WHY MIN VOL INTERNATIONAL INDEXES FOCUS ON THE WRONG FACTOR

Jeremy Schwartz – Global Chief Investment Officer
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Of all the smart beta equity factors that have resonated with investors and garnered the most assets, minimum volatility stands out. In the developed international world, the leading minimum volatility (min vol) ETF has garnered almost $9 billion in assets in a relatively short period.

One issue with minimum volatility factor investment approaches is that the inputs into these indexes are backward-looking optimizations with no sensitivity to valuation. This is a critique that can be leveled against many smart beta factors that crowd into these types of stocks and can lead to more extended valuation multiples.

Looking at valuations on international low-volatility stocks today, I see min vol stocks trading at a premium multiple to the markets. According to Bloomberg, the MSCI EAFE Minimum Volatility Index has a trailing 12m price-to-earnings (P/E) ratio of 17.1x this year's estimated earnings, while the MSCI EAFE Index has an estimated P/E ratio of 14.5x.[1]

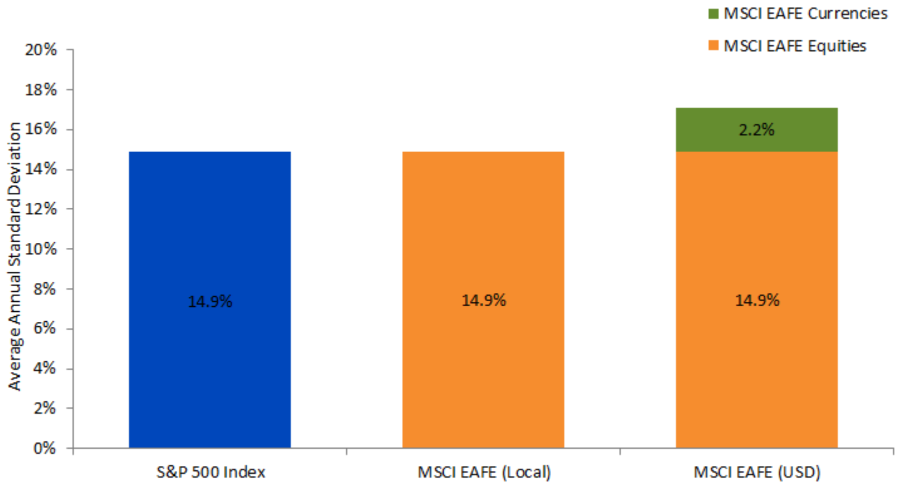
When MSCI created the min vol index series, it used an optimization function that looks at U.S. dollar returns and targets the lowest volatility with constraints to country and sector allocations. One complicating factor internationally is that there are both local market stock returns and currency returns. For example, due to the yen's negative correlation to Japanese equities, an optimization that includes currency exposure would allocate more weight to Japan, despite Japanese stocks in local FX terms potentially having much higher volatility than broader international markets.

A Different Way to Lower Volatility

WisdomTree has been advocating that currency exposure layered on top of equity risk adds to the volatility profile of broad-based international investments but not expected returns—with the Japanese yen and Swiss franc being the two primary outliers to that story. We believe another way to lower volatility, broadly, is to focus on stock exposure while mitigating the net exposure to currency risk.

We have found that, over the last 30 years, currency exposure raised the volatility to MSCI EAFE, a broad international index, by more than 200 basis points (bps) a year and resulted in these international stocks, which by themselves had the same volatility as the S&P 500, becoming a higher-volatility asset class.

S&P 500 Index and International Equity (3/31/86–3/31/18)



Sources: WisdomTree, Zephyr StyleADVISOR. Past performance is not indicative of future results. You cannot invest directly in an index.

