FOUR KEY CHARACTERISTICS THAT MAKE QUALITY STOCKS A GREAT LONG TERM CORE HOLDING

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03/17/2023

Building a house on weak foundations is a recipe for disaster. This is also true for equity portfolios. While core holdings may not be the most exciting, a portfolio's success will often hinge on their quality. Investors should look for four main characteristics in an asset they choose for the core of a portfolio:

- Reliable outperformance over the long term, anchored in known and proven investment principles
- Resilient behavior across the business cycle
- Defensiveness in crises
- Asymmetric risk profile, i.e., capturing more of the upside than the downside

Highly profitable companies are often regarded as great core holdings, since they easily tick all four of the boxes above. At WisdomTree, we believe that a high-quality strategy is the cornerstone of an equity portfolio. It is the key to building resilient portfolios that can help investors build wealth over the long term and weather the inevitable storms along the way.

Reliable Outperformance with the Quality Factor

Among practitioners, selecting stocks based on their quality attributes has a long track record. Warren Buffett does not stand alone in his focus on high-quality stocks. His mentor, Benjamin Graham, a founding father of value investing, recognized the value of high-quality companies as early as 1934 (Graham and Dodd 1934).

More recently, academics have also recognized the long-term outperformance of quality stocks. In 2014, Fama and French extended their three-factors model (market, size and value) to a five-factors model that includes two quality factors.[1]

Figure 1: High-Quality Stocks Historically Outperform the Market with Less Volatility

	Low Quality	High Quality	Market
Annualized Return	3.7%	8.9%	7.5%
Volatility	17.8%	14.7%	15.3%
Beta	1.13	0.94	-

Source: Kenneth French Data Library. Data is at a monthly frequency, and as of 11/30/22. Stocks are selected as above the median market cap, with "high" representing the top 30% by operating profitability and "low" representing the bottom 30% by operating profitability. The market represents the portfolio of all available publicly listed stocks globally. All returns are in U.S. dollars. Operating profitability for year t is annual revenues minus cost of goods sold, interest expense, and selling, general and administrative expenses divided by book equity for the last fiscal year end in t-1. You cannot invest directly in an index. Past performance is not indicative of future results.

In figure 1, the high-quality portfolio, which includes the 30% of stocks with the highest operating profitability in the global developed equities universe, outperforms the low-quality portfolio (which includes the 30% of stocks with the lowest operating profitability) by more than 4.5% per year since 1990. The high-quality portfolio also outperforms the market by 1.4% per year while delivering lower volatility, demonstrating its credentials as a recognized equity factor.

Historically, quality stocks have exhibited higher long-term returns and lower volatility, which creates a very attractive risk-return profile for core holdings in investors' portfolios.

Steady as Quality Goes

Quality stocks benefit from strong business models and steady financial results over time. Their financial performance is, therefore, more consistent and predictable from one period to the next. When building investment strategies focused on quality stocks, this translates into steady, robust returns in a large array of market scenarios. When compared with other equity factors, the quality factor tends to deliver more consistent periods of outperformance.

Figure 2: Rolling 10-Y Annualized Performance of U.S. Factors versus U.S. Equities as a Whole

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	Size	Value	Quality	Low Volatility	High Dividend
Percentage of Outperforming Periods	61%	75%	88%	77%	73%
Best Outperformance	12.1%	9.0%	3.1%	5.0%	7.1%
Worst Underperformance	-7.2%	-5.7%	-1.5%	-4.4%	-5.9%

Sources: WisdomTree, Kenneth French Data Library, as of 7/31/22, and represents the latest date of available data. Value: high 30% book-to-price portfolio. Size: low 30% portfolio. Quality: high 30% portfolio. Low Vol: low 20% portfolio. High Div: high 30 portfolio. Market: all CRSP firms incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ. Past performance is not indicative of future results.

In figure 2, we show the rolling outperformance of different equity factors relative to the U.S. equity markets over periods of 10 years. We observe that size outperforms in 61% of the period . In other words, an investor holding a small-cap investment for 10 years (at any point between 1960 and 2022) would have had six chances out of 10 to outperform. Others factors exhibit outperformance around 70% of the time. Quality stands out with a historical occurrence of outperformance of 88%.

