QUALITY AND PRICING POWER: AN UNSUSPECTING INFLATION HEDGE?

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We often define quality companies by measuring profitability and the efficiency of their capital usage to generate robust operating results. Assessing return on equity (ROE), return on assets (ROA) and leverage therefore becomes paramount.

But investors also gravitate to quality for its defensive characteristics during economic downturns and periods of market volatility.

Back in December, my colleague Pierre Debru authored a blog post that expanded on the defensive prowess of quality companies through another lens: their ability to maintain high pricing power in inflationary environments.

He explained that a company's ability to pass the higher input costs of labor, supplies and energy onto its "captive" customers (via higher sales prices) helps relieve the pressure of narrowing margins during inflationary periods, thereby defending their bottom line.

While the global economy continues to battle with record inflation, I thought it would be worthwhile to examine this concept in detail with WisdomTree's own quality suite.

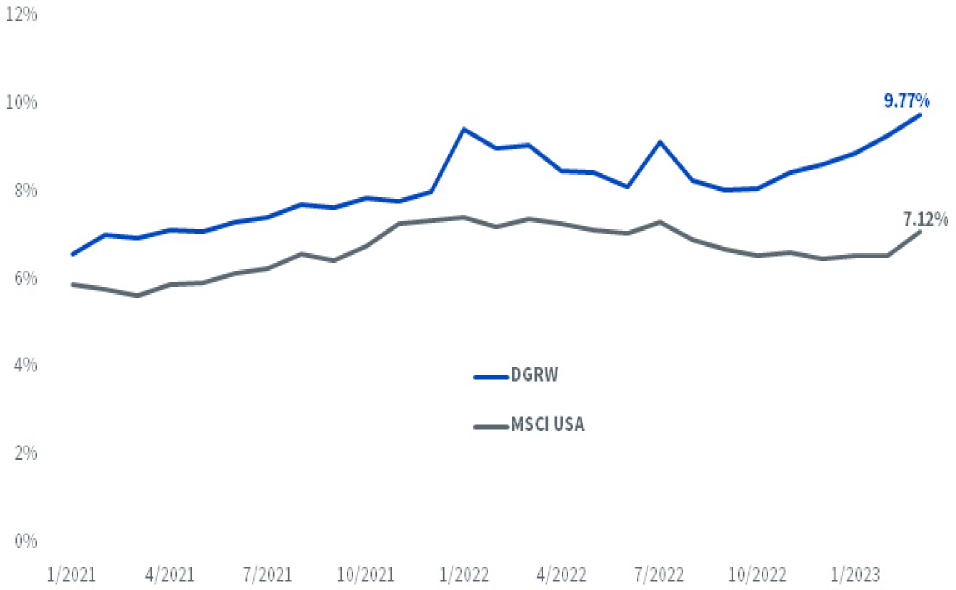
Improving Margins: A Marriage of Quality Stocks and Fundamental Weighting

WisdomTree's quality suite covers the U.S. large-cap, small-cap, developed international and emerging markets universes by allocating to equities with the highest quality scores, which are a mixture of static and trend-based profitability measures such as ROE and ROA. Each basket is dividend-weighted, resulting in Funds with high-quality profiles whose companies have the potential to grow their dividend payments in the future as well.

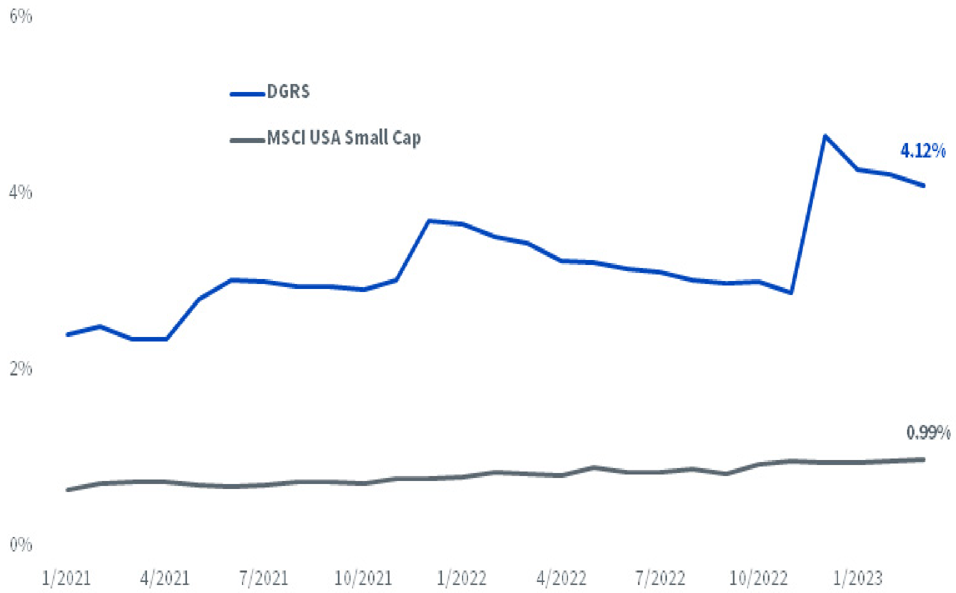
They have also exhibited strong profit margins throughout the high inflation environment of the last two years compared to broader indexes, suggesting that quality stocks indeed have a competitive advantage with higher pricing power and captive customer bases.

