EVERYONE TALKS ABOUT "QUALITY" FUNDS, BUT WHAT DOES THAT EVEN MEAN?

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Our industry likes to toss around terms that strike different thoughts in different people.

Just look at the "growth" and "value" investing styles. What are we growing these days? Earnings? Revenues? The customer base?

For valuations, some may want low P/E ratios, others high dividend yields, while maybe the "right" answer is some combination—or different measures altogether.

So it is with quality.

As it applies to stocks, what does that word mean? To boil it down: a smart beta quality screen is for investors who want highly profitable companies that manage to pull it off without a mountain of debt.

The oft-cited profitability metric is return on equity (ROE), while the debt part is sometimes found by checking how the company stacks up in the context of return on assets (ROA). If ROA is low and ROE is high, we know how the firm achieves it: management gooses the balance sheet with debt. You can minimize the goosing by explicitly incorporating ROA into a smart beta screen, which is something we do in a bunch of our Funds.

Figure 1: Definition of Quality, by Index Provider

WisdomTree	FTSE Russell	Standard & Poor's	MSCI
Return on Equity	Profitability	Return on Equity	Return on Equity
Return on Assets	Efficiency	Accruals Ratio	Stable Earnings Growth
Leverage	Earnings Quality	Financial Leverage	Financial Leverage
	Leverage		

Sources: Respective index providers, as of 7/7/21.

The intellectual framework for ROE is intuitive. Look for three things: business strength, stability and operational efficiency. Each is in the DuPont equation, which shows how quality—or ROE—is simply the interaction between profit margins, business efficiency and balance sheet risk (figure 2).

Ideally, achieving high ROE with low leverage is the way to go.

Figure 2: DuPont Equation for ROE

ROE = Profit Margin x Asset Turnover x Financial Leverage

Which Can Be Stated As:

$$ROE = \frac{\text{Net Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Total Assets}} \times \frac{\text{Total Assets}}{\text{Shareholder Equity}}$$

Source: WisdomTree.

The problem: while this is great in theory, quality strategies have been disappointing in recent market declines. Take a look at what happened in five of the last nine swoons in the S&P 500 (figure 3).

Figure 3: Quality Stocks' Struggles

Start	End	S&P 500 Index	S&P 500 Quality Index	Did Quality Stocks Outperform?
2/19/2020	3/23/2020	-33.79%	-31.20%	YES
7/26/2019	8/14/2019	-6.00%	-5.69%	YES
4/30/2019	6/3/2019	-6.60%	-6.75%	NO
9/20/2018	12/24/2018	-19.40%	-20.09%	NO
1/26/2018	2/8/2018	-10.10%	-9.50%	YES
11/3/2015	2/11/2016	-12.71%	-12.04%	YES
5/21/2015	8/25/2015	-11.90%	-12.75%	NO
9/18/2014	10/15/2014	-7.28%	-7.31%	NO
4/2/2012	6/1/2012	-9.60%	-10.67%	NO
10/28/2011	11/25/2011	-9.60%	-7.96%	YES
4/29/2011	10/3/2011	-18.64%	-11.46%	YES
4/23/2010	7/2/2010	-15.63%	-14.32%	YES
1/6/2009	3/9/2009	-27.19%	-22.66%	YES
11/4/2008	11/20/2008	-25.00%	-22.37%	YES
5/19/2008	10/27/2008	-39.93%	-38.09%	YES
10/9/2007	3/10/2008	-17.85%	-13.98%	YES
7/19/2007	8/15/2007	-9.27%	-9.29%	NO
	Median	-12.71%	-12.04%	

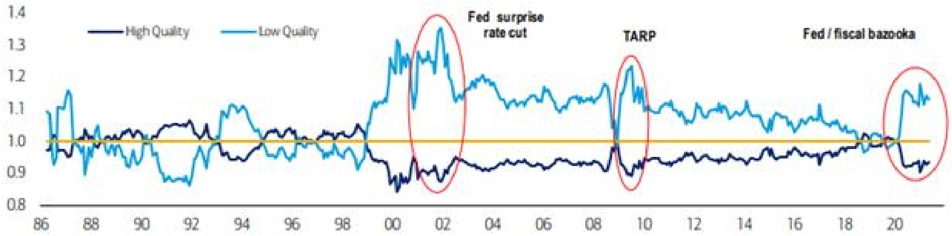
Source: WisdomTree, 06/30/07–06/30/21. Past performance is not indicative of future results. You cannot invest directly in an index.

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

Not only that, but quality has been lagging in this 15+ month market moon shoot. Sure, you could have bigger problems in life than watching the S&P 500 Quality index go up "only" 95.6% since March 23, 2020. Nevertheless, that is 4 percentage points short of the 99.7% run in the S&P 500 off the COVID-19 lows.

It's showing up in valuations. According to Bank of America's quant team, we have not seen high quality stocks this cheap relative to low quality peers in over a decade (figure 4).

Figure 4: High Quality (B+ or better) S&P Quality Ranks vs. Low Quality (B or worse) Fwd. P/E Relative to BofA Universe (1986-5/31/21)



Sources: FactSet, BofA U.S. Equity & Quant Strategy.

Though low quality has been running higher as the COVID-19-inspired economic depression transitioned to early recovery, one of these days we will enter the middle of the economic cycle—if that stage is not already here. The impulse to buy anything and everything, with little regard for operational efficiency, should seemingly fade as the clock ticks. That environment would enable quality concepts to claw out of this tunnel of frustration.

Here is a sample of our U.S. equity mandates, sorted by ROE. Many of them are clocking in higher than the S&P, with lower P/E ratios. Use this as a hunting ground for upping portfolio quality metrics.

Figure 5: Quality Spectrum

Fund	Ticker	Return on Equity (ROE)	Return on Assets (ROA)	Leverage (ROE Divided by ROA)	Forward P/E
WisdomTree U.S. High Dividend Fund	DHS	**14.3%**	2.5%	5.8	13.1
S&P 500	SPX	**14.6%**	3.1%	4.8	22.0
WisdomTree U.S. Dividend ex-Financials Fund	DTN	**15.7%**	4.6%	3.4	14.4
WisdomTree U.S. Quality Shareholder Yield Fund	QSY	**17.1%**	3.2%	5.3	14.7
WisdomTree U.S. LargeCap Fund	EPS	**17.3%**	3.3%	5.3	17.9
WisdomTree U.S. LargeCap Dividend Fund	DLN	**18.7%**	3.3%	5.8	16.9
WisdomTree U.S. Multifactor Fund	USMF	**19.3%**	4.7%	4.1	14.9
WisdomTree U.S. Quality Dividend Growth Fund	DGRW	**26.9%**	7.5%	3.6	17.6

Source: WisdomTree Digital Portfolio Developer, as of 6/30/21. You cannot invest directly in an index.

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You cannot invest directly in an index.

DEFINITIONS

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.

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.

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.

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

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.

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. .

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.