LOOKING BACK AT EQUITY FACTORS IN Q1 WITH WISDOMTREE

Pierre Debru – Head of Quantitative Research and Multi Asset Solutions, WisdomTree Europe.
12 Apr 2022

2022 opened with a sharp decline. The Ukraine War added further uncertainty to an already complex situation with entrenched inflation and upcoming rate hikes. In this installment of the WisdomTree Quarterly Equity Factor Review[1], we aim to shed some light on how equity factors behaved in Q1 2022 and how this may have impacted investors' portfolios.

- Value and High Dividend dominated in most regions.

- Pushed by increasing volatility and nervousness in the market, Min Volatility followed closely behind.

- Momentum and Size suffered mostly over the quarter, delivering underperformance across regions.

- Quality strategies delivered mixed results depending on their portfolio's overall valuation.

Looking forward, uncertainty continues to rise, being economic or geopolitical. Investors face a trifecta of worries: rate hikes, inflation and volatility. Those market conditions should continue to favour value, high-dividend and quality stocks.

Performance in focus: Value and High Dividend lead the march

In the first quarter of 2022, equity markets took stock of a changing economic and geopolitical landscape. This led to a sharp decline in the first two months of the year, and despite a rebound in March, the MSCI World lost -5.2%. Unusually, the US and European markets delivered the same performance of -5.3%. Emerging markets lagged, impacted, in part, by the zeroing of most Russian stocks at the start of the war in Ukraine.

Q1 2022 factor performance has been driven by high inflation, the upcoming rate hike cycle and the Ukraine War. Faced with such a brutal landscape, some factors did well, some did not:

- Value and High Dividend dominated in most regions. They are the only factors that managed to outperform in all four geographies over the quarter

- Pushed by increasing volatility and nervousness in the market, Min Volatility followed closely and ended up winning in emerging markets. Counterintuitively, it is in Europe that it did the worse

- Momentum and Size suffered mostly over the quarter, delivering underperformance across regions

- Quality is an interesting case. The MSCI Quality indices used here as a proxy for the factor have suffered over the quarter, underperforming by 2 or 3% in developed markets. However, in this instance, the definition of quality and the criteria used would have hugely impacted the result. Quality, left unattended, tends to tilt toward growth (investors pay for quality, after all). This is the case for the MSCI indices and explains the underperformance in a Value-dominated market. Other ways to create quality strategies, focusing on profitability and dividend growers, for example, have fared better over the period.

Figure 1: Equity factor outperformance in Q1 2022 across regions

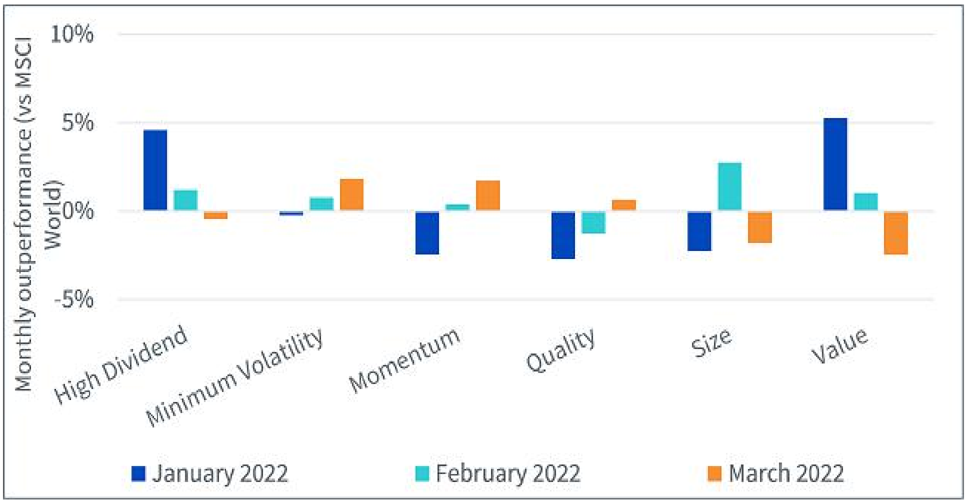
	World YTD 2022: -5.2%	USA YTD 2022: -5.3%	Europe YTD 2022: -5.3%	Emerging Markets YTD 2022: -7.0%
High Dividend	5.4%	3.6%	8.9%	2.2%
Minimum Volatility	2.2%	1.4%	-0.5%	4.7%
Momentum	-0.6%	-2.1%	-2.8%	-4.1%
Quality	-3.4%	-3.6%	-2.8%	-0.1%
Size	-1.3%	-0.7%	-4.5%	2.6%
Value	3.9%	1.3%	4.4%	3.3%

Source: WisdomTree, Bloomberg. 31st December 2021 to 31st March 2022.

