INFLATION, RECESSION AND GEOPOLITICAL RISK: CAN QUALITY OFFER A SAFE-HAVEN?

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2023 did not deliver the recession that many were expecting. Consumer strength helped carry the US, as the Federal Reserve (Fed) stayed determined to combat inflation. With credit card debt in the US above pandemic levels, excess savings spent, and inflation below wage growth, the Fed is now acknowledging that inflation can't be the only focus anymore and the risk of an overly restrictive monetary policy on the economy is of equal importance. While recession risks in the US are lowering, equity risks continue to mount with the prospect of low growth in the year ahead and sticky inflation.

Investors are worried about inflation, recession, policy errors, and geopolitical risks

This plethora of risks is increasingly weighing on investors' minds. In our recent professional investor survey[1], when asked which were the biggest risks to investors in the next 12 months, investors could not decide between all of them. They indicated being worried about inflation and global recession and also pointed to the risk of a banking crisis as well as policy errors from central banks (such as over-tightening). Geopolitical risks were also high on the list, which the continuing war in Ukraine as well as the recent events in the Middle East are only confirming.

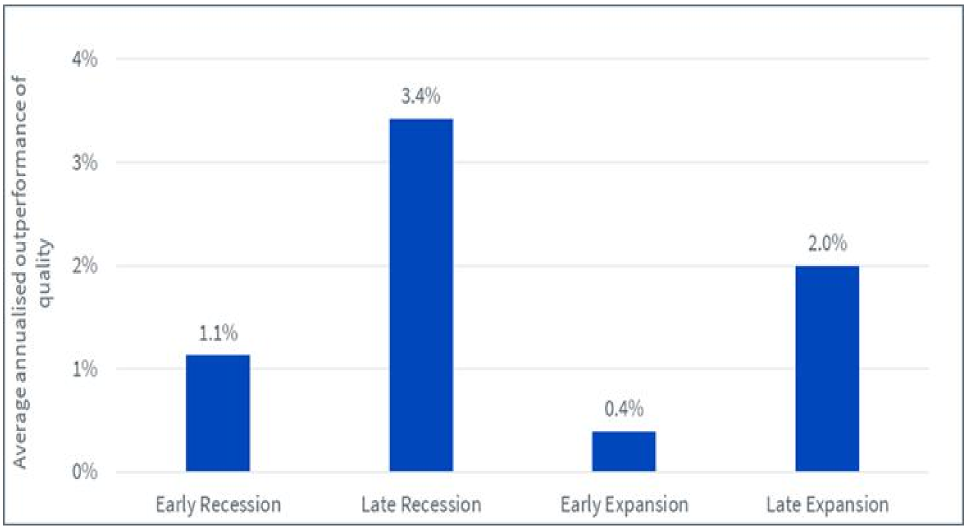
High quality, the factor for all worlds

With numerous risks on the horizon, and volatility on the rise, investors are looking to protect their portfolios. However, it is hard to prepare a bulletproof portfolio when the danger could come from any direction. Such a situation calls for versatile, resilient investments able to handle all kinds of markets. At WisdomTree, we tend to favour high-quality companies as an all-weather solution.

Figure 1 illustrates this capacity of high-quality stocks to outperform across many parts of the business cycle. The graph exhibits the average annualised outperformance of high-quality stocks (defined as the top 30% by operating profitability in the US equity universe) versus the market over four distinct parts of the cycle. The National Bureau of Economic Research defines recession and expansion periods in the US; then each of those periods is split into two halves of equal length.

What is striking is that high-quality companies outperformed in all 4 periods. The strongest outperformance appeared in the Late Recession, but the outperformance remains positive, on average, in other parts of the business cycle including the early expansion which tends to be more favourable to small cap and value stocks.

Figure 1: Quality outperformance over the business cycle versus US equities



Source: Kenneth French data library. Dec 1969 to August 2023. Data is calculated at a monthly frequency. Stocks are selected to be above the median market cap, with 'Quality' representing the top 30% by operating profitability. The portfolios are rebalanced yearly at the end of June. The market represents the portfolio of all available publicly listed stocks in the United States. All returns are in USD. 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 in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

Quality Dividend Growth – a recognised quality strategy with a successful track record across regions

At WisdomTree, our Quality Dividend Growth strategies aim to leverage high quality, dividend growing companies in the most efficient way.