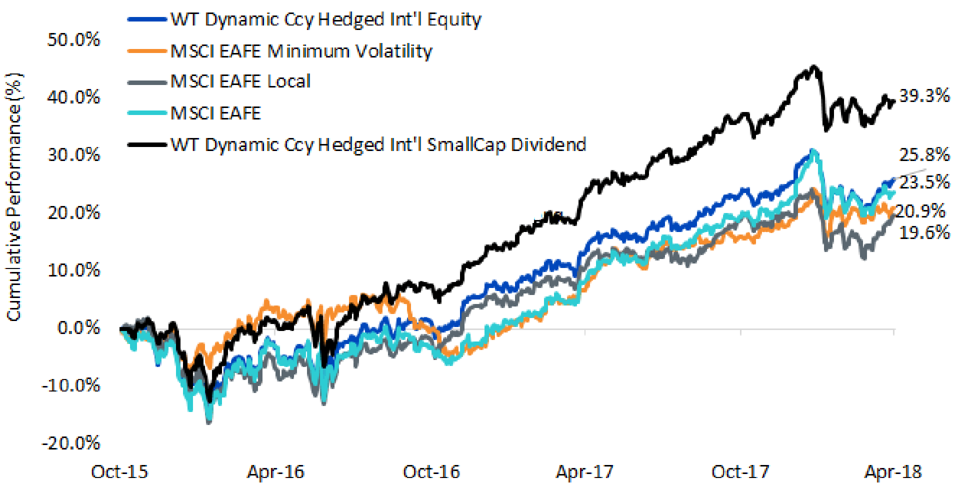
We believe that a better way to gain exposure to lower-volatility international investments is to either strategically hedge a broad international basket or implement a dynamic hedge, using a quantitative process that can also add to expected returns.

WisdomTree launched a dynamically hedged index family that we believe captures the primary volatility-reduction benefits but can outperform both hedged and unhedged benchmarks over longer-term cycles.

In the 2.5 years our core broad-based Index has been live, we have found that the WisdomTree Dynamic Currency Hedged International Equity Index was able to result in similarly low volatility as the MSCI EAFE Min Vol Index while providing meaningful value added over those stocks (see chart below).

In the live period since the launch of the WisdomTree dynamically hedged Indexes, the min vol factor has not added value from a stock selection basis when comparing the unhedged MSCI Min Vol Index to the unhedged MSCI EAFE Index. A factor that we have found to be a value add both in the last 2.5 years and also fairly consistently over the last 10 years has been a tilt to international small-cap stocks. The WisdomTree Dynamic Currency Hedged International SmallCap Equity Index outperformed our dynamically hedged broad market Index by 13.5%.

International Equities' Cumulative Performance (10/30/15–4/30/18)



Sources: WisdomTree, Bloomberg. Index net total returns. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

In contrast to the minimum volatility factor, which is selling at a premium to the MSCI EAFE Index, the WisdomTree International SmallCap Dividend Index is currently at a marginal discount, at 14.1x this year's earnings.

While I believe the goal of the MSCI minimum volatility indexing construct is a worthy one and that clients inherently desire an element of risk management when it comes to venturing into overseas equities, I believe managing currency risk directly could be a better risk management protocol than the traditional minimum variance index construct. Min vol indexes created meaningful stock selection risk that did not pay off over the last few years, when a direct currency risk management program could have equally lowered the volatility profile of international investments without making big country or sectors bets.

We do not believe the low-volatility factor is an *alpha-generating* factor, but rather a risk management practice, and that risk management can be achieved by hedging currencies. WisdomTree believes our dynamic FX hedging algorithms can be both an alpha-generating factor process and a risk management practice. We apply this approach to core international equities, small-cap equities and quality-based factor portfolios.

[1]Source: Bloomberg, as of 4/30/18.

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You cannot invest directly in an index.

DEFINITIONS

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

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 EAFE Minimum Volatility Index : The Index optimizies the MSCI EAFE universe for the lowest absolute risk using a given set of constraints. .

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

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

Basis point : 1/100th of 1 percent.

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.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Dynamic Hedge : Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of 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 tim.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.