The below charts illustrate the profit margins of the top two deciles, ranked by WisdomTree's quality scoring methodology, of common holdings between one of WisdomTree's quality dividend growth Funds and a market cap-weighted index representing the same equity region. Because these deciles represent holdings common to both the Fund and representative index, the improvement in net income margin is attributable to dividend weighting the high-quality stock basket versus traditional market cap weighting.

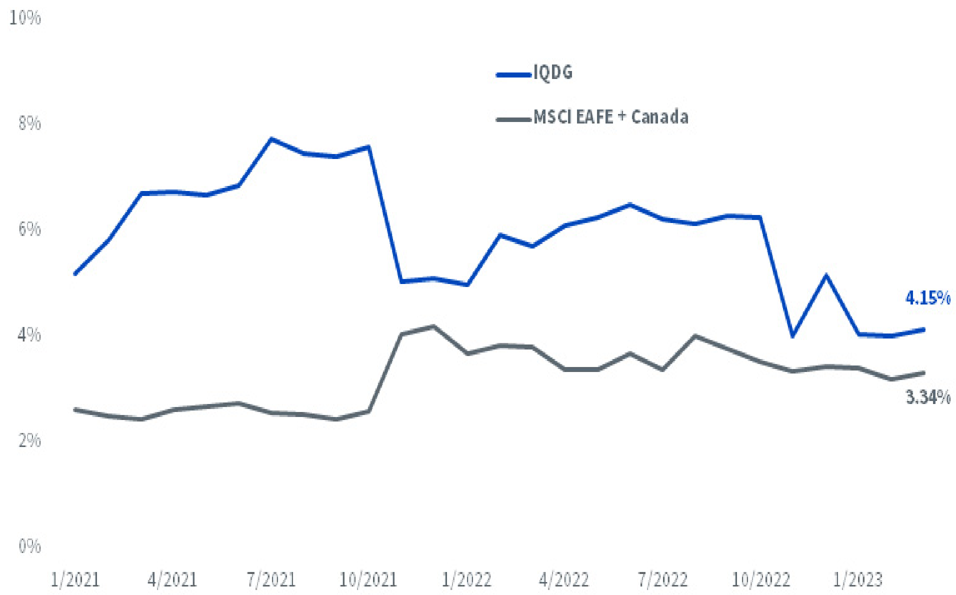
WisdomTree U.S. Quality Dividend Growth Fund (DGRW) vs. MSCI USA



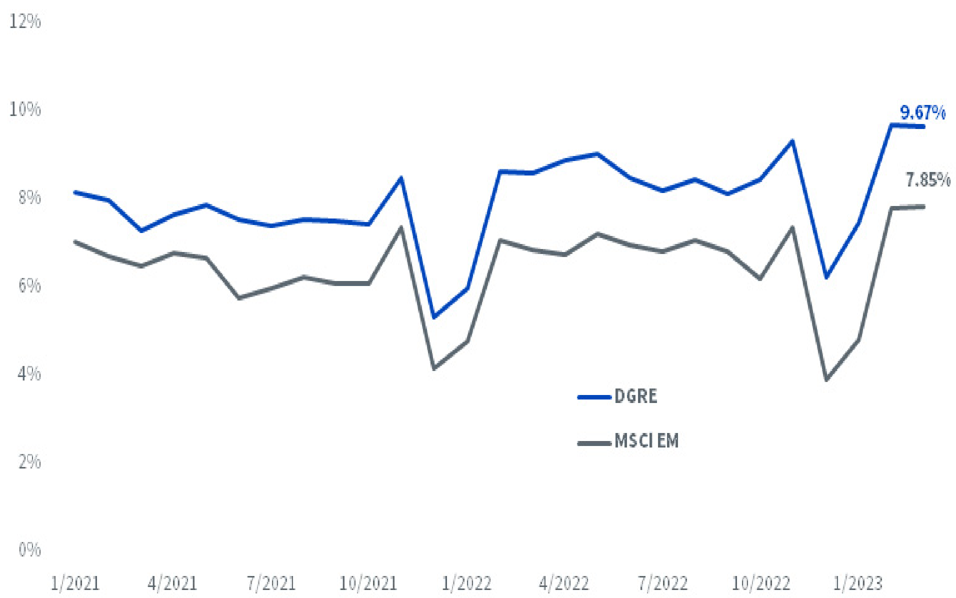
[WisdomTree U.S. SmallCap Quality Dividend Growth Fund (DGRS)]() vs. [MSCI USA Small Cap]()



