACK AT EQUITY FACTORS IN Q1 WITH WISDOMTREE

Pierre Debru – Head of Quantitative Research & Multi Asset Solutions at WisdomTree in Europe
04/25/2022

The year 2022 opened with a sharp decline. The war in Ukraine added further uncertainty to an already complex situation with entrenched inflation and upcoming rate hikes. In this instalment of the WisdomTree Quarterly Equity Factor Review, we aim to shed some light on how equity factors behaved in the first quarter of 2022 and how they may have impacted investors' portfolios.

- Value and high dividend dominated in most regions.
- Pushed by increasing volatility and nervousness in the market, minimum volatility followed closely behind.
- Momentum and size suffered the most over the quarter, delivering underperformance across regions.
- Quality strategies delivered mixed results depending on their portfolio's overall valuation.

Looking forward, uncertainty continues to rise, whether economic or geopolitical. Investors face a trifecta of worries: rate hikes, inflation and volatility. Those market conditions should continue to favor value, high-dividend and quality stocks.

Performance in Focus: Value and High Dividend Lead the March

In Q1 2022, equity markets took stock of a changing economic and geopolitical landscape. This led to a sharp decline in the first two months of the year, and despite a rebound in March, the MSCI World Index lost -5.2%. Unusually, the U.S. and European markets delivered the same performance of -5.3%. Emerging markets lagged, impacted, in part, by the zeroing of most Russian stocks at the start of the war in Ukraine.

Factor performance in Q1 2022 has been driven by high inflation, the upcoming rate hike cycle and the war in Ukraine. Faced with such a brutal landscape, some factors did well, some did not:

- Value and high dividend dominated in most regions, and are the only factors that managed to outperform in all four geographies over the quarter.
- Pushed by increasing volatility and nervousness in the market, min volatility followed closely and ended up winning in emerging markets. Counterintuitively, it did worse in Europe.
- Momentum and size suffered the most over the quarter, delivering underperformance across regions.
- Quality is an interesting case. The MSCI Quality indexes used here as a proxy for the factor have suffered over the quarter, underperforming by 2% or 3% in developed markets. However, in this instance, the definition of quality and the criteria used would have hugely impacted the result. Quality, left unattended, tends to tilt toward growth (investors pay for quality, after all). This is the case for the MSCI indexes and explains the underperformance in a value-dominated market. Other ways to create quality strategies, focusing on profitability and dividend growers, for example, have fared better over the period.

Figure 1: Equity Factor Outperformance in Q1 2022 Across Regions

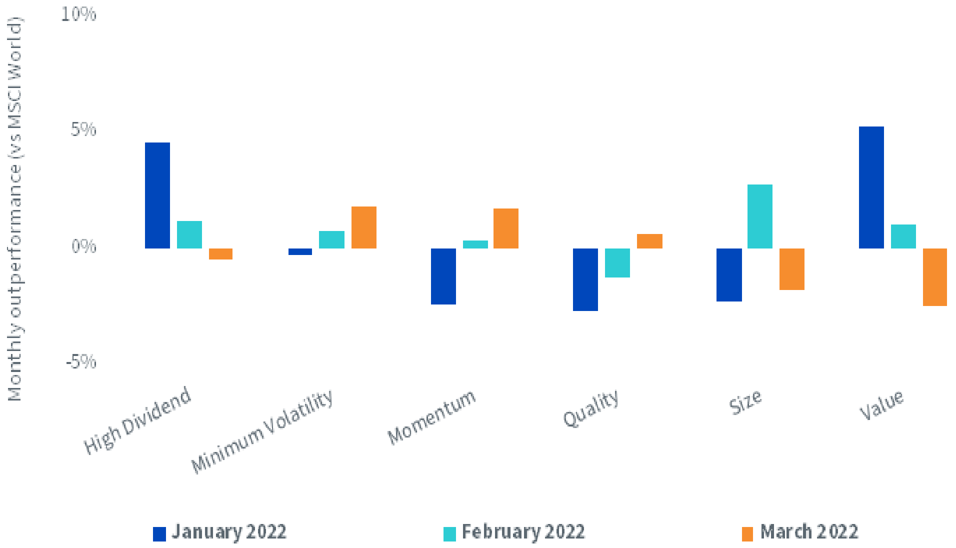
	World YTD 2022: -5.2%	USA YTD 2022: -5.3%	Europe YTD 2022: -5.3%	Emerging Markets YTD 2022: -7.0%
High Dividend	5.4%	3.6%	8.9%	2.2%
Minimum Volatility	2.2%	1.4%	-0.5%	4.7%
Momentum	-0.6%	-2.1%	-2.8%	-4.1%
Quality	-3.4%	-3.6%	-2.8%	-0.1%
Size	-1.3%	-0.7%	-4.5%	2.6%
Value	3.9%	1.3%	4.4%	3.3%

Sources: WisdomTree, Bloomberg, 12/31/21–3/31/22. **Historical performance is not an indication of future performance and any investments may go down in value.**

Looking deeper into factors' behavior over the quarter, we notice two distinct periods. In January and February, markets' main concerns focused on rate hikes and inflation. In January, we saw expectations of the number of hikes by the Federal Reserve skyrocket. This led to a focus on low duration equities, away from high duration equities.

