QUALITY INVESTING, AN ALL-WEATHER APPROACH

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Warren Buffett's widely-read annual letters to Berkshire Hathaway shareholders offer a fascinating insight into Buffett's investment philosophy. Often, these shareholder letters contain information that is particularly valuable in understanding how Buffett has managed to deliver such incredible long-term returns for his investors. After analyzing his letters, we believe the following extract is worth noting:

Berkshire Hathaway Inc. Acquisition Criteria[1]
+ Demonstrated consistent earning power
+ Businesses earning good return on equity while employing little or no debt

The key phrase here is "businesses earning good return on equity while employing little or no debt".

Quality Investing has a long history

Warren Buffet does not stand alone in his focus on high quality stocks. His mentor, Benjamin Graham, Jeremy Grantham from Grantham, Mayo, & van Otterloo (GMO) or the economist Robert Novy-Marx are well known proponents of quality investing. They all exhibited a rigorous focus on quality attributes of stocks.

In academia, Eugene Fama and Kenneth French arrived at a similar conclusion. In their seminal paper titled "A Five-Factor Asset Pricing Model" from September 2014[2], Fama and French introduce the "Quality Premium" and cite "operating profitability", defined as annual revenues minus cost of goods sold, interest expense and SG&A (Selling, General and Administrative Expenses), all divided by the book value of equity, as a source of investment returns.

In their analysis, they show that the best quintile of stocks based on operating profitability significantly outperforms all the other quintiles. For example, looking at Global Developed Equities from June 1990 to September 2019, the market delivered 7.3% average annual returns. The top quintile delivered 8.6%, an outperformance of 1.3% per year and the bottom quintile delivered 3.7%, an underperformance of 3.6%[3].

Warren Buffett has always been a master stock picker, and he is also able to make special acquisitions due to the terms he can offer. For the rest of us, diversified exposure to a portfolio of stocks that have the characteristics above via a systematic investment strategy is compelling. It allows the investor to systematically harvest the so-called quality premium.

Quality Investing an all-weather type approach

Style investing, as defined by academics, can provide two important benefits to investors: Long term outperformance as discussed earlier and diversification. Each equity style tends to behave differently depending on where we are in the business cycle.

Minimum volatility investing, for example, tends to be very defensive. Performing well in strong market corrections but lagging significantly in bull markets.
The opposite, **Size** tends to outperform and deliver above market performance in recovery and strong bull run but it struggles during bear markets.

Quality, on the contrary, tends to behave more evenly across business cycles. It tends to behave quite defensively in downturns but also tends to capture a fair share of the upside in bull runs.

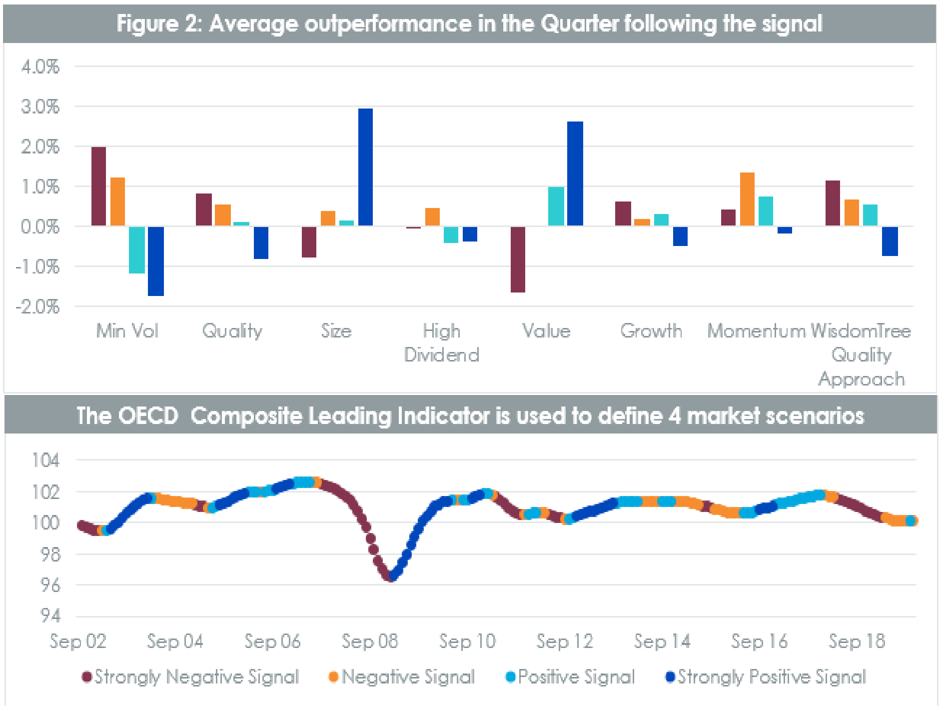
Those difference between styles can be observed in Figure 1, where each one exhibit a different upside and downside capture to the market.

