
LOOKING BACK AT EQUITY FACTORS IN Q3 WITH WISDOMTREE

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This summer, equities and in particular tech stocks continued their race to the top. In July and August alone, the S&P 500 was up +13.2% and the Nasdaq 100 Index +19.4%. Despite a small correction in September, this led to a second green quarter for equities. However, like earlier this year the good fortune was not evenly spread, and Tech stocks have continued to benefit above all else. Tech Mega Caps are now at a record level and the 5 biggest stock in the S&P 500 represent almost a quarter of the market cap of the index.

In the third instalment of the WisdomTree Quarterly Equity Factor Review, we aim to shed some light on how equity factors behaved over the last 3 months and how this has impacted investors' portfolios.

- In Q3, Momentum and Quality are the only factors to have outperformed in both the Developed World, USA, Europe and Emerging Markets.
- Both have benefitted from their all-weather profile, beating the respective market cap benchmarks both in the rally and the correction.
- There was a notable divergence in how these results were achieved:
 - Momentum conformed more closely to people's most likely current intuitions, benefitting from strong exposure to Information&Technology and Consumer Discretionary through companies like Apple, Microsoft and Amazon.
 - Quality, however, was able to deliver strong performance this quarter and year to date while at the same exhibiting reduced exposure to those sectors and those specific mega cap stocks.

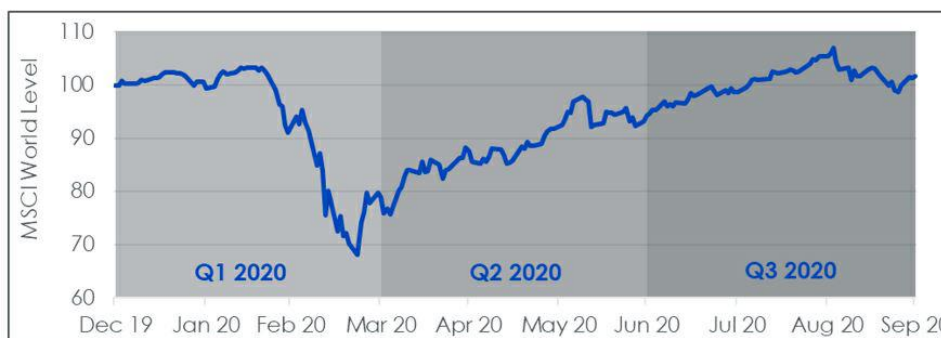
Looking forward to more uncertainty and an unpredictable US election, it is hard to discount the possibility that all-weather factors like Quality and Momentum continue to benefit in the near future.

Performance in focus: Clear winners and Losers

The third quarter of this year started like the second ended with a very powerful rally driven in most part by Tech and "Work from Home" themes. Equity markets have now erased all of the losses of the first quarter. However, since early September, the rally seems to have stalled on fears of a second wave for the Pandemic in Europe, Brexit

uncertainties and a lack of a new agreed fiscal stimulus package in the US. This may not be so surprising with the US elections only a few weeks away and markets predicting an increase in volatility and overall uncertainties for the start of Q4.

Figure 1: Year to Date Performance of MSCI World



Source: WisdomTree, Bloomberg. 31st December 2019 to 30th September 2020.

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

In the third quarter, the drivers of equity factor performance remained aligned with the first half of the year:

- Momentum and Quality led the way, outperforming the market cap weighted in all regions (Developed World, USA, Europe and Emerging Markets)
- Size followed up on its strong second half. It was the best performer in Europe and Emerging Markets but it struggled in the US with strong underperformance.
- Min volatility struggled over the quarter despite the downturn in September due to its low upside capture in July and August.
- Value and High Dividend continued to suffer with a third quarter of underperformance across regions.

Figure 2: Equity Factor Outperformance in Q3 2020 across regions

	World Q3 2020: 7.9%	USA Q3 2020: 8.8%	Europe Q3 2020: 0.1%	Emerging Markets Q3 2020: 9.6%
High Dividend	-4.8%	-4.3%	-2.4%	-10.2%
Minimum Volatility	-3.2%	-3.2%	1.1%	-4.3%
Momentum	3.3%	3.8%	4.0%	1.2%
Quality	1.3%	0.9%	3.6%	1.8%
Size	-0.5%	-3.3%	6.1%	2.3%
Value	-7.9%	-6.2%	-3.7%	-0.5%

Source: WisdomTree, Bloomberg. 30th June 2020 to 30th September 2020.

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Like in the first half, the third quarter of 2020 favoured the all-rounders

In the third quarter, the MSCI world performed strongly in July (+4.8%) and August (+6.7%) but stalled in September (-3.4%). In such a contrasted environment, only two equity factors managed to deliver outperformance in all 3 calendar months: Momentum and Quality. Both factors managed to capture the rally and more than match the market cap weighted index performance while cushioning the slight drawdown.