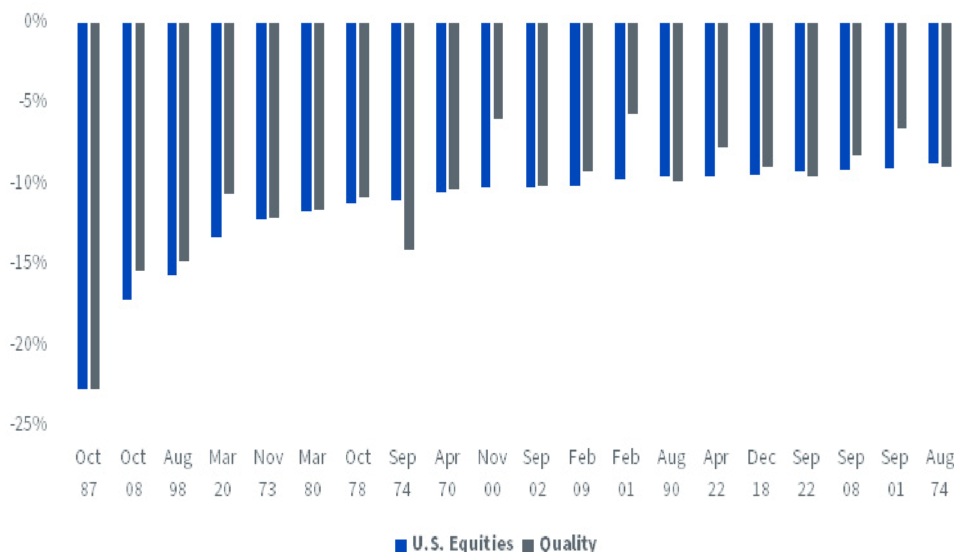
While the quality factor in many years may feel more like the Tortoise than the Hare, let's not forget La Fontaine's old adage "slow and steady wins the race."

Weathering Uncertainty and Market Drawdowns by Focusing on Highly Profitable Stocks

When investing strategically in equities, investors should look for strategies that can weather unexpected and unpredictable events. Core holdings need to be able to withstand drawdowns as they do not have a vocation to be traded in and out of the portfolio at every sign of trouble.

Quality is not the only defensive factor, of course. It is not, in fact, the most defensive factor, a mantel that min volatility claims easily. It is a defensive factor nonetheless, and it has demonstrated time and time again that it can protect investors' portfolios when equity markets turn south. Looking at the last 60 years, we can see that in 12 out of the 15 worst months in U.S. equities, the quality factor cushioned the drop and lowered the drawdown. In April 2022, for example, U.S. equities lost 9.45% while the quality factor lost only 7.73%, an improvement of 1.72%. Or, in March 2020, U.S. equities lost 13.26% while the quality factor lost only 10.62%, an improvement of 2.64%.

Figure 3: Performance of the Quality Factors in the Worst 15 Months for U.S. Equities since 1963



Source: Kenneth French Data Library. Data is at a monthly frequency and as of 12/31/22. Stocks are selected as above the median market cap, with quality representing the top 30% by operating profitability. The market represents the portfolio of all available publicly listed stocks in the U.S. All returns are in U.S. dollars. Operating profitability for year t is annual revenues minus cost of goods sold, interest expense, and selling, general and administrative expenses divided by book equity for the last fiscal year end in t-1. You cannot invest directly in an index. Past performance is not indicative of future results.

