

Not All Quality ETFs are Created Equal

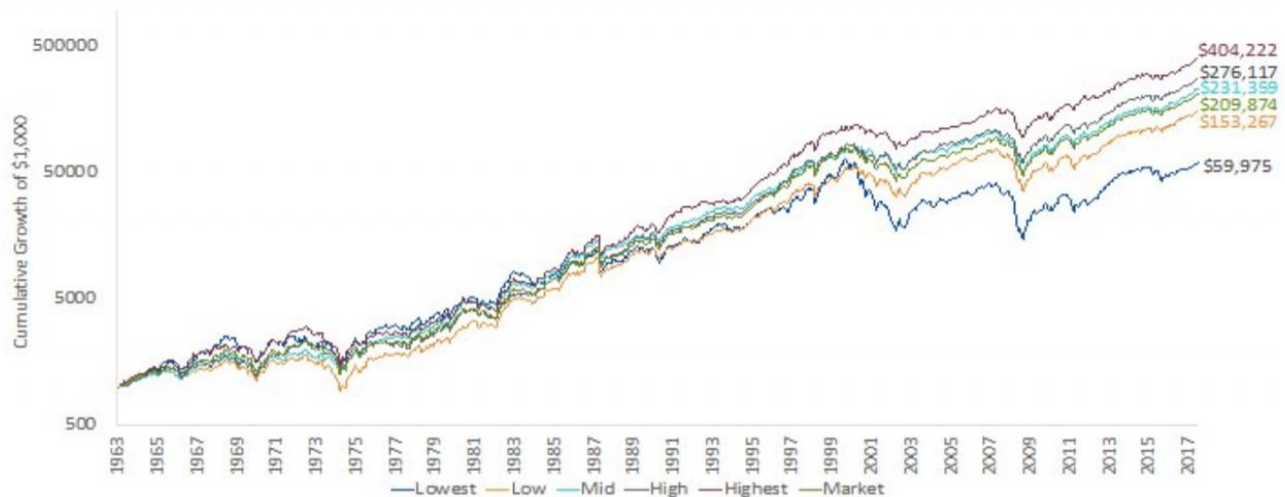


Photo Source: [Pixabay.com](https://www.pixabay.com/)

This isn't the time in the cycle to take excessive risk. The easy money has already been made. Astoria's 2019 playbook is as follows: **late cycle** economic forces + desynchronized global growth + a **deteriorating** earnings cycle = the need for **more defensive posturing** across stocks and bonds.

Astoria has been **vocal** about owning higher quality stocks in 2019. Why? Companies with above average ROE/ROA and increasing profitability should be rewarded in an environment when earnings are declining.

Second, higher quality stocks have historically **outperformed** lower quality stocks (see chart below). Since 1963, the highest quintile of US profitable companies has returned **11.63%** while the lowest quintile has returned **7.79%**. Higher quality companies have also outperformed the market which returned **10.30%** over this time-period.



	Average Annual Return	Sharpe Ratio
Highest	11.63%	0.45
High	10.86%	0.40
Mid	10.50%	0.39
Low	9.67%	0.32
Lowest	7.79%	0.16
Market	10.30%	0.37

Source: Kenneth French Data Library, with data as of 12/31/17, WisdomTree. Period based on the availability of operating profitability returns sorted into quintiles, beginning 6/30/63. The universe is U.S.-listed equities grouped based on operating profitability. Past performance is not indicative of future results. Sharpe Ratio: Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.

There are some key differences amongst Quality ETFs. Utilizing quantitative portfolio construction tools and aggregating the underlying fundamentals to determine the optimal ETF for your portfolio is **crucial**.

The key message from Astoria is to pick high quality stocks with strong balance sheets which have demonstrated the ability to grow their earnings regardless of the prevailing macroeconomic conditions. We find that **DGRW** (WisdomTree US Quality Dividend Growth ETF) and **QUAL** (iShares Edge MSCI USA Quality Factor ETF) have relatively higher factor loadings and have more balanced sector weights compared to some of the other larger Quality ETFs.

