A QUALITY OPPORTUNITY FOR QUALITY

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Something interesting is happening in the international quality market.

As my colleague Matt Wagner explained in a recent blog post, traditional finance theory posits that higher quality stocks should trade at a premium to the broader market (which contains both high- and low-quality companies) due to the perception and expectation of safety.

This premium is reflected in common valuation metrics like the price-to-earnings (P/E), price-to-book (P/B) and forward P/E ratios—a high-quality collection of companies would have higher measures than those of the broader equity market.

Put the opposite way, lower-quality stocks *should* trade at a valuation discount to the broader market because they're assumed to be riskier. Therefore, they should offer more compensation from a total return perspective to entice investors to own them.

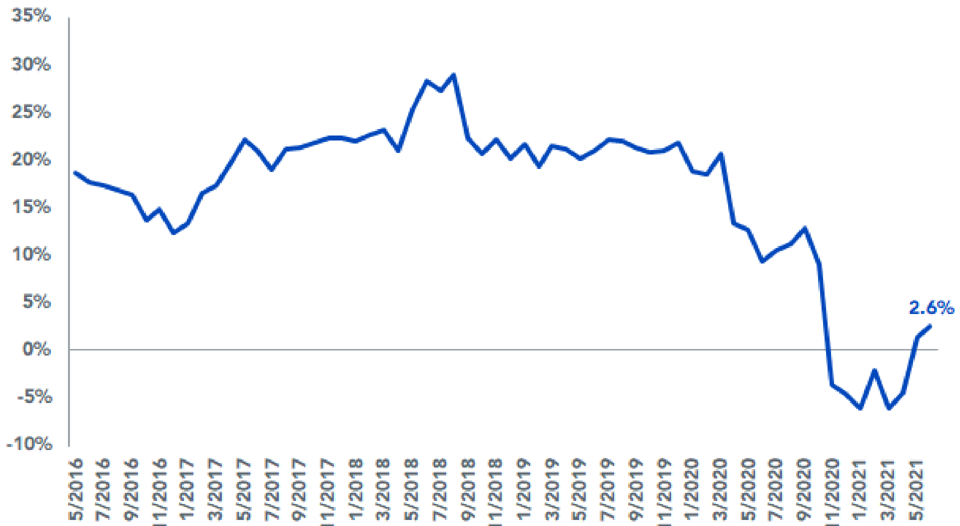
But there's often a disconnect between the way financial markets should work versus how they're working in the real world.

An Historic Opportunity for International Quality

One such disconnect is currently unfolding within the quality market for developed international equities.

Our barometer for international quality is the WisdomTree International Quality Dividend Growth Fund (IQDG), which launched in 2016 and has traded at a premium to the MSCI EAFE Index on a forward P/E basis since day one. However, beginning in the third quarter of 2018, this relationship began to slowly break down as lower-quality stocks rallied relative to higher-quality ones.

IQDG Forward P/E Premium/Discount Relative to MSCI EAFE



Sources: WisdomTree, FactSet, as of 6/30/21. Past performance is not indicative of future results. Subject to change.

You cannot invest directly in an index.

Fast-forward to late 2020, when IQDG's forward P/E ratio began trading at a discount to the MSCI EAFE for the first time ever, where it remained until just recently.

This was fundamentally at odds with the academic finance lessons we've been taught. Suddenly, there was a risk premium available to investors for owning (presumably) less risky and higher-quality stocks. Theoretically, there *should* have been higher expected return compensation in exchange for being more risk averse.

As of June, IQDG has been restored to a premium, albeit a modest one. It is trading almost in line with the MSCI EAFE, with a forward P/E premium of about 2%.

This is still impressively low by historical standards. Since inception, IQDG has traded at an average 16% premium to the MSCI EAFE, so its current reading is negligible.

IQDG Forward P/E Premium Discount Relative to MSCI EAFE Since Inception (4/7/2016)	
Most Recent	2.6%
Average	16.4%
Highest	28.9%
Lowest	-6.1%

Source: WisdomTree, FactSet, as of 6/30/21. Past performance is not indicative of future results. Subject to change. You cannot invest directly in an index.

What about [Trailing Earnings]?