Figure 1: Strategy style box

Source: WisdomTree, Bloomberg. Period September 2002 to November 2019. Calculations are based on monthly returns in USD. The inception date for the WisdomTree Global Quality Dividend Growth Index is 16 October 20155.

You cannot invest directly in an index. Above numbers include backtested data. Historical performance is not an indication of future performance and any investments may go down in value.

Looking at figure 2 below, we have split the last 17 years into 4 types of periods using the Organisation for Economic Co-operation and Development ("OECD") Composite Leading indicator ("CLI"). The CLI has been designed to provide early signals of turning points in the business cycle and therefore tends to decrease in a few months before the economy starts to slow down or increase before the economy restarts. So, a strong decline in CLI tends to indicate a probable downturn in equity markets for example. In figure 1, we show that Quality and the WisdomTree approach[4] to quality specifically do well in 3 of the 4 possible scenarios, delivering historical outperformance when the CLI decreases a lot, decreases a little but also increases a little. As such it is one of the most all-weather styles.



Source: WisdomTree, Bloomberg. Period September 2002 to November 2019. Calculations are based on monthly returns in USD. The inception date for the WisdomTree Global Quality Dividend Growth Index is 16 October *2015*[5].

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WisdomTree's approach to quality investing

Turning to our approach to quality investing, we believe that it's important to not dilute the potential power of quality by trying to apply too many stock selection rules or complex weighting schemes. In our view, the key is to be as simple and broad-based as possible, while still focusing on companies with high return on equity and low debt – attributes that are commonly considered to be fundamental in quality investing.

The following general principles are used in creating our Quality Dividend Growth indices:
+ Companies must have dividend coverage ratios greater than 1.0x: Paying out more dividends than a company earnings is not sustainable, in our opinion.
+ The Indices comprise of companies with the best combined rank of quality and growth factors from this universe:
? Quality ranking 50%: This is split evenly between three-year average return on assets (ROA) and three-year average return on equity (ROE).
? Growth ranking 50%: This is derived from analysts' long-term earnings growth expectations, which ultimately encompass the estimated growth in operating earnings per share over the company's next full business cycle – typically three to five years.
+ Weighting: The Indices are rebalanced annually according to the "dividend stream" i.e.

weighted to reflect the proportionate share of the aggregate cash dividends. This dividend stream weighting methodology brings valuation discipline to the index.
In the upcoming year 2020 which remains awash with uncertainty it could continue to be an interesting approach.

Source

1 Buffett, Warren. “Berkshire Hathaway Annual Shareholder Letter.” 27 February 2015.

2 Fama, Eugene F. & Kenneth R. French. “A Five-Factor Asset Pricing Model.” SSRN. September 2014.

3 Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/index.html. The returns are updated versions of those used in Eugene F. Fama and Kenneth R. French (2012) "Size, Value, and Momentum in International Stock Returns", Journal of Fincancial Economics.

4 WisdomTree Global Quality Dividend Growth net TR Index

5 Min Vol means MSCI World Min Vol Net TR Index. Quality means MSCI World Quality Sector Neutral Net TR Index. Value means MSCI World Enhanced Value Net TR Index, High Dividend means MSCI World High Dividend Net TR Index. Size means MSCI World Small Cap Net TR Index. Growth means MSCI World Growth Net TR Index. Momentum means MSCI World Momentum Net TR Index.

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+ WisdomTree Global Quality Dividend Growth UCITS ETF - USD
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