OUR LATE-CYCLE INVESTING GUIDE: QUALITY AT REASONABLE MULTIPLES

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Across the country, about one in five Americans[1] is spending August reviewing fantasy football pre-draft guides to strategize the best bang for their buck by position: maybe some combination of proven quality players that won't break the bank like veterans Drew Brees and Golden Tate, coupled with an upstart rookie like Saquon Barkley if still available midway through the first round. At WisdomTree, we've spent August trying to help investors form a game plan around a fundamental but critical question for their portfolios: What are your best ideas for investing at this later stage of the U.S. economic cycle?

Our answer: an approach that targets quality companies with strong balance sheets and healthy profitability at reasonable valuations.

My colleague's blog post broke down the return patterns of factors leading up to and during downturns and concluded that quality was "the best of factors in the worst of times." The behavioral rationale for this anomaly: when times get tough, investors become acutely focused on differences in current profitability and less attracted to promises of future revenue growth.

Five years ago, WisdomTree launched a global family of Quality Dividend Growth Indexes that has yielded impressive real-time results. A characteristic of these Indexes across global equity markets is the valuation premiums quality investing commands, with the U.S. the cheapest by our preferred measures.

Quality on Sale in the U.S?

The key to a successful fantasy football draft is to get the best performance from a player relative to the price paid. This concept, looking for quality at reasonable prices, is the same logic we take when we approach quality investing.

Warren Buffett's feelings on combining the elements of quality and value into one investing approach is summed up by the following quotation: "Value is buying good companies at cheap prices. Quality is buying great companies at fair prices."[2]

WisdomTree's Quality Dividend Growth Indexes, those for the U.S. as well as developed and emerging markets, select for quality dividend-paying companies based on three criteria: return on equity, return on assets and earnings growth expectations. After this quality screen, constituents are then weighted based on dividends.

The key to this approach, and all of WisdomTree's fundamentally weighted Indexes, is to delink price from constituent weights in order to mitigate paying premium prices for stocks simply because market prices dictate owning more of an increasingly expensive stock.

In the table below we show estimated price-to-earnings ratios and shareholder yields for the WisdomTree U.S. Quality Dividend Growth Index as well as the WisdomTree U.S. High Dividend Index in each respective region to illustrate the resulting valuations from this screening and weighting process across markets.

Regional Exposure	Estimated Index Price-to-Earnings (P/E) Ratios			Index Shareholder Yield (Dividend + Net Buyback Ratio)		
	WisdomTree Quality Dividend Growth Index	WisdomTree High Dividend Index	Quality P/E Ratio Premium (%)	WisdomTree Quality Dividend Growth Index	WisdomTree High Dividend Index	High Dividend Shareholder Yield Premium
United States	16.16x	15.27x	5.80%	4.32%	4.38%	0.06%
Developed International	18.08x	12.54x	44.14%	3.36%	5.03%	1.68%
Emerging Markets	14.28x	8.60x	66.06%	2.50%	4.75%	2.25%

Sources: WisdomTree, FactSet. Data as of 7/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

High Yield vs. Quality

The WisdomTree High Dividend Index, constituted with the highest-dividend-yielding companies in each market, represents a deeper value cut of each respective market. What is interesting to note is that in the developed and emerging markets, the quality Indexes are 44% and 66% more expensive, measured by P/E ratios, than the high-dividend Indexes. In the U.S., this premium is a much more modest 5.8%.

On the basis of shareholder yield, a measure combining dividend yield and net buyback yield, the high-dividend Indexes in the developed international and emerging markets have a 1.68% and 2.25% yield advantage to the respective quality Index. In the U.S., the shareholder yield of the quality Index is roughly equivalent to the high-dividend Index.

Thus, in the U.S., the dividend yield that is sacrificed when comparing the quality Index to the high-dividend Index is more than made up for in the net buyback yield benefit for the quality Index. The process of screening for profitable, growing companies results in constituents that are not only growing their dividends but are also buying back more shares. How has increased weight in companies with higher shareholder yields contributed to returns?

Reviewing the Box Score: Higher Shareholder Yields Boost Outperformance

Using the attribution tool available on our website, we are able to quantify the impact on relative returns for the WisdomTree U.S. Quality Dividend Growth Index across shareholder yield quintiles. Since inception, one of the more interesting things to note is the best-performing segment in the S&P 500 is that of companies with zero or negative shareholder yield. This category returned 20.6%, far and away the best-performing category in the benchmark. This is not surprising when one considers that the type of companies that have outperformed have been information technology and consumer discretionary companies that are neither paying dividends nor are net purchasers of their own shares. The WisdomTree Index was under-weight in this segment of the market by nearly 8%, resulting in a headwind to the strategy of 61 basis points (bps).