2019: The Year of the Quality ETF?

We were recently quoted in a CNBC article (click [here](#)) that Quality ETFs will take in more assets than any other factor category in 2019.

As of mid February, US listed Quality ETFs have taken in approximately **\$2 bln** in assets. While this may not appear significant, the entire equity ETF universe has seen approximately **\$20 bln** of outflows in 2019.

Astoria originally pegged quality as one of our **key 2019 themes** in our January 3rd blog (click [here](#)) and reiterated it our year ahead outlook on January 8th (click [here](#)). We like high quality stocks for the following reasons:

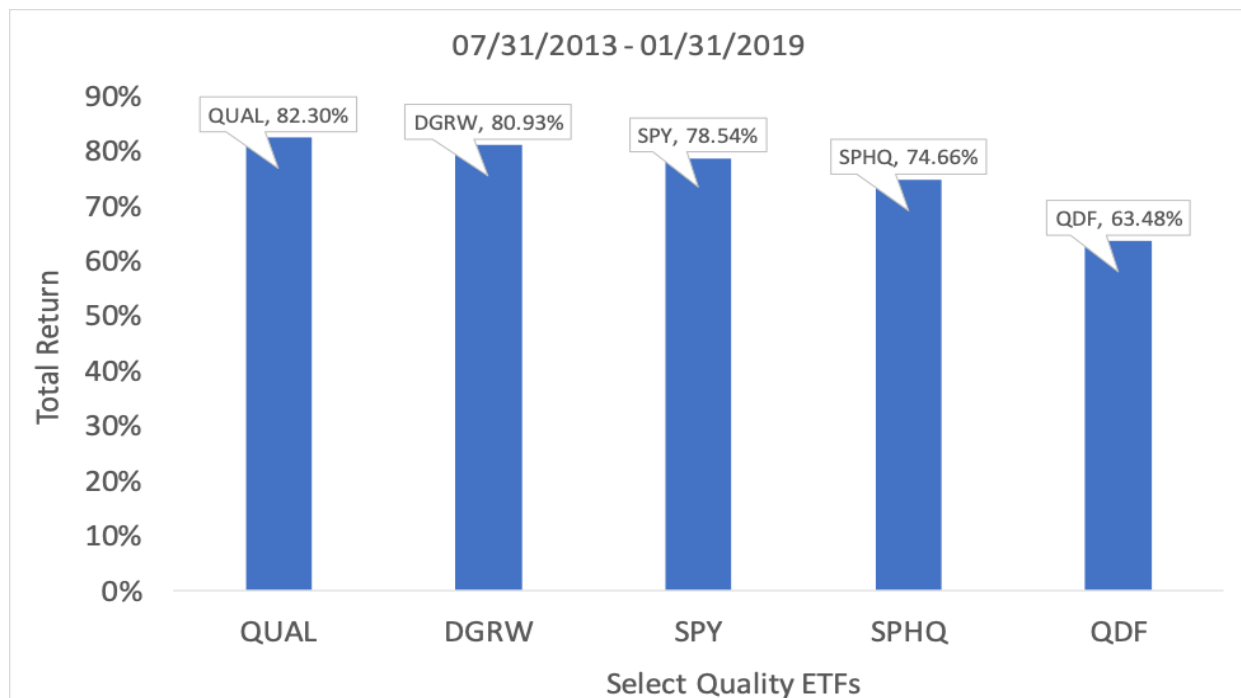
1. The **earnings cycle is deteriorating** and companies with **above average ROE/ROA and increasing profitability** are likely to be rewarded more on a relative basis.
2. The quality factor has historically shown to be **robust, pervasive, and has been persistent over time**.

We believe 2019 will be more defensively driven due to global growth becoming more desynchronized, the earnings cycle is deteriorating, late cycle economic forces, and elevated macro risks (trade tariffs, Brexit, China slowdown, etc.). See our recent CNBC interview (click [here](#)) or the Behind the Markets podcast with the Wharton School of Business (click [here](#)) where we reviewed our 2019 investment outlook.