Historical performance is not an indication of future performance and any investments may go down in value.

Looking deeper into factors' behaviour over the quarter, we notice two distinct periods. In January and February, markets' main concerns focused on rate hikes and inflation. In January, we saw expectations of the number of hikes by the Federal Reserve skyrocket. This led to a focus on low duration equities, away from high duration equities. Looking through holdings in different factors, this translates into tailwinds for Value and High-Dividend and quite large headwinds for growth. This is what we observe in the monthly returns, with Value and High dividend outperforming in both months. However, March saw a slight shift in perspective, with markets starting to worry about the effect of rate hikes on growth and the recovery. The inversion of the yield curve put an emphasis on such worry, and this led to the continued increase in market volatility. Therefore March saw a turn towards more risk-off assets with Min Volatility and Quality benefitting while more cyclical factors like Size and Value suffered more.

Figure 2: Month to Month outperformance of equity factors in developed markets



Source: WisdomTree, Bloomberg. 31st December 2021 to 31st March 2022.

Historical performance is not an indication of future performance and any investments may go down in value.

Factors, inflation and rate hikes

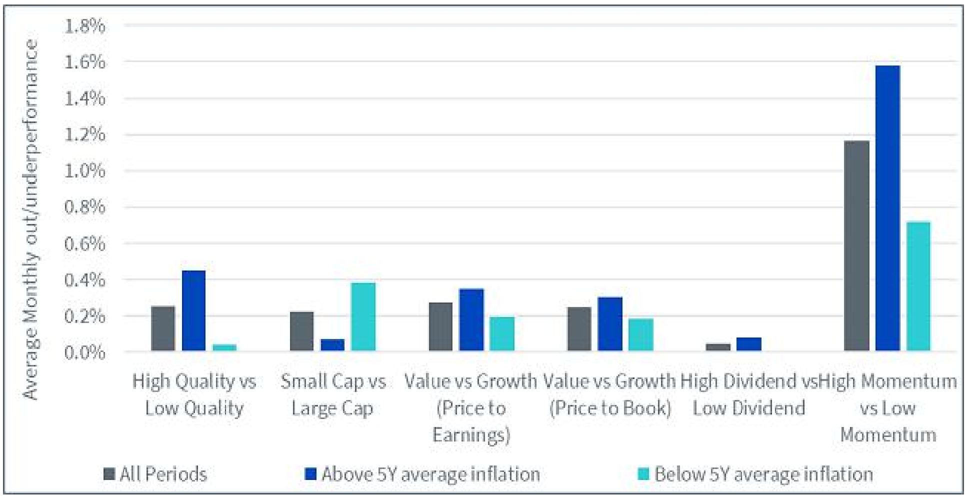
Inflation is back after a 15 year, if not 30 year, hiatus. In some way, markets and investors have forgotten how equities behave in an inflationary environment. As always, History is a very good teacher.

Figure 3 illustrates the average monthly outperformance of US equities organised by factor pairs in periods of above-average or below-average inflation. Historically, it is quite clear that

- High-quality stocks have created most of their historical outperformance compared to low-quality stocks in periods of higher inflation

- Similarly, value stocks, high dividend stocks and momentum stocks have also created more outperformance in periods of above-average inflation but less aggressively than quality

Figure 3: Factors average outperformance versus US equity markets based on inflation regimes by pairs



Source: Kenneth French data library. Data from July 1963 to January 2022. Factors are defined as the value-weighted basket of the 30% stocks with the relevant characteristics. Min Volatility uses lower variance, Quality use operational profitability, Value uses the lowest price to earnings or price to book, Size uses the lowest market cap, High dividend uses the highest dividend yield and momentum uses the last 12 months' price performance.

Historical performance is not an indication of future performance and any investments may go down in value.