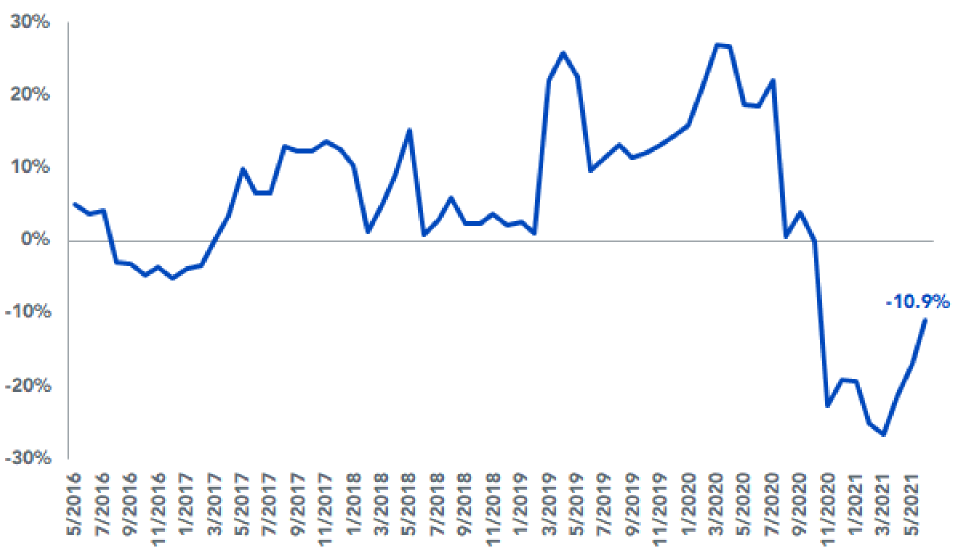
Let's look at the affordability of international quality from another perspective.

After all, we are exiting a global pandemic where the revenues and profits of many cyclical companies with weaker [balance sheets] may have disproportionately suffered compared to peers on more stable financial footing. As we return to an environment of global economic growth, prices for lower-quality stocks may be buoyed by investors' renewed optimism.

Through this lens, perhaps it makes sense that lower-quality companies are enjoying a tailwind, thereby reducing the valuation premium that high-quality stocks have traditionally commanded over the broader market.

But the thesis is even stronger if we use the P/E ratio with trailing earnings instead of estimated earnings. That way, we capture at least six months of last year, when the pandemic and its economic ramifications were in full force.

IQDG P/E Premium/Discount Relative to MSCI EAFE



Sources: WisdomTree, FactSet, as of 6/30/21. Past performance is not indicative of future results. Subject to change. You cannot invest directly in an index.

Using trailing earnings, IQDG remains at a deep discount relative to MSCI EAFE. Not only is the magnitude of the discount (about 11%) impressive, but it's notable that it has almost always traded at a premium since inception as well.

Historically, it has averaged a premium of about 5%. Though it has recovered from its deepest discount in March 2021, it still remains underpriced relative to the broader developed equity market.

IQDG P/E Premium Discount Relative to MSCI EAFE Since Inception (4/7/2016)	
Most Recent	-10.9%
Average	4.8%
Highest	26.9%
Lowest	-26.6%

Sources: WisdomTree, FactSet, as of 6/30/21. Past performance is not indicative of future results. Subject to change. You cannot invest directly in an index.

What about Fundamentals?

Given the valuation gap, an astute investor might think there's sufficient reason for it to exist in the first place. Perhaps the underlying "quality" companies must not be as high-quality as we're led to believe. Right?

Wrong. IQDG still manages to deliver nearly three times as much return on equity (ROE) and over 7% more return on assets (ROA) than broad developed markets, resulting in about one-third as much leverage as well.

It even manages to deliver higher-quality characteristics compared to U.S. markets, proxied by the S&P 500 Index. Traditionally, developed markets have traded at a discount to the U.S. since their economies tend to be more cyclical in nature with reduced profitability metrics.

Nonetheless, IQDG outshines even the mighty, Information Technology-laden S&P 500 in a test of quality, offering 1.5 times ROE, nearly three times ROA and about half as much leverage.

Fundamentals Comparison as of 6/30/2021

Fund/Index	P/E	Forward P/E	Return-on-Equity (ROE)	Return-on-Assets (ROA)	Return-on-Sales (ROS)	Leverage
IQDG	20.8x	16.9x	22.1%	8.5%	22.8%	2.6x
S&P 500	31.2x	22.0x	14.6%	3.1%	14.0%	4.8x
MSCI EAFE	23.3x	16.5x	8.3%	1.1%	9.6%	7.3x

Sources: WisdomTree, FactSet, as of 6/30/21. Past performance is not indicative of future results. Subject to change. You cannot invest directly in an index.

…But What about Performance?

The affordable opportunity to own international quality is not a result of poor performance either.

On a year-to-date basis (as of June 30, 2021), both IQDG and its currency-hedged twin (IHDG—WisdomTree International Hedged Quality Dividend Growth Fund) are in the top quartile of funds in the Morningstar Foreign Large Growth category based on NAV performance. IHDG is number two overall, while IQDG stands at #16 out of more than 450 funds.

An Opportunity Reminiscent of Value

At WisdomTree, we've preached the merits of quality exposure through U.S. markets for a long time. For once, however, there's an opportunity to access quality in developed international markets, which we have not been as optimistic about until this year.

The relative valuations described above remind us of WisdomTree's value investing ethos. But this time, the "value" opportunity is in the quality factor, which we've always believed in for the long term.

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You cannot invest directly in an index.

DEFINITIONS

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.

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.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Price-to-book ratio : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Forward P/E ratio : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Trailing Earnings : The amount of profit that a company produces during prior fiscal year.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

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.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

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.

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

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.

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