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# VALUE AND QUALITY: BALANCING THE FACTORS

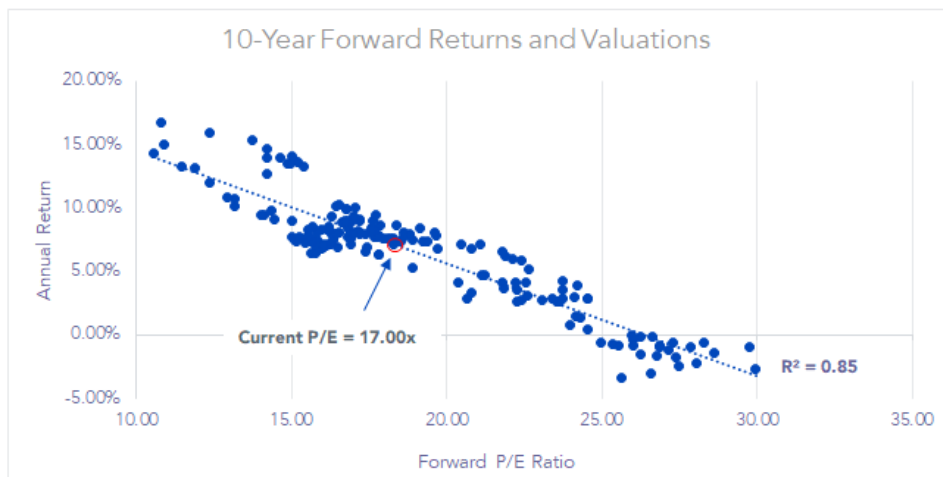
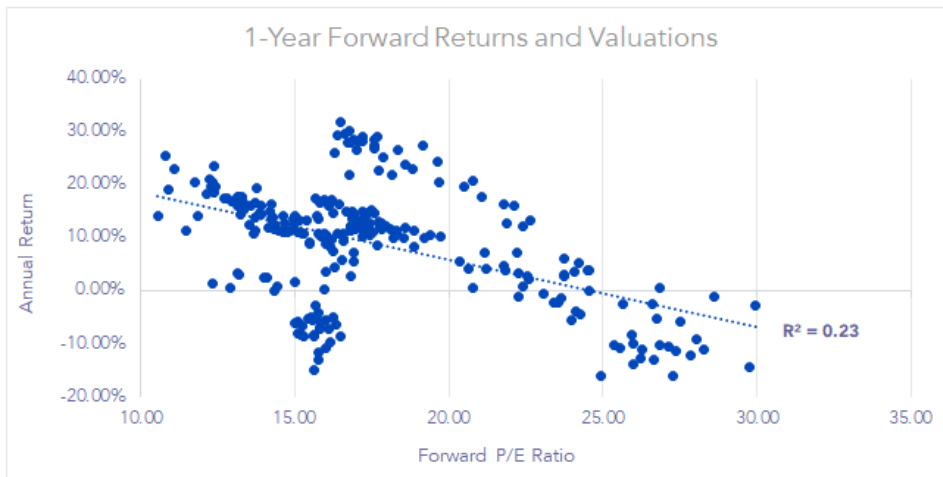
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03/09/2020

Starting [valuations](#) make a big difference when forecasting long-term equity index returns.

In the near term, not so much.

Take these charts of the [S&P 500 Index](#). Intuitively, we know lower valuations tend to be associated with higher returns. Over 1-year return periods, the  $R^2$  between [price-to-earnings \(P/E\)](#) multiples and returns is a lackluster 0.23, but a remarkably convincing 0.85 for 10-year returns.

S&P 500 Index



Sources: WisdomTree, FactSet, Bloomberg, 4/30/1995–2/28/2020. Blue dots represent monthly observations of the forward P/E ratio of the S&P 500 at a point in time and subsequent forward returns of the S&P 500. Returns based on index total returns. 10-year returns are average annual total returns. Forward P/E ratio excludes negative earners. You cannot invest directly in an index. Past performance is not indicative of future returns.

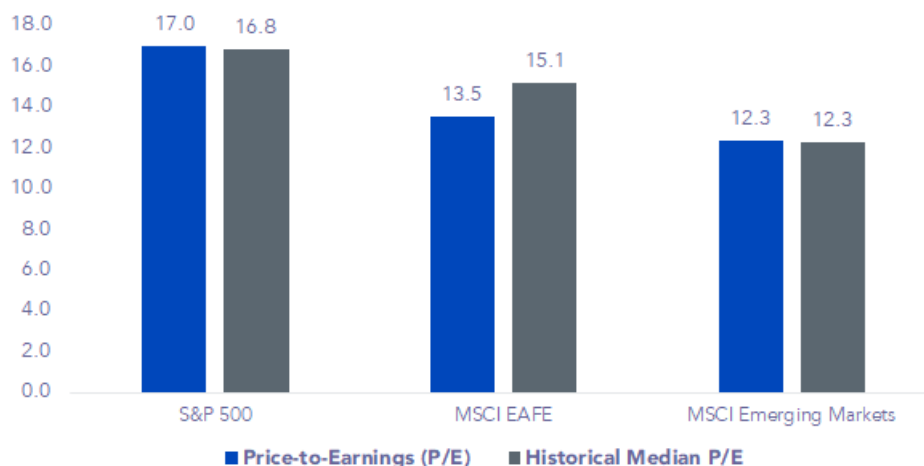
For definitions of terms in the chart, please visit our [glossary](#).