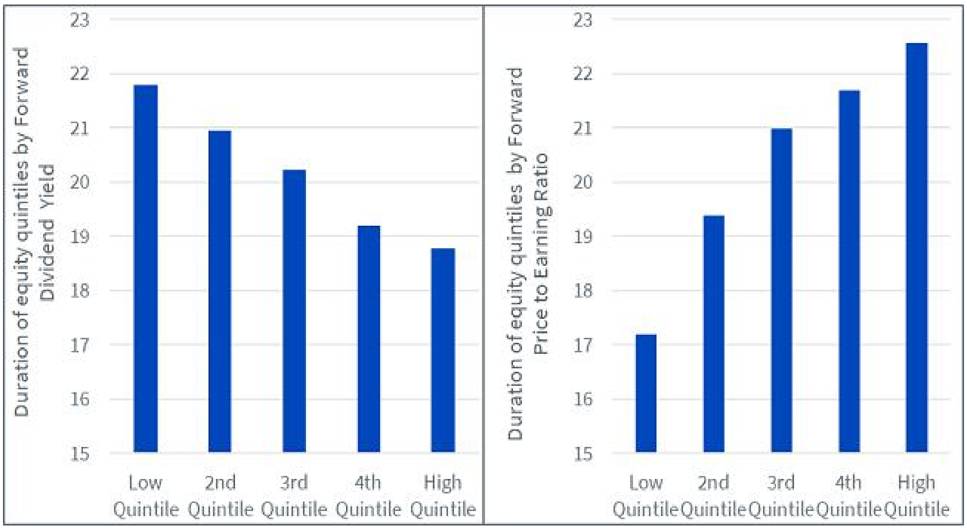
Implied duration is an interesting indicator of potential resistance to a rate hike cycle. Figure 4 exhibits the duration of equity stocks using a concept called 'implied equity duration', which measures the sensitivity of a stock just like the Macaulay duration measures interest rate sensitivity of bonds. It applies an extended duration calculation formula using forecasted cash flows for the company where cash flows are predicted using earnings and changes in Book Value. Stocks are then organised in equal-weighted quintiles depending on their estimated forward dividend yield or forward price to earnings ratios ("P/E"). We observe that:

- The quintile with the highest forward dividend stocks has the lowest duration on average, and the relationship is monotonic, with duration decreasing as the dividend yield increases

- The quintile with the cheapest stocks has the lowest duration on average, and the relationship is monotonic, with duration increasing as the P/E increases

In line with recent performance, this analysis points to high dividend and value stocks as being resistant to a scenario of rate hikes.

Figure 4: Estimated implied duration of equities by dividend and price to earnings ratio quintiles in the S&P 500



Source: WisdomTree, Bloomberg Intelligence. As of 31st Dec 2021.

Historical performance is not an indication of future performance and any investments may go down in value.

Valuations continue to come down across the board

In Q1 2022, valuations have decreased almost across the board for factors. Only high dividend stocks in Europe and emerging markets and value stocks in the US have seen a slight increase in price to earnings ratios. Size and Momentum have seen the sharpest drop.

Figure 5: Historical Evolution of Price to Earnings ratios of equity factors

	World		USA		Europe		Emerging Markets	
	P/E Ratio	Δ3Months	P/E Ratio	Δ3Months	P/E Ratio	Δ3Months	P/E Ratio	Δ3Months
Market	17.9	-2.4	20.1	-2.7	13.5	-2.4	12.4	-0.7
High Dividend	13.7	-0.7	15.0	-0.9	11.4	0.2	8.1	0.5
Minimum Volatility	20.5	-1.3	21.5	-2.3	18.2	-2.0	15.4	-0.5
Momentum	18.7	-3.3	20.5	-3.7	13.2	-3.8	14.6	-7.2
Quality	21.7	-2.8	22.4	-3.1	19.4	-2.2	15.5	-0.3
Size	17.1	-3.4	18.9	-4.3	15.8	-4.7	12.3	-1.5
Value	9.2	-0.3	10.4	0.1	8.6	-0.9	6.4	0.2

Source: WisdomTree, Bloomberg. As of 31st March 2022.

Historical performance is not an indication of future performance and any investments may go down in value.

Looking forward, uncertainty continues to rise, being economic or geopolitical. Inflation, pushed by commodity prices themselves stoked by the Ukraine War, shows no sign of slowing down. In response, Central Banks are turning increasingly hawkish, with the Federal Reserve planning to hike and reduce their balance sheet aggressively at the same time. This leaves investors with a triple worry: rate hikes, inflation and volatility that should continue to favour value, high-dividend and quality stocks.

World is proxied by MSCI World net TR Index. US is proxied by MSCI USA net TR Index. Europe is proxied by MSCI Europe net TR Index. Emerging Markets is proxied by MSCI Emerging Markets net TR Index. Minimum volatility is proxied by the relevant MSCI Min Volatility net total return index. Quality is proxied by the relevant MSCI Quality net total return index.

Momentum is proxied by the relevant MSCI Momentum net total return index. High dividend is proxied by the relevant MSCI High Dividend net total return index. Size is proxied by the relevant MSCI Small Cap net total return index. Value is proxied by the relevant MSCI Enhanced Value net total return index.

Sources

[1] Definitions of each factor are available below

Related blogs

+ Quality for uncertain times
+ Looking back at equity factors in Q4 with WisdomTree

Related products

+ WisdomTree Global Quality Dividend Growth UCITS ETF - USD Acc (GGRA/GGRG)
+ WisdomTree US Equity Income UCITS ETF (DHS/DHSD)

View the online version of this article here.

Important Information

Marketing communications issued in the European Economic Area ("EEA"): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as "WisdomTree" (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.