DGRW and QUAL Have Outperformed the S&P 500 Over the Past 5 Years Despite a QE Induced Rally

Let's dive deeper into the some of the larger Quality ETFs.

- 4 of the larger Quality ETFs have shown **considerable performance differences** over the past 5 years. This speaks to the point that **not all Quality ETFs are created equal** and investors need to **understand the underlying index methodology** and look at the portfolio's risk characteristics.
- QUAL (iShares Edge MSCI USA Quality Factor ETF) and DGRW (WisdomTree US Quality Dividend Growth ETF) have done notably better than QDF (FlexShares Quality Dividend ETF) and SPHQ (Invesco S&P 500 Quality ETF) since July 2013.



Source: Bloomberg

- Over the past 5 years, the US economy has had varying periods of acceleration and slowdowns, but the general trend has been **cyclicals outperforming defensives**.



Source: Bloomberg

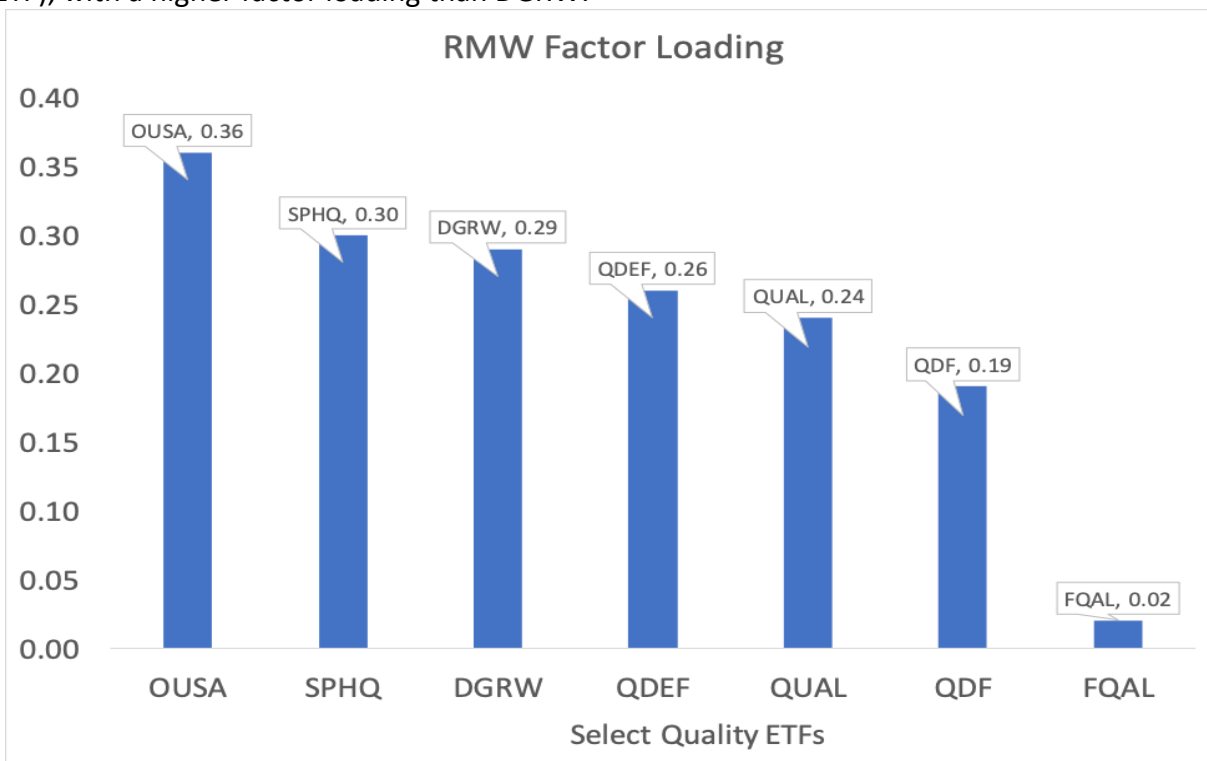
- If high quality stocks performed well when the market was driven by QE and led by cyclicals, why wouldn't quality work when the market shifts to a more defensive tone?