Looking through holdings in different factors, this translates into tailwinds for value and high dividend and even larger headwinds for growth. This is what we observe in the monthly returns, with value and high dividend outperforming in both months. However, March saw a slight shift in perspective, with markets starting to worry about the effect of rate hikes on growth and the recovery. The inversion of the yield curve put an emphasis on such worry, and this led to the continued increase in market volatility. Therefore March saw a turn toward more risk-off assets with min volatility and quality benefitting while more cyclical factors like size and value suffered to a greater degree.

Figure 2: Month-to-Month Outperformance of Equity Factors in Developed Markets



Sources: WisdomTree, Bloomberg, 12/31/21–3/31/22. Historical performance is not an indication of future performance and any investments may go down in value.

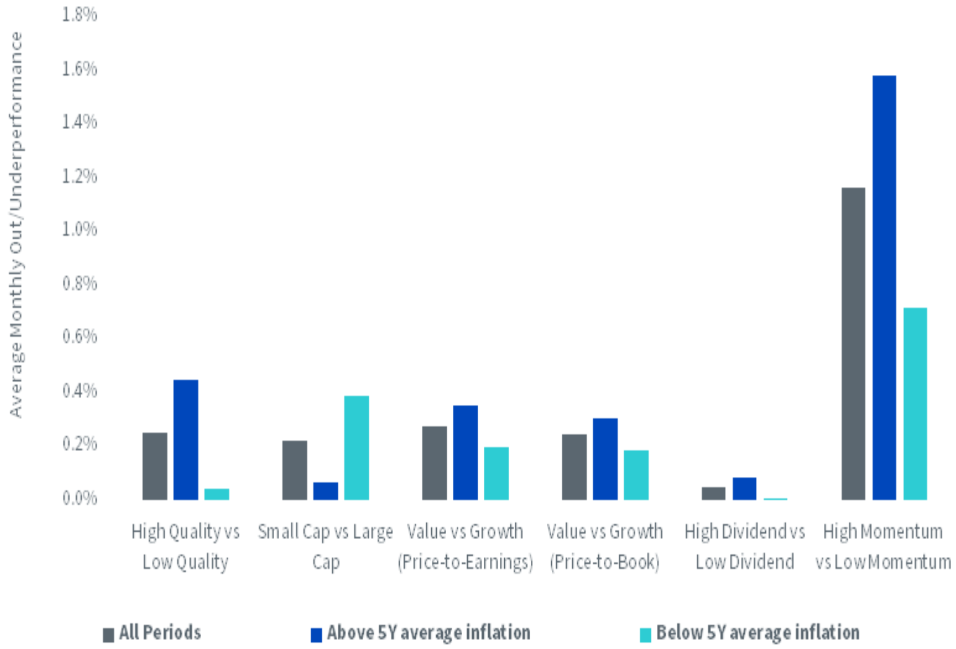
Factors, inflation and rate hikes

Inflation is back after a 15-year, if not 30-year, hiatus. In some way, markets and investors have forgotten how equities behave in an inflationary environment. As always, history is a good teacher.

Figure 3 illustrates the average monthly outperformance of U.S. equities organized by factor pairs in periods of above-average or below-average inflation. Historically, it is quite clear that:

- High-quality stocks have created most of their historical outperformance compared to low-quality stocks in periods of higher inflation.
- Similarly, value stocks, high dividend stocks and momentum stocks have also created more outperformance in periods of above-average inflation but less aggressively than quality.

Figure 3: Factors' Average Outperformance versus U.S. Equity Markets Based on Inflation Regimes by Pairs



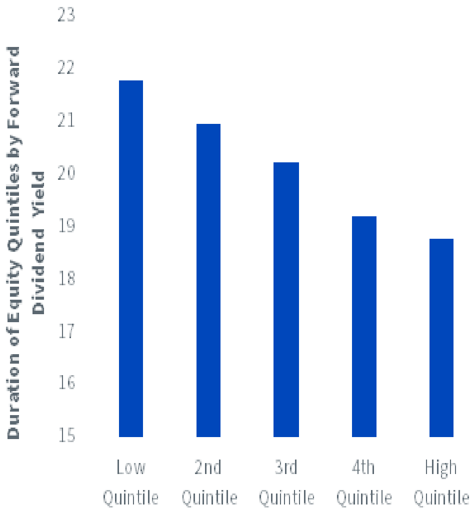
Source: Kenneth French Data Library, data from July 1963 to January 2022. Factors are defined as the value-weighted basket of the 30% stocks with the relevant characteristics. Min volatility uses lower variance, Quality use operational profitability, Value uses the lowest price-to-earnings or price-to-book, Size uses the lowest market cap, High dividend uses the highest dividend yield and momentum uses the last 12 months' price performance. **Historical performance is not an indication of future performance and any investments may go down in value.**