Our exchange-traded funds (ETFs) are constructed around dividend paying companies with the best-combined rank of earnings growth, return on equity and return on assets within an ESG-filtered universe of companies with sustainable dividend policies. Stocks are also risk-tested using a proprietary risk screen (Composite Risk Score), which uses Quality and Momentum metrics to rank companies and screen out the riskiest companies and potential value traps. Each company is then weighted based on its cash dividend paid (market capitalization x dividend yield), which introduces valuation discipline in this high-quality portfolio.

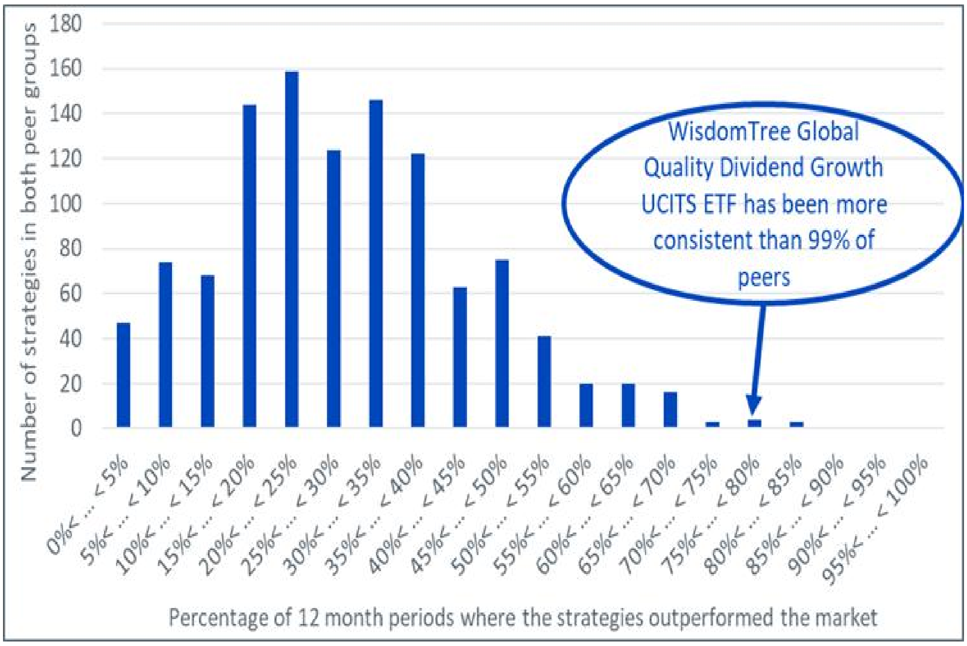
Those steps, in combination, deliver an all-weather strategy that can be used as a strategic holding to withstand volatility in the markets.

The WisdomTree Global Quality Dividend Growth UCITS ETF has outperformed the market by 0.7%[2] per annum since its launch, with a lower volatility of only 14.8% (1.3% less than the market).

To demonstrate the ‘all-weatherness’ of high-quality dividend growing companies and the capacity to outperform in most market scenarios, we look at the WisdomTree Global Qualit y Dividend Growth UCITS ETF.

+ Our ETF outperformed the market in 75%[3] of the 12-month periods since its launch in 2016.
+ Out of the 1129 strategies (mutual funds and ETFs, both active and passive) that have at least as long a track record as our ETF (that is, a launch date before 7 June 2016) and that have a tracking error of at least 0.75% to the market (that is, they are not trackers of MSCI World), only five strategies have managed to outperform more often.
+ This means that 1122 strategies had less consistent returns than our Quality Dividend Growth ETFs.

Figure 2: Distribution of strategies depending on the proportion of 12-month periods in which they outperformed the market



Source: WisdomTree, Morningstar. Period from 30 June 2016 to 30 June 2023. Calculations are based on monthly NAV in USD. 2 peer groups are used: Global Income and Global Large Cap Blend. Performances over periods longer than a year are annualised. **You cannot invest directly in an index.**
Historical performance is not an indication of future performance, and any investments may go down in value.

Sources

[1] Pan European Professional Investor Survey, August 2023, 803 respondents, conducted by Censuswide.

[2] Source: WisdomTree, Morningstar. Period from 7 June 2016 to 30 September 2023. **Historical performance is not an indication of future performance, and any investments may go down in value.**

[3] Source: WisdomTree, Bloomberg, Morningstar, June 2016 to June 2023.

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