Not All Quality ETFs are Created Equal

As the Chief Investment Officer of Astoria, I have spent **20 years in the ETF ecosphere** doing portfolio construction research, analyzing ETFs, and structuring portfolios for investors. Picking the right Quality ETF isn't a trivial task.

Astoria has a **unique value proposition** in the ETF model portfolio space. We **leverage extensive amounts of technology, software, and risk models** to analyze the underlying ETF portfolio risk characteristics.

Amongst the 2 largest Quality ETFs, DGRW provides a slightly **higher factor loading** (RMW) compared to QUAL. There are 2 other ETFs, OUSA (O'Shares FTSE US Quality Dividend ETF) and SPHQ (Invesco S&P 500 Quality ETF), with a higher factor loading than DGRW.



Data Source: PortfolioVisualizer.com. (RMW) Robust Minus Weak: The profitability premium. Data retrieved on February 7th, 2019.

Below is a table showing the 5 factor loadings for the larger Quality ETFs.

Factor Analysis Summary										
ETF Name	ETF Ticker	Rm-Rf	SMB	HML	RMW	CMA	Alpha	Annul Alpha	R ²	
O'Shares FTSE US Quality Dividend ETF	OUSA	0.82	-0.13	-0.22	0.36	0.47	-0.11%	-1.26%	83.80%	
Invesco S&P 500 Quality ETF	SPHQ	0.88	0.02	-0.13	0.30	0.22	0.04%	0.51%	93.00%	
WisdomTree US Quality Dividend Growth ETF	DGRW	1.02	-0.05	-0.08	0.29	0.20	0.01%	0.08%	97.90%	
FlexShares Quality Dividend Defensive ETF	QDEF	0.87	0.00	-0.08	0.26	0.32	0.03%	0.38%	94.90%	
iShares Edge MSCI USA Quality Factor ETF	QUAL	0.94	-0.05	-0.08	0.24	-0.03	0.01%	0.08%	96.00%	
FlexShares Quality Dividend ETF	QDF	0.96	0.03	-0.02	0.19	0.38	-0.04%	-0.44%	96.30%	
Fidelity Quality Factor ETF	FQAL	0.92	-0.04	-0.03	0.02	-0.04	0.02%	0.23%	98.00%	

Data source: Portfolio Visualizer. Data for DGRW, QUAL, QDF, SPHQ, and QDEF is based on the time period August 2013 through December 2018. Data for OUSA and FQAL is based on the time period October 2016 through December 2018.

Comparing the 2 Largest Quality ETFs

DGRW (WisdomTree US Quality Dividend Growth ETF)

- DGRW **applies a quality and a growth screen** when constructing the portfolio. In Astoria's view, this is particularly attractive as we don't necessarily think investors should be ignoring growth stocks but instead picking securities which **have both growth and quality characteristics**.
- The earnings growth ranking is **50%** of the portfolio construction process and is derived from companies' **long-term earnings growth expectations**.
- The quality ranking is the remaining 50% of the screening process and is split evenly between a **three-year average return on assets (ROA)** and the **three-year average return on equity (ROE)**.
- DGRW removes companies with higher dividend yields. The logic here is that if companies are paying out more than they earn, companies may have to cut back their dividends in the future.

DGRW Methodology

Selection Criteria & Rationale

The universe of eligible companies begins with the WisdomTree U.S. Dividend Index of 1,462 investable dividend payers as of November 30, 2017, the date of annual screening. Then we add the following screening criteria:

- Minimum market capitalization of \$2.0 billion
- Must have dividend coverage ratio greater than 1.0x, as companies that do not have enough earnings to support their dividends are less likely, we believe, to be dividend growth leaders

Weighting

The Index is Dividend Stream® weighted to reflect the proportionate share of the aggregate cash dividends of each constituent. This gives bigger weight to companies growing their dividends.

