A CORE STRATEGY WITH VALUE PRICES

Jeremy Schwartz – Global Chief Investment Officer
08/06/2020

It's not easy being a value investor these days.

For several years, market gains have been concentrated in technology and mega-cap growth. Anything without large weights to the FAANG[1] stocks has lagged miserably.

Over the last three years, the Russell 1000 Value Index lagged the S&P 500 Index by over 900 basis points (bps) per year.[2]

It's … staggering.

Sector Bets Are a Key Factor in This Gap

Financials have almost twice as much weight in the Russell 1000 Value as in the S&P 500. Information technology, the big market leader, is about 10% of the Russell 1000 Value versus over 25% of the S&P 500.

Sector Weights		
Sector	**S&P 500**	**Russell 1000 Value**
Financials	9.89%	18.42%
Health Care	14.58%	14.42%
Industrials	7.90%	12.25%
Information Technology	27.48%	9.80%
Communication Services	10.90%	9.43%
Consumer Staples	7.05%	8.33%
Consumer Discretionary	11.18%	7.01%
Utilities	3.13%	6.15%
Energy	2.53%	4.83%
Real Estate	2.80%	4.77%
Materials	2.56%	4.61%

Sources: WisdomTree, FactSet, 7/31/20. You cannot invest directly in an index. Weights subject to change.

Even if you look at the S&P 500 Equal Weight Index, it has lagged the market cap-weighted S&P 500 Index by about 5% per year over the last three years.[3]

Which is interesting, because equal weighting has historically been an effective strategy.

Over the long term, equal-weighted indexes have outperformed cap-weighted indexes, according to Fama-French data.

On a rolling three-year basis, the U.S. market equal-weighted strategies had a median excess return of 25 bps annualized. On a rolling 10-year basis, the median excess return was 70 bps annualized.[4]

Equal weighting the S&P 500 also leans toward value-factor benchmarks, unfortunately. The weights are not as extreme as the Russell 1000 Value. But part of the reason the equal-weighted index has lagged is due to its higher weighting in financials and energy, and lower weights in technology.

Sector Weights			
Sector	S&P 500	Russell 1000 Value	S&P 500 Equal Weight
Financials	9.89%	18.42%	12.72%
Health Care	14.58%	14.42%	13.11%
Industrials	7.90%	12.25%	14.77%
Information Technology	27.48%	9.80%	14.60%
Communication Services	10.90%	9.43%	4.43%
Consumer Staples	7.05%	8.33%	6.72%
Consumer Discretionary	11.18%	7.01%	11.95%
Utilities	3.13%	6.15%	5.61%
Energy	2.53%	4.83%	4.61%
Real Estate	2.80%	4.77%	5.81%
Materials	2.56%	4.61%	5.69%

Sources: WisdomTree, FactSet, 7/31/20. You cannot invest directly in an index. Weights subject to change.

Call us crazy, but we believe valuation matters to long-term returns, and concentration at the top of the index cannot continue forever.

But if you're afraid of the high-multiple market leaders, do you have to accept these sector and factor bets to move away from cap weighting?

We think there could be a better solution.

WisdomTree created our multifactor strategy–the WisdomTree U.S. Multifactor Fund (USMF)–to offer exposure to multiple factors:

- Yes, **value**–by judging stocks within each industry on six valuation metrics, most of which are earnings-based, we try to avoid the sector biases of traditional value strategies.
- On the opposite side of value, we look at **quality** ratios like return on equity (ROE), return on assets and the trend change in these variables to get stocks with increasing earnings. This is also done within industries.
- We also look at **momentum**, which we apply on a risk-adjusted basis that helps to avoid "value traps."
- We added a diversifying factor called the low-correlation factor that looks for stocks that are less sensitive to the overall market averages. During a volatile year, this should be a helpful factor.

Valuations of this multifactor strategy today display a value tilt similar to that of a traditional value index, but the strategy achieves those "low prices" while being sector-neutral to the market.

