ARE YOU OVERPAYING TO MANAGE VOLATILITY IN YOUR PORTFOLIO?

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If you ask investors whether they think that low volatility is a good strategy for a particular equity market, it is interesting to consider what they might be thinking of through the lens of behavioral finance.

Option 1: They're thinking of a strategy's total standard deviation and the fact that volatility can refer to both upside and downside performance movements.

Option 2: They're thinking of a strategy that has a lower chance of generating negative returns.

We think there's good reason to believe the mental translation investors make is the second option.

No Strategy Is without Weaknesses

Every investment strategy has a different balance of pros and cons, and the art of building a portfolio is in matching the two with the needs of different individual investors. It's not a simple task.

Even if people think low-volatility exposures are a way to achieve defensive equity positions, it is not enough to think that because the name includes the words "minimum volatility" or "low volatility" that the work is done. It's important to look under the hood of any strategy to determine what risks may or may not be evident.

Many Minimum Volatility Strategies Do Not Consider Valuation

In figure 1, we see that for the MSCI USA Minimum Volatility Index:

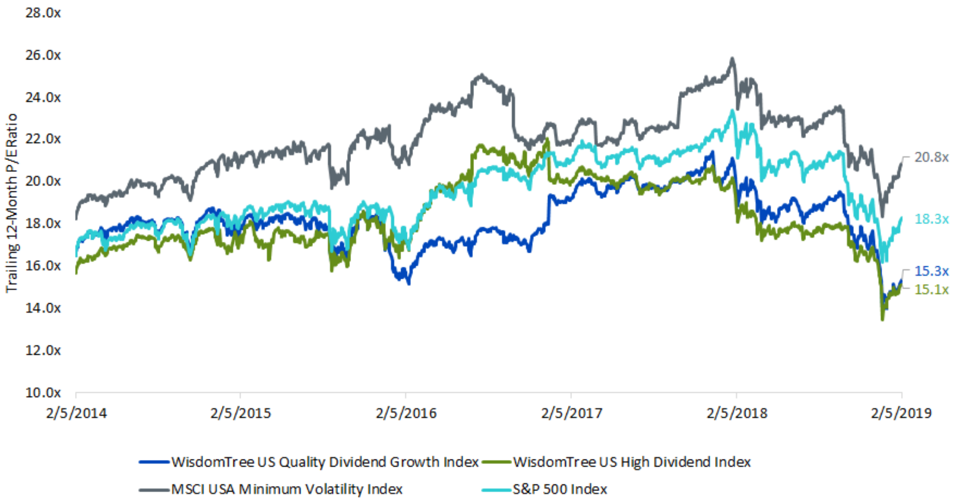
- Over the five years ended February 5, 2019, the trailing P/E ratio was always higher than the S&P 500 Index. This peaked around the time of the near-term low in the U.S. 10-Year Treasury interest rate, which occurred July 8, 2016, at around a 25% premium, meaning the P/E of the low-volatility stocks was 25% higher than the market.

- Over the same period, the maximum valuation discount of both the WisdomTree U.S. Quality Dividend Growth Index and the WisdomTree U.S. High Dividend Index versus the S&P 500 Index was approximately 16% to 18%. As of February 5, 2019, this is precisely where we find ourselves—very close to this level of the maximum observed P/E ratio discount over the past five years.

Maybe you're reading this and saying, "so what?" If the low-volatility stocks go down less, then they should be more expensive. They've probably outperformed, and that is why their P/E ratio is this much higher.

Let's test that thinking.

Figure 1: Minimum Volatility Stocks Are Expensive in February 2019



Source: Bloomberg, with data covering five years, for the period 2/5/14–2/5/19. Past performance is not indicative of future results. You cannot invest directly in an index.