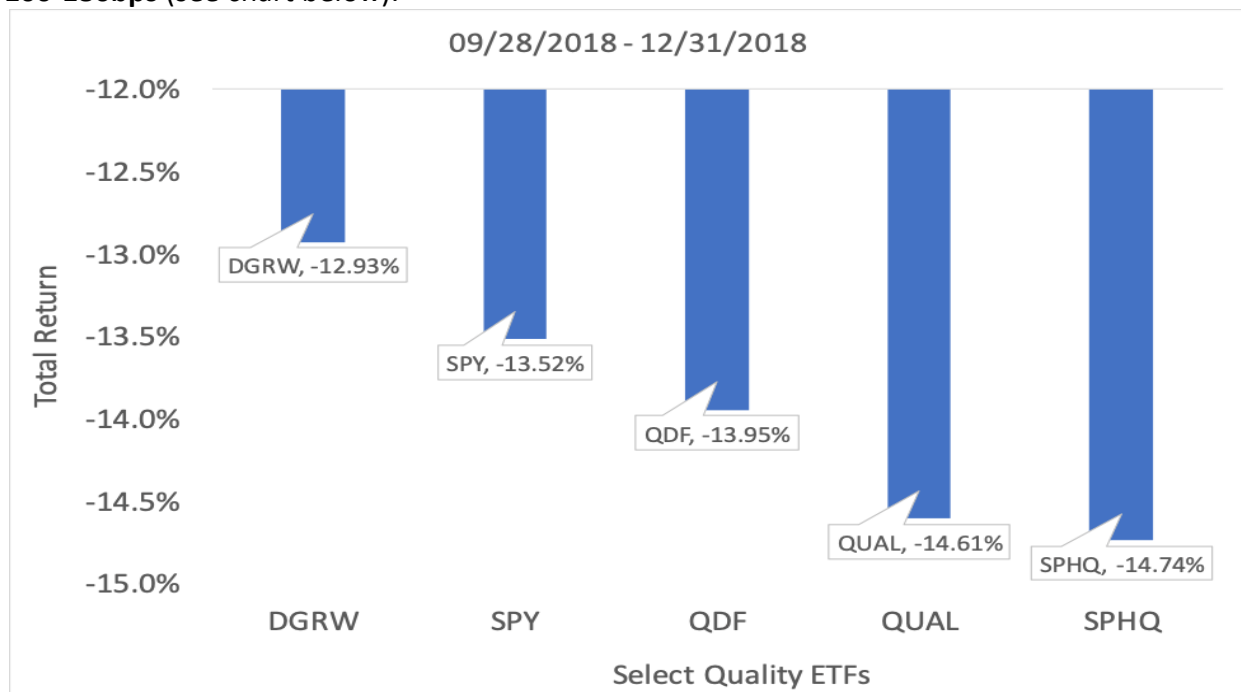
Single Holding and Sector Caps

At the annual rebalance, the following caps apply:

- No single stock can represent more than 5% of the Index
- No sector can represent more than 20% of the Index
- Between annual rebalances, single stock weights and sector weights may fluctuate above the 5% and 20% marks, respectively, due to market movement

