
WHAT WAZE CAN TEACH US ABOUT INVESTING

Jeremy Schwartz – Global Chief Investment Officer
04/03/2017

I recently attended a conference where participants discussed the topic of financial advisor processes in client interactions. One presenter made a great analogy that I want to extend beyond his specific use, as it also speaks to the power of creating a robust investment process and discipline in terms of how one builds and [rebalances](#) portfolios.

The presenter asked, “How many of you use Waze to help navigate your driving directions?”

Of course, almost every hand in the packed auditorium went up.

When we question Waze and deviate from the directions of its algorithm, we almost always regret it. Waze is able to help identify potential risk areas, give us a road map of how to get to our destination quickest, and then reset directions if a certain route gets clogged. Waze is powered by a sophisticated set of models that steer us in the right direction.

How Does Waze Tie to Investing?

I think of the drive toward [passive](#) investing and factor-based investing more generally to be adopting a Waze-like algorithm for good investment management approaches.

The problem with traditional discretionary managers is that they’re human and subject to the behavioral biases in decision making that all of us have. The power of using Waze and algorithms more broadly is making an investment process systematic and unemotional. We want to override Waze because we think we know a better way. But the power of creating an investment process—what factor-based investing is all about—is to lock yourself into the discipline of following that investment process without deviating from it. Computers don’t have emotion—they just evaluate the inputs and give you the best directions they can.

What Are Your Goals, and How Can You Systematize Your Investment Process?

WisdomTree created rules-based indexes over 10 years ago that were designed to mitigate the [valuation](#) risk inherent to [market cap-weighted](#) strategies that have no valuation-based rebalancing.

Following a value-based investment strategy can be difficult to execute in real time. You are constantly buying what is out of favor—when it is difficult to do so—and selling what has been popular.

When styles come in and out of favor—and value investing has been out of favor for the 10 years since WisdomTree launched—how many [active managers](#) stick to the discipline of their approach? We recently wrote up a [research piece reviewing the 10-year history of these earnings-weighted strategies](#).

As market valuations rise, this rules-based discipline to search out valuation-based opportunities becomes increasingly important, in my view. But how do you identify those opportunities?

Systematically Lower [P/E Ratios](#) at Each Rebalance

The [WisdomTree Earnings Index](#) family has systematic factor exposures both to a [quality](#) investing style—by only including profitable companies—as well as a value discipline by reanchoring portfolio weights away from just market cap and toward earnings.

This investment process results in a reduced price-to-earnings (P/E) ratio for a general market index. The differences in valuation show up most pronounced in mid- and small-cap indexes. In these market segments, the universe tends to have higher P/E ratio dispersion and more companies are unprofitable, so weighting by earnings can be more different in mid- and small caps than large caps.

Rebalancing Systems

Rebalancing annually back to our [Earnings Stream](#) is how we systematize the investment process and undergo a process to refresh the portfolio based on the latest valuations. We systematically reduce exposure to stocks that increased in valuation and add to exposures that have fallen in valuation.

As investors think about the markets today, as well as their overall investment approach, we encourage them to adopt a waze-like, systematic process for approaching both their individual managers and how they construct their overall portfolios.

When you think about the risks that are in the market today, market valuations are near the top of the list. Having a process to lower overall valuations of your exposures in the market is one of most important elements of investing at today's more heightened market multiples. This is also where WisdomTree's fundamentally weighted Indexes were designed to help solve a common problem.

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

Rebalance: An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Passive: Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

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.

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.

Active manager: Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

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.

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 time.

Earnings Stream[®]: Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.