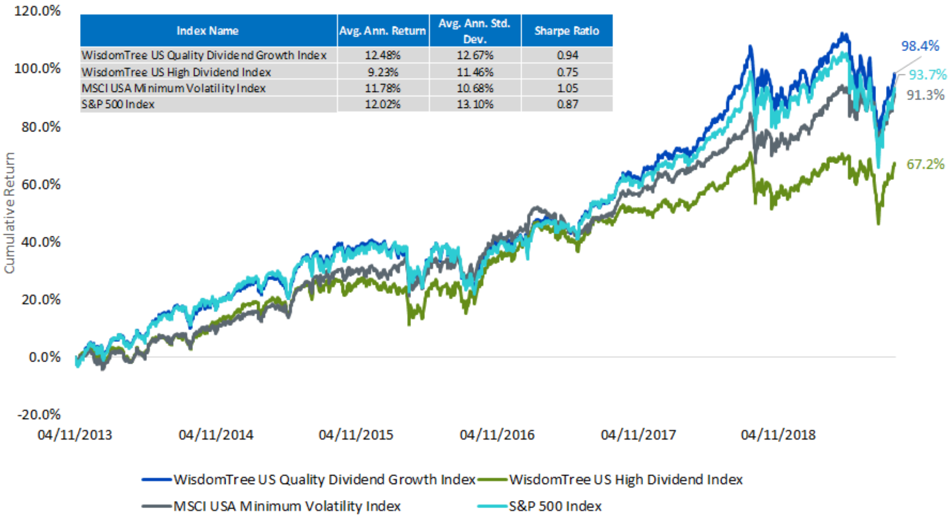
Balancing Upside and Downside Equity Moves with the WisdomTree Quality Dividend Approach

The WisdomTree U.S. Quality Dividend Growth Index began live calculation on April 12, 2013. There was a massive U.S. equity rally out of the gate, followed by the high volatility that we saw enter the scene in 2018. Figure 2 shows us the following:

- The WisdomTree U.S. Quality Dividend Growth Index outperformed the other three indexes over this period, which includes both upside and downside volatility. Stocks (such as Facebook, Amazon, Netflix and Google) that do not pay regular dividends are excluded.
- It is remarkable how much of a headwind the WisdomTree U.S. High Dividend Index faced over this period. This is one of the most "anti-momentum" strategies that WisdomTree has developed, and momentum was a factor driving the markets during much of the upward trends during this period.
- The MSCI USA Minimum Volatility Index delivered market-like performance over this period of nearly six years. Yes, risk was lower, but performance does not explain the reason why the approach should have such a premium multiple over the market.

Figure 2: WisdomTree U.S. Quality Dividend Growth Index Live History Compared

with the MSCI USA Minimum Volatility Index



Index Name	Avg. Ann. Return	Avg. Ann. Std. Dev.	Sharpe Ratio
WisdomTree US Quality Dividend Growth Index	12.48%	12.67%	0.94
WisdomTree US High Dividend Index	9.23%	11.46%	0.75
MSCI USA Minimum Volatility Index	11.78%	10.68%	1.05
S&P 500 Index	12.02%	13.10%	0.87

Source: Bloomberg, with data for the period 4/12/13–2/5/19, the live calculation history of the WisdomTree U.S. Quality Dividend Growth Index. Past performance is not indicative of future results. You cannot invest directly in an index.

Maybe WisdomTree Is Unique and the Period Is "Too Short"