It's important to note that U.S. valuations have come down significantly over the past two weeks, improving long-term forward earnings expectations. However, as analysts update earnings forecasts to reflect the negative impacts of the coronavirus, forward earnings multiples will likely be pushed up.

#### Tilting to [Quality](#)

Despite valuation's correlation to long-term returns, many investors have shorter time horizons, where scouring for the least expensive market valuations may be of little use. Given the backdrop of tepid growth outside the U.S.—or negative growth in major markets like China and Japan that have been more exposed to the coronavirus—broad index valuations are more attractive than in the U.S. These valuations support a case for over-weighting foreign equities, particularly developed international markets.

#### Index Valuations



Sources: WisdomTree, FactSet, 4/28/1995–2/28/2020. Price-to-earnings measured by forward price-to-earnings excluding negative earners. You cannot invest directly in an index. Past performance is not indicative of future returns.

But we believe more richly valued quality companies within these markets—those with higher earnings and less leverage—are likelier to outperform segments of the markets with the most depressed valuations, like European and Japanese banks, if a slower growth environment persists.

High-quality, sustainable [dividend](#)-payers make up a segment of the market that may fare well in a persistent low-[growth](#), low-[interest-rate](#) environment outside the U.S. Given recent action and signaling by major global central banks, [monetary policy](#) looks likely to stay accommodative, making such companies relatively attractive.

WisdomTree’s family of international quality dividend growth ETFs targets dividend payers (approximately 300 securities) with high growth and profitability characteristics. Companies are then weighted by their cash dividends paid.

The table below illustrates the valuations of the [WisdomTree Global ex-U.S. Quality Dividend Growth Fund \(DNL\)](#), the [WisdomTree International Quality Dividend Growth Fund \(IQDG\)](#) and the [WisdomTree International Hedged Quality Dividend Growth Fund \(IHDG\)](#) relative to the 10 largest mutual funds by assets in the Morningstar Foreign Large Growth Category.

(For a brief primer on the differences between ETFs and mutual funds, please click [here](#).)

- IQDG and IHDG seek to track indexes with the same stock selection and weighting methodology for developed international equities. IHDG hedges the fluctuation of foreign currency returns.
- DNL utilizes a similar screening and weighting process for international developed and emerging markets companies.

Why do we compare these ETFs to active mutual funds?

These funds are defined as what WisdomTree terms Modern Alpha<sup>®</sup> ETFs: a rules-based approach to investing that seeks to combine the outperformance potential of active with the benefits of passive, such as daily transparency of holdings and usually lower expense ratios.

Unlike ETFs that track market-cap weighted indexes, these ETFs were created to have similar outperformance objectives as actively managed mutual funds.

As a result of their rules, these Funds have lower earnings-multiples and higher dividend yields, while also boasting significantly higher profitability (ROE and ROA) than the largest mutual funds.

#### Fundamentals vs. Top 10 Mutual Funds by Assets in Foreign Large Growth

| Name                           | P/E          | Forward P/E  | Dividend Yield | Return-on-Equity | Return-on-Assets |
|--------------------------------|--------------|--------------|----------------|------------------|------------------|
| IHDG                           | 18.30        | 18.30        | 2.70%          | 24.10%           | 9.78%            |
| IQDG                           | 18.38        | 18.34        | 2.75%          | 23.98%           | 9.75%            |
| DNL                            | 16.20        | 15.68        | 3.51%          | 23.55%           | 9.53%            |
| <i>Top Ten Funds - Average</i> | <i>22.68</i> | <i>20.26</i> | <i>1.68%</i>   | <i>12.99%</i>    | <i>2.30%</i>     |

Sources: WisdomTree, FactSet, Morningstar, as of 12/31/19.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

Performance data for the most recent month-end is available at [wisdomtree.com](http://wisdomtree.com).

For standardized performance of the Funds in the chart, please click their respective tickers: [DNL](#), [IQDG](#) and [IHDG](#).

In the table below, we compare the same funds based on pre-tax operating income growth. In addition to the WisdomTree Funds' higher profitability, this table shows their constituents also had faster compound annual growth rates (CAGR) in pre-tax operating profit.