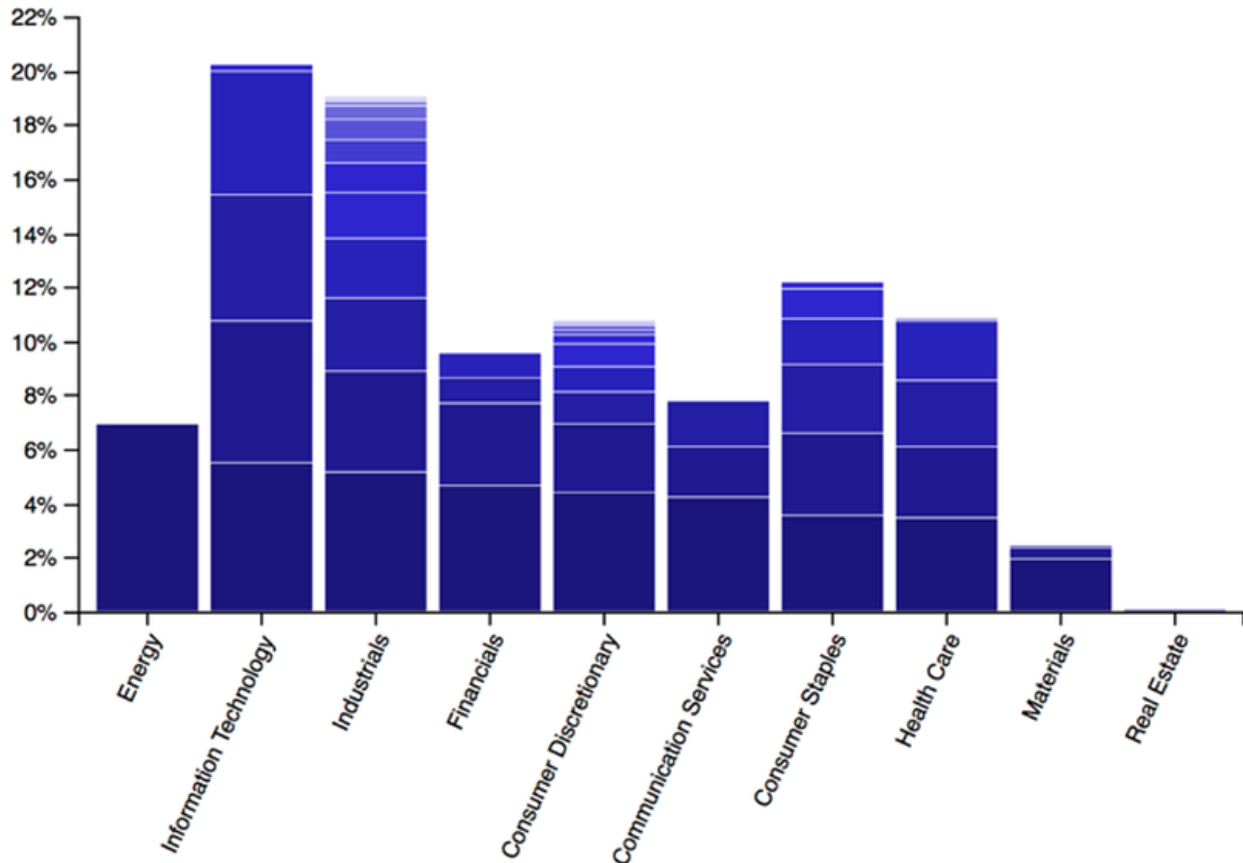
Source: WisdomTree

- During the heightened volatility of Q4 2018, **DGRW outperformed the larger Quality ETFs between 100-180bps** (see chart below).