Figure 3: Global Developed Equities calendar month outperformance (vs MSCI world)



Source: WisdomTree, Bloomberg. 30th June 2020 to 30th September 2020.

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As expected, Min Volatility performed the best in September but failed to deliver performance in July and August. Surprisingly more cyclical factors like Size and Value did not manage to outperform at the end of the rally in July and August.

Last quarter we had pointed in this blog to the expected uncertainty and the likelihood for all-weather factors like Quality and Momentum to do well in such environments. Looking forward to the end of the year, the uncertainty in the market appears even more certain. As of the 1st October, the CBOE Volatility Index (VIX) Futures Curve already points to a 6 points increase (up to 33). In such an unpredictable world, it is hard to discount the possibility that the all-rounders (Quality and Momentum) continue to benefit.

Have Big Tech been driving factors’ outperformance this quarter?

Before moving to valuations, let’s take a quick detour to look at the aforementioned underperformance of cyclical factors in Q3. A lot has already been written about the unusual concentration and performance at the top of the S&P 500. The fact is that the Top 5 now represents a record 22.5%² of the index (Apple 6.7%, Microsoft 5.7%, Amazon 4.8%, Facebook 2.3% and Alphabet 3.1%). Those 5 stocks spread across 3 sectors: Information&Technology, Communications Services and Consumer Discretionary, even if investors might naturally be thinking of them all as ‘tech stocks’.

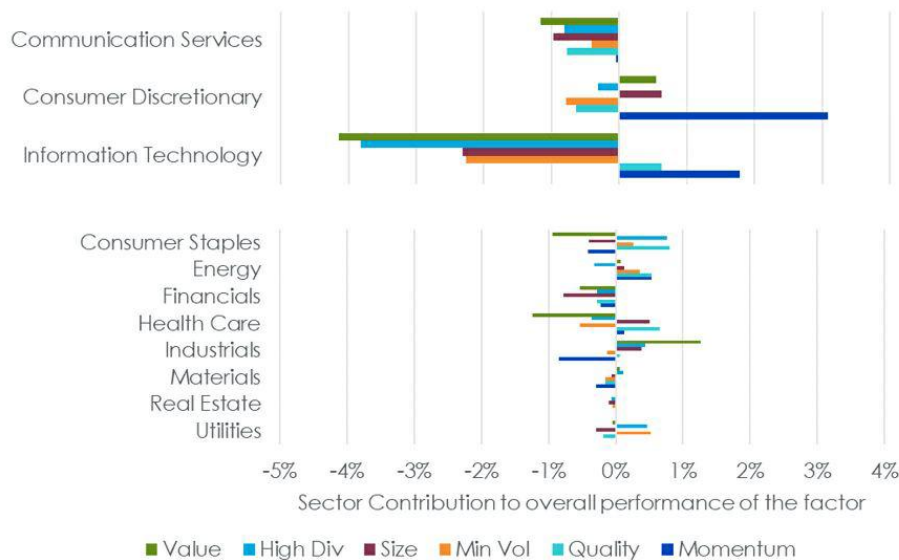
Looking at the sectorial performance attribution of US equity factors in Q3 it is very interesting to note that:

- Information&Technology and Consumer Discretionary had the biggest impact on the performance of all the factors in Q3 with contribution ranging from -4% to +3% when the contribution of other sectors ranged from -1% to 1% only.

- The cyclical factors size and value suffered from large negative contribution from Communication and Information& Technology which explain their lack of rebound in Q3.
- Momentum has benefitted very strongly from its exposure to both Consumer Discretionary and Information&Technology which explain why it is leading the factor race this quarter and this year.
- Quality benefited slightly from its Information&Technology exposure but suffered from under investment in Consumer Discretionary and Communication Services. Despite, this less than ideal sectorial exposure (or exposure to the S&P 500 Top 5), Quality has managed to outperform the market cap index and all factors except Momentum.

Looking forward to the next quarters, it is possible that the S&P 500 Top 5 mean reverts in weight and in performance, if and when that happens most factors including Quality should benefit while Momentum may suffer from such mean reversion.

Figure 4: Sector contributions to US equity factor outperformance (vs S&P 500)



Source: WisdomTree, Bloomberg. 30th June 2020 to 30th September 2020.

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Valuations are up across the board

After the sharp increase in Q2, valuations have stabilized in Q3. Most Factors got slightly more expensive except for Size.

- Despite a reduction in P/E Ratio in the US and world, Size remained pretty expensive in developed markets.

- Momentum also continued to exhibit elevated valuation.
- Quality continued to exhibit very stable multiples with a current premium of less than one point versus the MSCI world.
- Finally, value and High Dividend remain very cheap compared to the markets and are even becoming more so in Europe.

Figure 5: Historical Evolution of Price to Earnings ratios of Equity Factors



Source: WisdomTree, Bloomberg. As of 30th September 2020. Historical Data represents the last 3 years from 30th September 2017 to 30th September 2020.

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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.

² As of 30th September 2020.

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