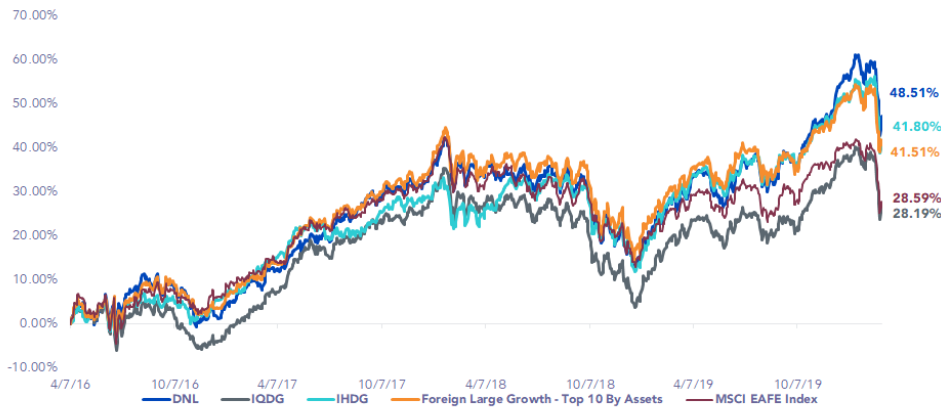
|             | Median Pre-Tax Operating Income Growth |       |       |               |
|-------------|--|-------|-------|---------------|
|             | IHDG                                   | IQDG  | DNL   | Top Ten Funds |
| 1-YEAR CAGR | 9.2%                                   | 9.1%  | 10.5% | 5.7%          |
| 3-YEAR CAGR | 14.0%                                  | 13.8% | 14.7% | 9.0%          |
| 5-YEAR CAGR | 14.7%                                  | 14.4% | 15.6% | 8.0%          |

Sources: WisdomTree, FactSet, as of 12/31/19. Median operating income growth calculated based on current constituents of respective funds and current top 10 largest mutual funds in the Morningstar Foreign Large Growth Category. Past performance is not indicative of future results. Weights subject to change.

For definitions of terms in the chart, please visit our [glossary](#).

For a little more than three years<sup>1</sup>, DNL has been one of the best-performing funds in its category, outpacing the average returns of the ten largest mutual funds by assets by 700 [basis points \(bps\)](#) cumulatively. IHDG, which benefitted from a strengthening dollar environment, also bested this group by 29 bps<sup>2</sup>.

**Performance vs. Average of Top 10 Mutual Funds in Morningstar Foreign Large Growth**



Sources: WisdomTree, Morningstar, Bloomberg, 4/7/16–3/5/20. Cumulative returns based on NAV total returns.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at [wisdomtree.com](http://wisdomtree.com).

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

We believe U.S. large-cap growth valuations have become increasingly stretched after a recent spell of outperformance. This backdrop has led many investors—wisdomTree included—to call for a [mean-reversion](#) period of outperformance for U.S. [large-cap](#) value. Valuations of foreign equities are more modest, but growth has similarly outperformed value for an extended period.

WisdomTree's quality dividend growth methodology strikes a unique balance between screening for companies with premium profitability and growth, while also having a valuation discipline with dividend weighting.

While this methodology may cause these strategies to lag in a global reflationary environment, it also may strike a balance for investors—mitigating exposure to distressed European and Japanese banks that dominate most value funds, while also having discounted valuations relative to the largest foreign large growth funds.

<sup>1</sup>Time period chosen per standard look-back periods.

<sup>2</sup>All data points are at NAV

**Important Risks Related to this Article**

There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. To the extent the Funds invest a significant portion of their assets in the securities of companies of a single country or region, they are likely to be impacted by the events or conditions affecting that country or region. Dividends are not guaranteed and a company currently paying dividends may cease paying dividends at any time. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile and may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As these Funds can have a high concentration in some issuers, the Funds can be adversely impacted by changes affecting those issuers. The Funds invest in the securities included in, or representative of, their Indexes regardless of their investment merit and the Funds do not attempt to outperform their Indexes or take defensive positions in declining markets. Heightened sector exposure

increases the Funds' vulnerability to any single economic, regulatory or other development impacting that sector. This may result in greater share price volatility. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read each Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

**IMPORTANT INFORMATION**

**U.S. investors only:** Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

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## 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.

**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.

**R-squared**: Represents the percentage of a fund or security's movements that can be explained by the independent variable.

**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.

**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 time.

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

**Growth**: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**Interest rates**: The rate at which interest is paid by a borrower for the use of money.

**Monetary policy**: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

**Basis point**: 1/100th of 1 percent.

**Large-Capitalization (Large-Cap)**: A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.