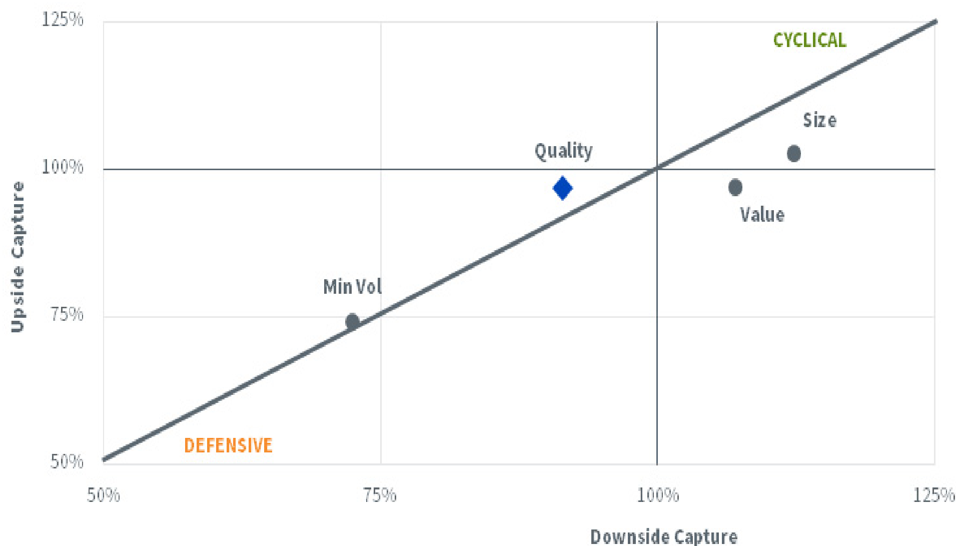
This is also the case over longer time periods. During the Covid crisis (i.e., between February and March 2020), the S&P 500 lost 29% while quality lost 25.75%, cushioning the blow by 3.3%. In 2022, it reduced it by 12%.[2]

Overall, the quality factor delivers outperformance in most crises, providing well-needed respite to investors when they need it the most. However, contrary to other defensive factors, the quality factor can also participate in the upside, making it an ideal candidate for long-term investments.

The All-Weather Factor

Over the long term, the key to a successful investment is to capture more of the upside than of the downside. A strategy that demonstrates such an asymmetric profile will thrive over the long run. Figure 4 shows the upside capture and downside capture ratio of the quality factor relative to other strategies, calculated on monthly returns. The upside capture ratio is the percentage of market gain captured by a strategy when markets go up, and the downside capture ratio is similarly the percentage of market losses endured by a strategy when markets go down.

Figure 4: Upside and Downside Capture Ratio of Various Equity Factors and Peers



Sources: WisdomTree, Bloomberg. Period April 2013–January 2023. Calculations are based on monthly returns in U.S. dollars. Quality is proxied by WisdomTree U.S. Quality Dividend Growth TR Index. Min Vol is proxied by MSCI USA Min Vol TR Index. Value is proxied by MSCI USA Enhanced Value TR Index. Size is proxied by MSCI USA Small Cap TR Index. You cannot invest directly in an index. Past performance is not indicative of future results.

Strategies that sit above the grey line have a strong advantage over the ones sitting below the line. Their upside capture ratio is bigger than their downside capture ratio, which means that they capture more of the upside when the market is up than they lose when the market is down.

Quality is the strategy furthest above the line. So, it benefits from having a very asymmetric profile with an upside capture ratio of 97% and a downside capture ratio of only 91%. In other words, it is a factor that can both grow and defend.

Looking at our list of four characteristics, quality investments tick all the boxes. Anchored in academic research, quality strategies have the strength to grow over the long term and also to weather any temporary storm. This makes quality an ideal candidate for a strategic, long-term, core investment in equities.

[1] (Fama and French, A Five-Factor Asset Pricing Model 2014)

[2] Sources: WisdomTree, Bloomberg. Periods 2/19/20–3/18/20 and 12/31/21–12/31/22. Calculations are in U.S. dollars. Quality is proxied by the WisdomTree U.S. Quality Dividend Growth TR Index. You cannot invest in an index. Above numbers include backtested data. *Past performance is not indicative of future results.*

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

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DEFINITIONS

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.

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.

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.

Drawdowns : Periods of sustained negative trends of return.

Upside capture : A measure of how one index performs during periods when a benchmark index is moving in the positive direction. A value of 100% indicates that both would tend to move upward at the exact same pace.

Down Capture : Measure of the performance of an investment relative to a benchmark index during a down market.