

**In the past few decades, index-based investment strategies have gained traction for providing exposure to different asset classes. Numerous benefits including easy diversification, generally low fees, tax efficiency, and daily transparency of holdings have helped these types of strategies flourish. While the first set of indices were traditional market cap-weighted offerings, there is a growing body of evidence suggesting that a rules-based approach to indexing can add significant value.**

Currently, there is significant research being conducted around developing different approaches to factors<sup>1</sup>—which, simply put, represent certain equity attributes that may be associated with higher returns. There are many ways to gain exposure to these factors individually or to mix them together into diversified exposures.

## DEFINING THE BUILDING BLOCKS: WISDOMTREE'S FACTORS

Though there are many factors written about as supposed sources of excess return premia, the five most readily and widely accepted are:

1. Value
2. Size
3. Quality
4. Momentum
5. Low Volatility

## MULTIFACTOR DIVERSIFICATION CAN HELP REDUCE RISK AND REGRET

In today's world, the proliferation of different indices as well as the strategies designed to track them makes it easier than ever to generate exposure to all sorts of different risk premia or factors. However, as the chart below demonstrates, although the factors did well over the long-term, in any given year they experienced both out and underperformance. Since it is a practical impossibility to consistently know ahead of time which factors will be the best (or worst) performing, we believe a multifactor approach makes sense.

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<sup>1</sup> Cerniglia, Joseph & Frank J. Fabozzi. "Academic, Practitioner, and Investor Perspectives on Factor Investing." The Journal of Portfolio Management, 2018.

Figure 1: Factor focus of strategy: Calendar year returns show factor performance ebbs &amp; flows

Year	Annual Returns				
	WisdomTree U.S. Multifactor Index	MSCI USA Diversified Multi-Factor Index	MSCI USA Select Factor Mix Index	SciBeta USA Multi-Beta Multi-Strat EW-4F Index	S&P 500 Quality, Value, & Momentum Multi-factor Index
2003	6.0%	2.4%	-0.6%	1.4%	-2.2%
2004	11.7%	10.3%	4.7%	9.6%	9.1%
2005	10.2%	9.9%	2.6%	7.6%	16.9%
2006	-0.0%	1.3%	0.6%	1.4%	1.6%
2007	2.9%	-0.5%	0.3%	0.7%	10.2%
2008	3.7%	-2.1%	3.8%	2.0%	4.4%
2009	0.1%	2.7%	-0.6%	-0.9%	-7.7%
2010	1.8%	2.9%	1.5%	5.4%	-5.3%
2011	3.0%	5.3%	5.3%	1.8%	8.7%
2012	0.8%	-0.5%	-1.4%	-1.7%	1.9%
2013	4.4%	4.8%	2.6%	-0.8%	2.6%
2014	2.7%	1.5%	-0.2%	2.8%	-0.9%
2015	-0.8%	-0.8%	-0.0%	0.3%	-0.7%
2016	-2.1%	2.1%	1.6%	-0.6%	-0.8%
2017	-0.4%	-0.4%	1.2%	-2.5%	3.3%
2018	0.5%	-5.1%	0.1%	-1.9%	-1.3%
Total	2.6%	1.6%	1.4%	1.5%	2.3%

Sources: Bloomberg, Factset, MSCI. Period is from 31 December 2001 to 30 June 2019. You cannot invest directly within an Index. The WisdomTree US Multifactor Index began live calculation on 12 June 2017. The MSCI USA Diversified Multifactor Index began live calculation on 17 February 2015. The MSCI Factor strategies do represent underlying indexes and do include backtested returns. **Value:** MSCI USA Enhanced Value Index, which began live calculation on 12 December 2014. **Minimum Volatility:** MSCI USA Minimum Volatility Index, which began live calculation on 2 June 2008. **Momentum:** MSCI USA Momentum Index, which began live calculation on 15 February 2013. **Size:** MSCI USA Risk-Weighted Index, which began live calculation on 28 June 2011. **Quality:** MSCI USA Sector Neutral Quality Index, which began live calculation on 12 December 2014. Returns are calculated net of tax withholdings. **Historical performance is not an indication of future performance and any investments may go down in value.**

## WISDOMTREE'S FACTORS EXPLAINED

As a firm specialising in the process of building equity indices since 2006, WisdomTree looked to develop a newer way of both defining investment factors as well as mixing them together to ensure ongoing multifactor diversification. WisdomTree has defined four factors to be utilised within its multifactor index:

### + Fundamental factors

- **Value:** Focused on Sales-to-Price, Book-to-Price, Earnings-to-Price, Estimated Earnings-to-Price, EBITDA<sup>2</sup>-to-Enterprise Value, Operating Cash Flow-to-Price
- **Quality:** Focused on static observations and trends of Return on Equity, Return on Assets, Gross Profits over Assets, and Cash flow over assets

<sup>2</sup> EBITDA: Earnings before interest, taxes, depreciation, and amortization. It is the net income of a company with interest, taxes, depreciation, and amortization added back to it.