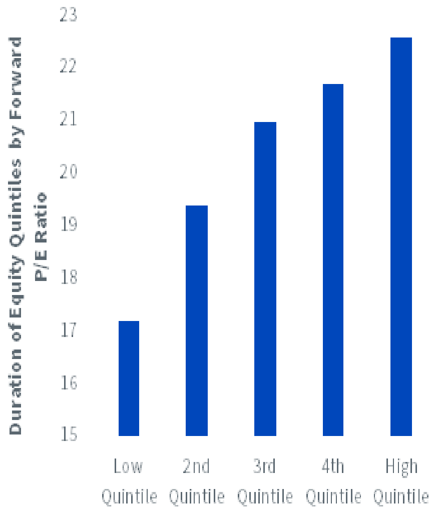
Implied duration is an interesting indicator of potential resistance to a rate hike cycle. Figure 4 exhibits the duration of equity stocks using a concept called 'implied equity duration,' which measures the sensitivity of a stock just like the Macaulay duration measures interest rate sensitivity of bonds. It applies an extended duration calculation formula using forecasted cash flows for the company where cash flows are predicted using earnings and changes in book value. Stocks are then organized in equal-weighted quintiles depending on their estimated forward dividend yield or forward price-to-earnings ratios (P/E). We observe that:

- The quintile with the highest forward dividend stocks has the lowest duration on average, and the relationship is monotonic, with duration decreasing as the dividend yield increases.
- The quintile with the cheapest stocks has the lowest duration on average, and the relationship is monotonic, with duration increasing as the P/E increases.

In line with recent performance, this analysis points to high dividend and value stocks as being resistant to a scenario of rate hikes.

Figure 4: Estimated Implied Duration of Equities by Dividend and P/E Ratio Quintiles in the S&P 500





Sources: WisdomTree, Bloomberg Intelligence, 12/31/21. **Historical performance is not an indication of future performance and any investments may go down in value.**

Valuations continue to come down across the board

In Q1 2022, valuations have decreased almost across the board for factors. Only high dividend stocks in Europe and emerging markets and U.S. value stocks have seen a slight increase in P/E ratios. Size and momentum have seen the sharpest drops.

Figure 5: Historical Evolution of P/E Ratios of Equity Factors

	World		USA		Europe		Emerging Markets	
	P/E Ratio	Δ3Months	P/E Ratio	Δ3Months	P/E Ratio	Δ3Months	P/E Ratio	Δ3Months
Market	17.9	-2.4	20.1	-2.7	13.5	-2.4	12.4	-0.7
High Dividend	13.7	-0.7	15.0	-0.9	11.4	0.2	8.1	0.5
Minimum Volatility	20.5	-1.3	21.5	-2.3	18.2	-2.0	15.4	-0.5
Momentum	18.7	-3.3	20.5	-3.7	13.2	-3.8	14.6	-7.2
Quality	21.7	-2.8	22.4	-3.1	19.4	-2.2	15.5	-0.3
Size	17.1	-3.4	18.9	-4.3	15.8	-4.7	12.3	-1.5
Value	9.2	-0.3	10.4	0.1	8.6	-0.9	6.4	0.2

Sources: WisdomTree, Bloomberg, 3/31/22. **Historical performance is not an indication of future performance and any investments may go down in value.**

Looking forward, economic and geopolitical uncertainty will likely increase. . Inflation, driven by commodity prices that are themselves stoked by the war in Ukraine, shows no sign of slowing down. In response, central banks are becoming increasingly hawkish, with the Federal Reserve planning to hike and reduce their balance sheet aggressively at the same time. This leaves investors with a triple worry: rate hikes, inflation and volatility that should continue to favor value, high dividend and quality stocks.

Important Risks Related to this Article

Pierre Debru is an employee of WisdomTree UK Limited, a European subsidiary of WisdomTree Asset Management Inc.'s parent company, WisdomTree Investments, Inc.

World is proxied by MSCI World net total return index. U.S. is proxied by MSCI USA net TR index. Europe is proxied by MSCI Europe net TR Index. Emerging markets is proxied by MSCI Emerging Markets net TR index. Minimum volatility is proxied by the relevant MSCI Min Volatility net TR index. Quality is proxied by the relevant MSCI Quality net TR index.

Momentum is proxied by the relevant MSCI Momentum net TR index. High dividend is proxied by the relevant MSCI High Dividend net TR index. Size is proxied by the relevant MSCI Small Cap net TR index. Value is proxied by the relevant MSCI Enhanced Value net TR index.

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

+ Looking Back at Equity Factors in Q4 with WisdomTree

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.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Inflation : Characterized by rising price levels.

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.

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

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.

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

Momentum : 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.

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.

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.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

MSCI World Equity Index : The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

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

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.