# THE MARRIAGE OF QUALITY & VALUE

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The large-cap value investment style is one of the most popular styles among U.S. investment managers. Intuitively, this makes sense, as it involves following large, well-known companies in an attempt to see when their share prices dropped below what would be justified by their fundamentals. But large-cap value isn't the only investment style there is. **Marrying Quality & Value** Clearly, the focus in value strategies is on how price relates to fundamentals such as dividends, earnings or book value. Quality factors focus on the inherent stability of the fundamentals themselves, making the two approaches interesting complements. Robert Novy-Marx wrote:[1]

> Because strategies based on profitability are growth strategies, they provide an excellent hedge for value strategies, and thus dramatically improve a value investor's investment opportunity set. In fact, the profitability strategy, despite generating significant returns on its own, actually provides insurance for value.

We tested this premise using the MSCI USA Quality and MSCI USA Value indexes. To function as an "insurance" characteristic, the MSCI Value and MSCI Quality should not be outperforming or underperforming at the same time. **MSCI USA Quality vs. MSCI USA Value–Excess Returns against the MSCI USA Index (Rolling Three-Year)**


Sources: MSCI, Zephyr StyleADVISOR, with data from 11/30/1975 to 6/30/2015. Past performance is not indicative of future results. You cannot invest directly in an index.

• **Excess Returns Appear to Offset Each Other:** When the MSCI USA Quality Index was outperforming the MSCI USA Index, the MSCI USA Value Index was underperforming it–and to a similar degree. With the exception of the most recent three-year period, the potential cited by Novy-Marx appears intact. We also wanted to further test another statement made by Novy-Marx, which was, "Adding a profitability strategy on top of an existing value strategy actually reduces overall portfolio volatility …"[2] To test this, we looked at how a 50/50 allocation split between the MSCI USA Quality Index and the MSCI USA Value Index (Value & Quality Blend) did compared to the MSCI USA Value Index alone. • **Did the Value & Quality Blend Outperform the MSCI USA Value Index by Itself?** The percentage of rolling periods when the Value & Quality Blend outperformed the MSCI USA Index was higher than it was for just the MSCI USA Value Index–and we tested rolling periods of 3, 5, 7, 10, 15, 20, 25 and 30 years in order to see a wide range of different time frames. • **Did the Value & Quality Blend Lead to an Improved Sharpe Ratio Compared to the MSCI USA Value Index Alone?** As the length of the rolling periods increased–similar to what we saw with the excess returns earlier–the percentage of times the

Sharpe ratio improved also increased. Even on the shorter end, rolling three-year periods, the Sharpe ratio increased more than half the time, i.e., in more than 50% of the rolling periods examined. **Marriage of High Dividend & Quality Dividend Growth** WisdomTree has two strategies that look at different types of dividend-paying stocks to fit in these categories: • **Value:** The WisdomTree High Dividend Index (High Dividend) searches for relatively higher-yielding U.S. dividend payers, thereby establishing a value type of exposure. With the extended period of low interest rates that we've seen, these types of stocks have tended to become more expensive, as they are seen as sources of potential income generation. • **Quality Dividend Growth:** The WisdomTree U.S. Quality Dividend Growth Index (Quality Dividend Growth) focuses on growth and quality factors in its selection process, thereby establishing a quality type of exposure. We think the fact that these stocks represent one of the more exciting valuation opportunities in U.S. equities—given their (usually) lower debt, higher return on equity (ROE) and higher growth expectations—these stocks could command a more premium multiple. It's worth noting that the two Indexes share 34 common constituents, comprising approximately 21% of the weight of High Dividend and 29% of Quality Dividend Growth.[3] **Current State of Complementarity** In creating a 50/50 blend of these two Indexes today, we see: • **Smaller Sector Bets Compared to the S&P 500 Index:** By itself, Quality Dividend Growth was 12% under-weight Financials, whereas High Dividend was 17% under-weight Information Technology. The 50/50 blend was still under-weight Information Technology, but now by only 8.8%. The biggest over-weight for the 50/50 blend was 5.8% to Consumer Staples. • **Attractive Valuation Characteristics:** The 50/50 blend exhibited a 15.6x price-to-earnings (P/E) ratio and a 3.43% dividend yield. That's compared to about 15.3x and 2.2%, respectively, for the S&P 500. • **Emphasis on Quality:** Looking at the median three-year average return on equity of the 50/50 blend, we see 14.1%, while the number for the median three-year average return on assets is 5.7%,—figures that are actually very close to the S&P 500. Had we not complemented High Dividend with Quality Dividend Growth, we would be looking at 9.1% for the median three-year average ROE and less than 3.0% for the median three-year average ROA. For those interested in WisdomTree's thoughts on quality, please see our full research paper The Dividends of a Quality and Growth Factor Approach. [1]Robert Novy-Marx, "The Other Side of Value: The Gross Profitability Premium," 6/12. [2]Robert Novy-Marx, "The Other Side of Value: The Gross Profitability Premium," 6/12. [3]Weight in common constituents as well as weight sourced from Standard & Poor's, with data as of 9/25/15.

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## DEFINITIONS

**Large-Capitalization (Large-Cap)** : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term “large market capitalization”. Market capitalization is calculated by multiplying the number of a company’s shares outstanding by its stock price per share.

**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.

**Fundamentals** : Attributes related to a company’s actual operations and production as opposed to changes in share price.

**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** : A portion of corporate profits paid out to shareholders.

**Book Value** : refers to the net asset value of a company determined by subtracting liabilities and intangible assets from Total assets.

**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.

**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.

**MSCI USA Quality Index** : refers to the MSCI USA Quality Index which is a large and mid cap US equity index aiming to capture the performance of quality growth stock. The Index screens its parent index, the MSCI USA Index for ROE, stable year-over-year earnings growth, and low financial leverage.

**MSCI USA Value Index** : is a large and mid cap US equity index aiming to capture securities exhibiting overall value style characteristics. The Index screens for book value to price, 12-month forward earnings to price, and dividend yield as value characteristics.

**Excess Returns** : refers to investment returns on a securities above that of a benchmark or index exhibiting similar risk characteristics.

**MSCI USA Index** : is designed to measure the performance of large and mid cap segments of the US market.

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

**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.

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

**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.

**Return on Equity (ROE)** : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have 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.

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

**Median** : The median is the value within a dataset at which 50% of all observations occur above and 50% occur below.

**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.