WTDGI - WisdomTree U.S. Quality Dividend Growth Index vs. 500 - S&P 500 Index

Shareholder Yield Attribution | As of: 7/31/2018 | MTD | YTD | 1Y | 3Y | 5Y | Since Inception

	Attribution Component				Average Category Weight			Category Performance	
Category	Allocation	Stock Selection	Interaction	Total Attribution	Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
1st Quintile (Highest Shld. Yield)	0.08%	0.59%	0.02%	0.69%	18.99%	15.92%	3.07%	18.17%	14.03%
2nd Quintile	-0.14%	0.32%	0.10%	0.28%	35.57%	25.42%	10.15%	14.13%	12.94%
3rd Quintile	-0.02%	0.23%	-0.05%	0.16%	24.17%	21.04%	3.13%	12.01%	11.27%
4th Quintile	0.02%	-0.12%	-0.00%	-0.10%	15.02%	14.55%	0.48%	13.02%	13.82%
5th Quintile (Lowest Shld. Yield)	-0.09%	0.49%	-0.25%	0.15%	5.36%	12.59%	-7.23%	18.04%	14.20%
Zero & Neg. Yield	-0.53%	-0.32%	0.24%	-0.61%	0.87%	8.79%	-7.92%	14.99%	20.63%
N/A	-0.09%	-0.01%	-0.00%	-0.10%	0.01%	1.70%	-1.69%	0.10%	20.11%
Total	-0.77%	1.18%	0.06%	0.47%	-	-	-	14.21%	13.74%

Sources: WisdomTree, FactSet, for the period 4/30/13–7/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

In the face of this headwind, the WisdomTree Index's combined over-weight of more than 13% in the top two yielding quintiles offered up nearly 100 bps of outperformance, contributing to the Index outperforming the S&P 500 by 47 bps. What this tells us is that over a long enough period, in this case just over five years, a broad approach that assigns greater weight to companies consistently rewarding their shareholders via dividends and share buybacks can result in superior aggregate total returns—even amid a sustained rally from non-dividend-paying companies.

With the First-Round Pick…

The table below helps summarize select relevant fundamentals to illustrate how WisdomTree's Index compares to respective MSCI quality and value indexes, as well as the broader market. In sum, the WisdomTree Index stacks up between the quality and value Indexes on measures of valuation (P/E and Dividend Yield) and profitability (ROE and ROA), and bests the S&P 500 on both.

Given the well-documented benefits of owning quality companies with an eye to valuation discipline, we would rank the WisdomTree U.S. Quality Dividend Growth highly on our draft board.

Fundamentals	WT U.S. Quality Dividend Growth	MSCI USA Quality	MSCI USA Enhanced Value	S&P 500
Forward Price-to-Earnings (P/E) Ratio	16.7x	18.2x	11.7x	17.4x
Long-Term Earnings Growth Expectations	10.0%	10.7%	6.4%	10.5%
Dividend Yield	2.4%	2.1%	2.5%	1.9%
Return on Equity	18.7%	23.3%	11.3%	14.8%
Return on Assets	4.2%	5.6%	2.2%	3.2%
ROE x Earnings Retention	11.2%	14.5%	8.0%	9.8%

Sources: WisdomTree, Bloomberg, as of 7/31/18.

[1]Eric Allen Hall, "The Dark Side of Fantasy Football," The Washington Post, 9/10/17.

[2]Robert Novy-Marx, "Quality Investing," University of Rochester, December 2012 (significantly revised May 2014).

physically deliver to an investor must print the monthly performance report to accompany this blog.

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You cannot invest directly in an index.

DEFINITIONS

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

Fundamental weighting : A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.

Estimated P/E ratios : Share price divided by estimated 12-month earnings per share. Lower numbers indicate an ability to access greater amounts of estimated 12-month earnings per dollar invested.

Shareholder Yield : A data point that references the combination of dividend yield and buyback yield.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Net Buyback Yield : A company's net share buyback is the difference between the capital raised by issuing new shares and the money the company spent on buying back any outstanding shares. A positive net share buyback means that more was spent on buying back existing shares than received from issuing new shares. Net buyback yield is the amount of a company's net buybacks divided by its market capitalization. Please note that net buyback yield does not represent a dividend paid by the company.

Dividend : A portion of corporate profits paid out to shareholders.

Quintile : One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor’s Index Committee designed to represent the performance of the leading industries in the United States economy.

Basis point : 1/100th of 1 percent.