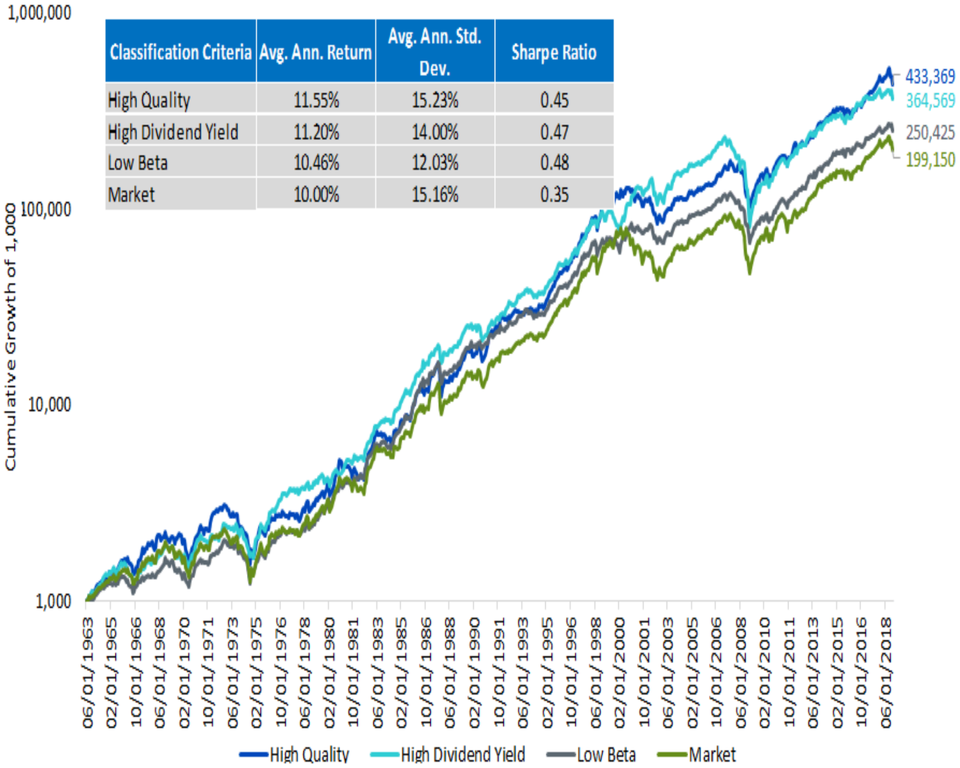
Let's take the concepts of "higher quality," "high dividend yield" and "low volatility" and look at a much longer period.

The Kenneth French Data Library is a publicly available source allowing us to go back to 1963 and test these concepts on an average annual return, average annual standard deviation and Sharpe ratio basis. Figure 3 indicates the following:

- The group of "High Quality" stocks sorted annually outperformed the other groups over this period. The average annual standard deviation of these stocks was very similar to that of the market, leading to a higher Sharpe ratio than the market, which is similar to what we saw with the WisdomTree U.S. Quality Dividend Growth Index in figure 2.
- The "High Dividend Yield" and "Low Beta" groups did better than the "High Quality" stocks at lowering risk. However, the range of Sharpe ratios was from 0.45 to 0.48. Yes, the "High Quality" stocks had the lowest end of the range, but is a 0.03 difference something that would have been noticeable during a period of almost 60 years?

Figure 3: How Does the Longer-Term Data Compare with the More Recent Period?

Classification Criteria	Avg. Ann. Return	Avg. Ann. Std. Dev.	Sharpe Ratio
High Quality	11.55%	15.23%	0.45
High Dividend Yield	11.20%	14.00%	0.47
Low Beta	10.46%	12.03%	0.48
Market	10.00%	15.16%	0.35



Source: Kenneth French Data Library, with data for the period 6/30/1963–12/31/18. High Quality refers to the top 20% of U.S. publicly listed equities ranked on the basis of operating profitability. High Dividend Yield refers to the top 20% of U.S. publicly listed equities ranked on the basis of trailing 12-month dividend yield. Low Beta refers to the bottom 20% of U.S. publicly listed equities ranked on the basis of beta relative to the market of all U.S. publicly listed companies. Market refers to all U.S. publicly listed equities. Performance does not represent the performance of any index.

Conclusion: Quality Looks Attractive Now and Has Held Up Over the Long Term

If investors are looking to reinitiate or add exposure to U.S. equities at present, we think that a quality approach, such as the WisdomTree U.S. Quality Dividend Growth Index, could lead to a better valuation opportunity than the more defensively oriented MSCI USA Minimum Volatility Index.

In fact, if people believe the market is headed for a sharp correction, we'd think the WisdomTree U.S. High Dividend Index could be similarly defensively positioned without the valuation risk inherent to the low-volatility grouping.

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.

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You cannot invest directly in an index.

DEFINITIONS

Standard deviation : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

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 USA Minimum Volatility Index : Aims to reflect the performance characteristics of a minimum variance strategy applied to the large and mid cap USA equity universe.

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.

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.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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.

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.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Sharpe ratio : Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.