Source: Bloomberg

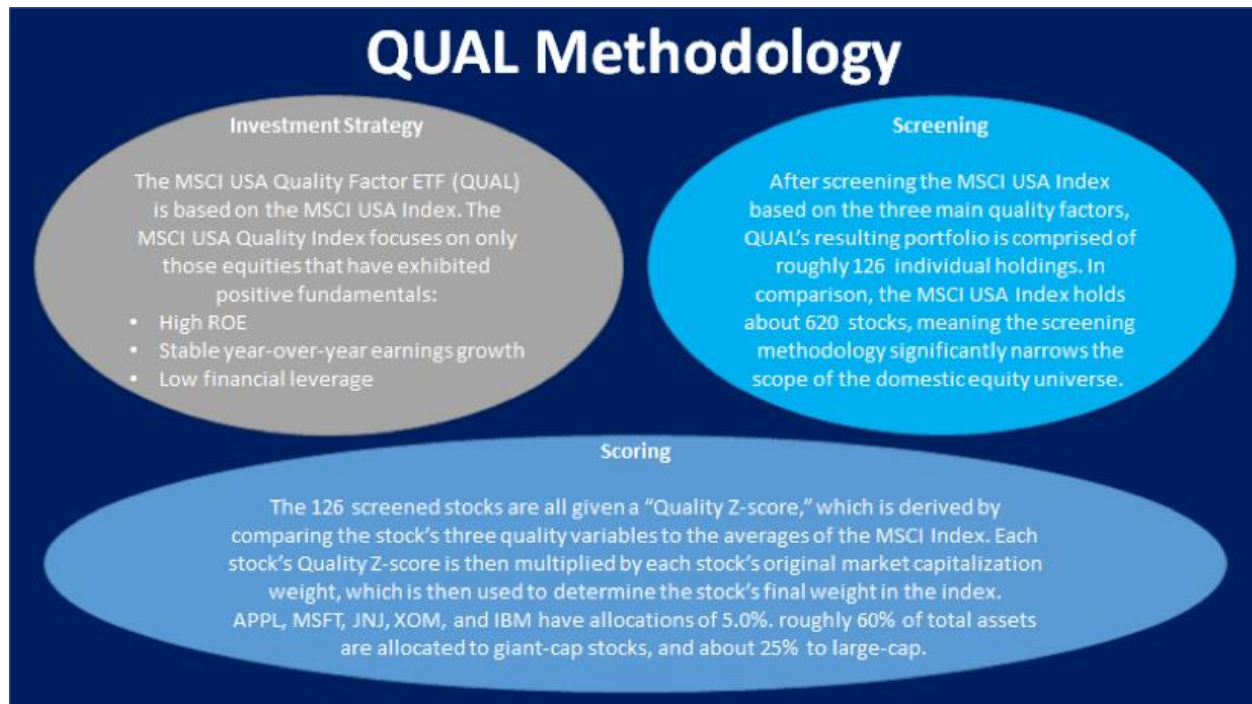
- In our view, these are substantial return differences considering investors are quick to rotate amongst ETFs because of a few basis point difference in management fees.
- DGRW's top sector exposures are Information Technology (20%), Industrials (19%), and Consumer Staples (12%).



Source: ETFAction.com

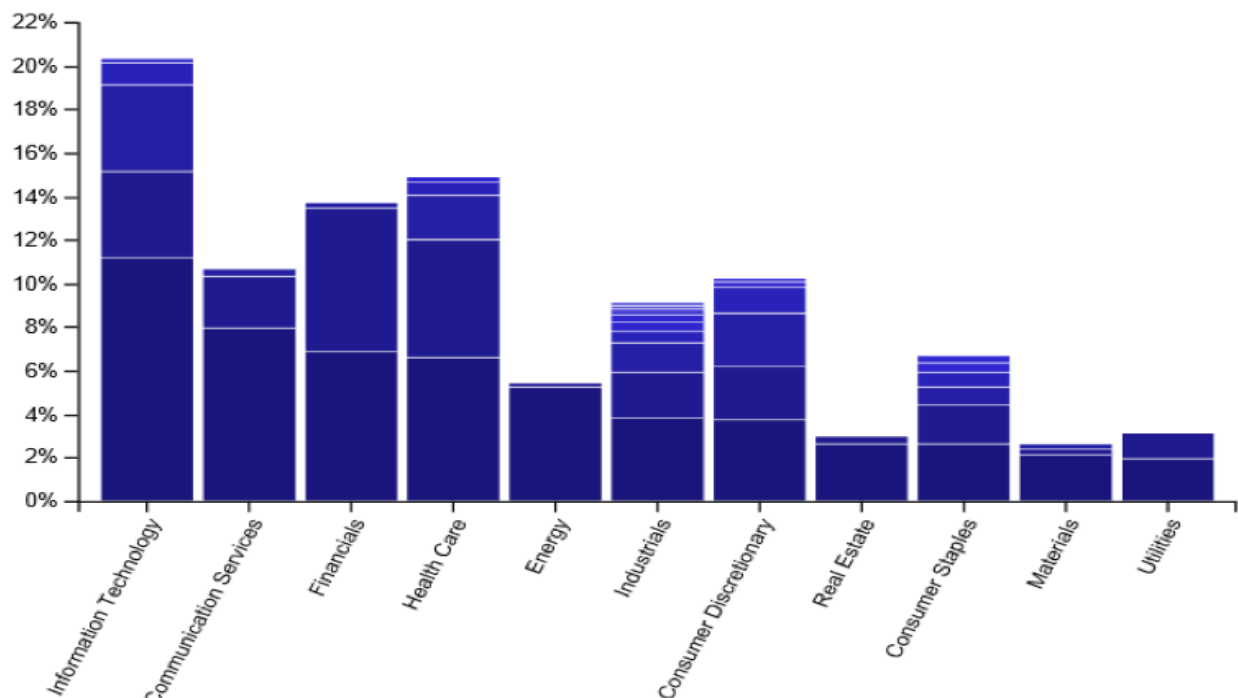
QUAL (iShares Edge MSCI USA Quality Factor)