**+ Technical factors**

- **Momentum:** Risk-adjusted total returns over historical periods (6 and 12 months)
- **Low Correlation:** Incorporates diversification potential of stocks that are less correlated to the market

**WISDOMTREE'S MULTIFACTOR METHODOLOGY EXPLAINED**

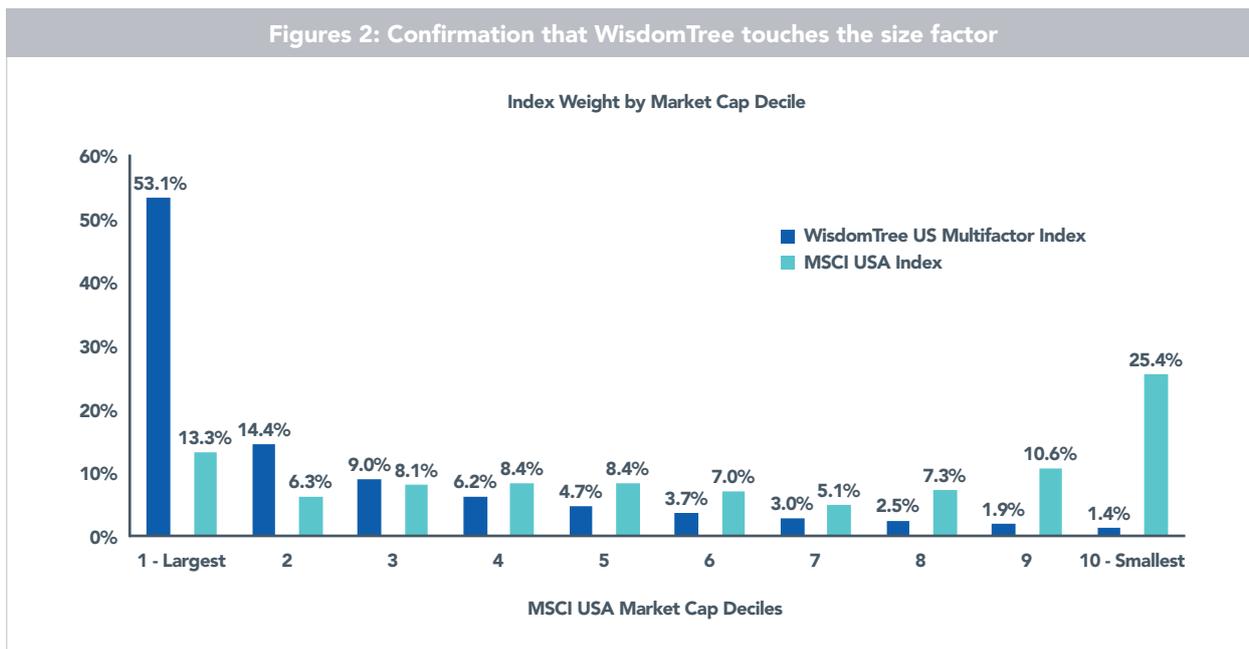
On a quarterly basis, WisdomTree applies a quantitative process that constructs and refreshes the exposures of the WisdomTree US Multifactor Index:

1. The process begins with the 800 largest eligible stocks (by market capitalization) within WisdomTree's universe.
2. Each stock is then ranked across ALL FOUR factors and given a composite multifactor score. This is an important distinction, as WisdomTree's approach is not one that focuses on mixing great single factor stocks together.
3. The top 200 stocks are selected for WisdomTree's Index.
4. Each of these stocks is then assigned a volatility score (defined as trailing 12-month volatility of returns) that rewards less volatile stocks.
5. The final portfolio of 200 stocks is weighted on the basis of two factors:
  - i. The composite multifactor score, where a higher score would lead to a higher weight and vice versa; and,
  - ii. The volatility score, where a lower trailing 12-month volatility would lead to a higher weight, and vice versa
6. When all is said and done, the final Index is adjusted to be sector neutral to remove sector tilts relative to a market capitalization-weighted universe

**THE SIZE FACTOR: DID WISDOMTREE FORGET A FACTOR?**

You may be thinking that WisdomTree has forgotten a factor. Yes, low correlation might tilt toward a concept similar to low volatility, but there is nothing that directly indicates a capability to capture the "size" factor.