[WisdomTree International Quality Dividend Growth Fund (IQDG)]() vs. [MSCI EAFE + Canada]()



WisdomTree Emerging Markets Quality Dividend Growth Fund (DGRE) vs. MSCI Emerging Markets



Sources: WisdomTree, FactSet, MSCI, as of 3/31/23. Reflects profit margins of top 2 deciles by WT Quality score among common holdings. Period covered is 12/31/2020 through 3/31/2023 to represent the global, high-inflation environment of the last few years. Subject to change. You cannot invest directly in an index. Past performance is not indicative of future results.

We can draw two important inferences from the improvement in profit margins.

First, we see that the quality factor can potentially provide a hedge against high inflation (perhaps compounding the efficacy of equities against inflation), which we detailed recently, since high-quality companies with captive customers can defend their profit margins better than others with more sensitive, price-elastic customer bases.

Procter & Gamble's most recent earnings report[1] from Friday, April 21, provides a compelling example of this effect. During the quarter, organic sales grew 7% due to a 10% increase from pricing that was only slightly offset by volume (which declined 3%). In the U.S., organic sales grew 6%, which included volume *growth* rather than a decline, suggesting that consumers were relatively insensitive to price increases and did not meaningfully alter their purchasing behavior.

Notably, Procter & Gamble reported a 16.92% profit margin, only about 1% lower than their average margin over the past eight reported quarters, which dates back to the initial inflationary impulses in the U.S. post-pandemic environment in early 2021. Margins since then have remained consistently rangebound between 15.6% and 21.9%.

DGRW has benefited from their success as well. Procter & Gamble (PG) is currently a top five holding within the Fund at about 3.06% (as of April 21). It has also averaged a 3.5% weight over the past three years while growing its dividend from $0.79 to $0.87 and then to $0.91 per share over the previous eight quarters. More broadly, the top two deciles of companies by quality score within DGRW amount to more than 36% of the Fund as of March 31[2].

Second, the improvement in profit margin is attributable to dividend weighting when the holdings are identical, as the methodology rewards companies that already have operations healthy enough to grow their dividends in the first place.

If structurally higher inflation persists over the near term, or we encounter a recessionary economic landscape, these innate, defensive characteristics of high-quality companies may buffer investors' portfolios, as they did in 2022 and throughout much of the post-pandemic environment.

Quality Dividend Growth Performance

Fund/Index	Calendar Year 2021	Calendar Year 2022	12/31/20-3/31/23 (Annualized)
DGRW (NAV)	24.43%	-6.37%	8.82%
MSCI USA	26.45%	-19.89%	3.93%
Relative Performance	-2.02%	13.52%	4.89%
DGRS (NAV)	23.24%	-13.06%	4.96%
MSCI USA Small Cap	19.11%	-17.60%	0.85%
Relative Performance	4.13%	4.54%	4.11%
IQDG (NAV)	12.37%	-20.19%	-0.22%
MSCI EAFE + Canada (USD)	12.62%	-14.33%	1.88%
Relative Performance	-0.25%	-5.86%	-2.10%
DGRE (NAV)	2.37%	-21.20%	-6.81%
MSCI EM (USD)	-2.54%	-20.14%	-8.97%
Relative Performance	4.91%	-1.06%	2.16%

Sources: WisdomTree, Bloomberg, as of 3/31/23. Past performance is not indicative of future results. The performance data quoted represents past performance and is no guarantee of future results. Investment returns and the 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. Current performance may be lower or higher than the performance data quoted. Holdings are subject to change.

For the most recent month-end performance, click the respective ticker: DGRW, DGRS, IQDG, DGRE.

[1] Source: Procter & Gamble Q3 2023 Earnings Call transcript from April 21, 2023, obtained via Bloomberg on April 24, 2023.

[2] For most recent fund holdings and their percentages please click here.

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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.

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.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Inflation : Characterized by rising price levels.

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.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

Dividend weighted : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

MSCI USA Index : is designed to measure the performance of large and mid cap segments of the US market.

MSCI USA Small Caps Index : a small-cap US equity index aiming to capture the performance of the securities within this size segment. .

MSCI Canada Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of the Canadian equity market.

MSCI Emerging Markets Index : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as "emerging markets" by MSCI.