The Russell 1000 Value currently has a ROE of only 10%, compared to nearly 14% for the S&P 500, justifying its lower average P/E ratio. Notably, USMF currently has a lower P/E ratio than the Russell 1000 Value but a 90% higher ROE, and a higher ROE than the market.

This is a unique combination of factor diversification.

	Valuation			Profitability	
Name	Price to Earnings	Price to Cash Flow	Price to Sales	Return on Assets	Return on Equity
USMF	18.20	11.56	1.70	7.04%	19.28%
S&P 500 Equal Weight Index	22.74	9.34	1.38	2.14%	10.34%
Russell 1000 Value Index	19.85	9.15	1.57	2.03%	10.07%
S&P 500 Index	24.95	13.44	2.38	3.02%	13.98%

Sources: WisdomTree, FactSet, 7/31/20. You cannot invest directly in an index.

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

Sector Weights				
Sector	USMF	S&P 500	Russell 1000 Value	S&P 500 Equal Weight
Financials	9.98%	9.89%	18.42%	12.72%
Health Care	16.04%	14.58%	14.42%	13.11%
Industrials	8.22%	7.90%	12.25%	14.77%
Information Technology	25.11%	27.48%	9.80%	14.60%
Communication Services	11.43%	10.90%	9.43%	4.43%
Consumer Staples	7.24%	7.05%	8.33%	6.72%
Consumer Discretionary	11.96%	11.18%	7.01%	11.95%
Utilities	2.81%	3.13%	6.15%	5.61%
Energy	2.13%	2.53%	4.83%	4.61%
Real Estate	2.54%	2.80%	4.77%	5.81%
Materials	2.54%	2.56%	4.61%	5.69%

Sources: WisdomTree, FactSet, 7/31/20. You cannot invest directly in an index. Weights subject to change.

While you can see these factor tilts in the underlying P/E multiples and ROE figures, our factor grid below shows how much of each strategy's weight is allocated to these various factors.

- USMF actually had more value exposure than the Russell 1000 Value, and over two times as much exposure to high-quality stocks.
- While a value index generally has exposure to "poor momentum stocks," USMF had more balanced momentum exposure, because the factor is one of its stock selection criteria.

The weighting process of this multifactor strategy has a factor and risk weighting that gives it an equal-weighted experience.

Looking forward, given our view that the weights of the top-five stocks by market cap could be hard to sustain, USMF is a strategy that can help manage valuation risk without betting big against any sector or specific low-quality tilt.

Cumulative Performance since USMF Inception

Figure 6_Cumulative Weight

Fund performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and 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. Performance data for the most recent month-end is available at wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

For standardized performance of USMF, please click here.

[1]As of 7/29/20, the WisdomTree U.S. Multifactor Fund (USMF) held Facebook (0.70% weight), Amazon (0.83%) and Netflix (0.81%).

[2]Source: Bloomberg, 8/4/17-8/4/20.

[3]Source: Bloomberg, 8/4/17-8/4/20.

[4]Source: Kenneth French Data Library, 12/31/1926-12/31/2019. Based on annual observations.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Investing in a Fund exposed to particular sectors increases the vulnerability to any single economic, political or regulatory development. This may result in greater share price volatility. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

Diversification does not eliminate the risk of experiencing investment losses.

References to specific securities and their issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

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.

For more investing insights, check out our Economic & Market Outlook

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

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.

Mega Cap : Market Capitalization over $100 Billion.

FAANG : An acronym referring to the stocks of the five most popular and best-performing American technology companies: Facebook, Amazon, Apple, Netflix and Alphabet (formerly known as Google).

Russell 1000 Value Index : A measure of the large-cap value segment of the U.S. equity universe, selecting from the Russell 1000 Index.

Basis point : 1/100th of 1 percent.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

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.

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.

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.

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.

Risk-adjusted basis : When calculating the return, we refines the return by measuring how much risk is involved in producing that return.

Low Correlation : Characterized by assets that have a relatively lower correlation vs the market over time. This term is also associated with the Low Correlation Factor which associates these stock characteristics with excess returns vs the market over time.

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.

Diversification : A risk management strategy that mixes a wide variety of investments within a portfolio.