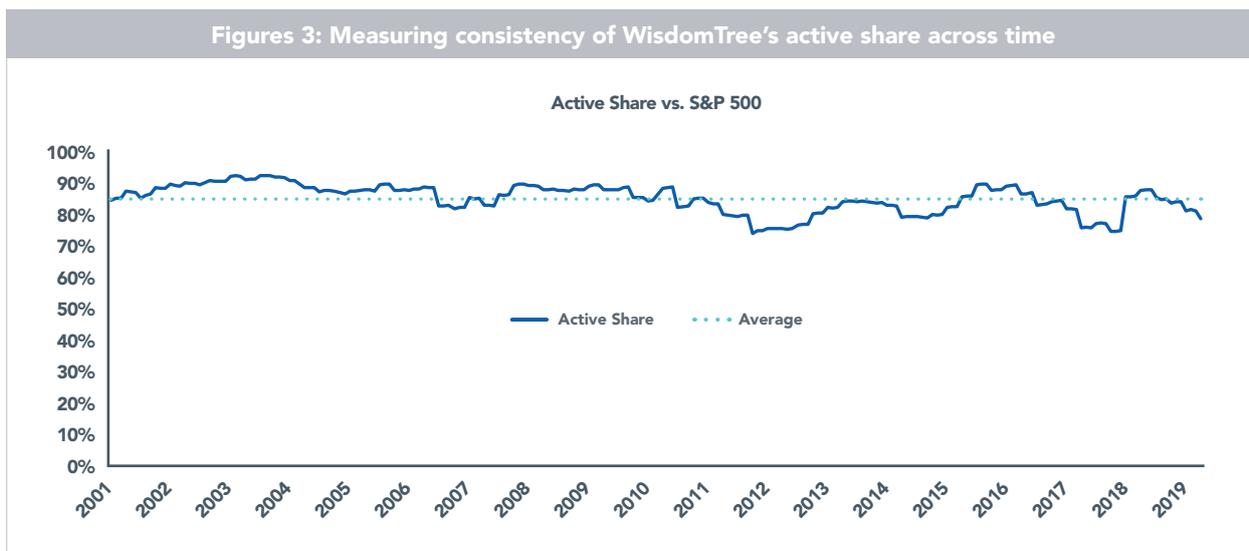
Looking back at WisdomTree's distinct methodology, you'll note that both the composite multifactor score and the low volatility score are based on measures that are sensitive to company size. A direct consequence of weighting by such measures is that there is an inherent bias toward an equally-weighted approach—which means smaller stocks receive more weight than they might otherwise receive. Figure 2 shows the market capitalization size decile exposures.



Source: Bloomberg. Data as of 30 June 2018. **Historical performance is not an indication of future performance and any investments may go down in value.**

**DRIVING ALPHA AND EARNING DIFFERENTIATED RETURNS**

Another very important discussion occurring within investments today regards how certain active managers seem to “hug benchmark indices” with very low active share (a measure of how much an investment manager’s stocks and weighting differs from the benchmark). Active share has gained popularity as a concept as people are looking to justify the fees charged by active managers. Greater degrees of active share may be associated with a greater chance of unique investment returns, however, it is worth noting that high active share without a sound strategy may not give an investor a very strong chance at ultimate outperformance.



Source: Factset. Period is from 30 March 2001 to 30 June 2019. Data includes backtested index history. **Historical performance is not an indication of future performance and any investments may go down in value.**

**CONCLUSION: EVOLUTION OF INDEX CREATION IS SET TO CONTINUE**

What we've seen is that WisdomTree has initiated a new type of "smart-beta" or "modern-alpha" index. Multifactor brings a new approach, in that the concept of "alpha-diversification" is embedded into the methodology. If one believes that things like value, size, quality, low volatility and momentum do in fact carry long-term outperformance potential, a diversified approach to exposure could very well look like a promising long-term investment strategy to consider.

Fund Info: WisdomTree US Quality Dividend Growth UCITS ETF								
Ticker	Distributing/ Accumulating	Exchange	ISIN	BBG Code	Reuters Code	Listing Currency	Base Currency	TER%*
USMF	Distributing	LSE	IE00BD8ZCY59	USMF LN	USMFL	USD	USD	0.30%
FCTR	Accumulating	LSE	IE00BD8ZD313	FCTR LN	FCTR.L	USD	USD	0.30%
USMF	Distributing	Borsa Italiana	IE00BD8ZCY59	USMF IM	USMFW.MI	USD	USD	0.30%
FCTR	Accumulating	Borsa Italiana	IE00BD8ZD313	FCTR IM	FCTRW.MI	USD	USD	0.30%

\*TER: Total Expense Ratio.

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