- QUAL tracks an index of US large and mid-cap stocks. The stocks are selected and weighted by **high ROE, stable earnings growth and low debt/equity**.
- In our view, QUAL also has a sound methodology and has been the clear leader so far with \$9 bln in assets in the Quality ETF space.
- QUAL tends to be more **concentrated** with only 120 stocks or so.
- There are some notable differences in the constituents and their weights for QUAL and DGRW so investors need to be comfortable with the portfolio risk characteristics when deciding between both ETFs.



Source: ETFdb.com, Blackrock / iShares, MSCI.

- QUAL's top sector exposures are Information Technology (20%), Health Care (15%), and Financials (14%).



Source: ETFAction.com

In the table below, we highlight some of the fundamental variables and sector weights for select Quality ETFs. Some factor ETFs will incorporate a quality metric in their screening methodology, but the focus isn't quality per se. We've skipped those for the time being.

ETF Name	Ticker	Information Technology Weight	Health Care Weight	Consumer Staples Weight	Financials Weight	Industrials Weight	Other Weight	Fundamental Variable Used
WisdomTree US Quality Dividend Growth ETF	DGRW	20%	11%	12%	10%	19%	28%	ROA, ROE, Long Term Growth Expectations, Dividend Coverage Ratio
iShares Edge MSCI USA Quality Factor ETF	QUAL	20%	15%	6%	14%	10%	35%	High ROE, Stable Earnings Growth, Low Debt/Equity
Invesco S&P 500 Quality ETF	SPHQ	40%	13%	10%	4%	8%	25%	ROE, Changes in Net Operating Assets, & Financial Leverage
FlexShares Quality Dividend ETF	QDF	21%	11%	8%	13%	13%	34%	Capital Efficiency, Profitability, & Cash Flow
Xtrackers Russell 1000 US QARP ETF	QARP	19%	15%	12%	4%	13%	37%	Quality (ROA, Change in Asset Turnover, Accruals) + Value (CF yield, earnings yield, sales to price)
O'Shares FTSE US Quality Dividend ETF	OUSA	15%	16%	17%	3%	13%	36%	High Quality, Low Volatility, & High Dividend Yield
FlexShares Quality Dividend Defensive ETF	QDEF	21%	12%	10%	12%	7%	38%	High Dividend Yield & Low Beta
Fidelity Quality Factor ETF	FQAL	20%	14%	7%	13%	10%	36%	Profitability, Cash Flow, & Balance Sheet

Source: ETFAction.com. Refer to each of the ETF's respective index methodology for more details.

Will ETF providers start to add the word quality to their ETF name in lieu of capturing what has been an emerging theme in just 6 weeks of this year? As someone who has worked in the ETF industry for 20 years, we wouldn't be surprised.

In our next report, we will drill further into the fundamental characteristics of Quality ETFs.

Best, John Davi
Founder & CIO of Astoria

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