EUROPEAN EQUITIES HEATING UP: A QUALITY GROWTH APPROACH

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Over the past eight years of the U.S. bull market in equities, it has not paid to diversify outside of the more richly valued U.S. markets. But recently, the international markets have been outperforming, and sentiment has been improving. The European economies are a number of years behind the U.S. in their economic recovery, and the markets have the potential to catch up with the U.S.

One-Two Punch: Valuation & Growth

As of May 25, from a valuation perspective, a forward price-to-earnings (P/E) ratio of 16 and a current dividend yield of 3.3% for the MSCI Europe Index start to support a compelling investment story when compared to the S&P 500 Index P/E at 19 and a yield of 2.0%. This valuation is further enhanced by looking at the relative opportunities compared to traditional fixed income instruments. In the U.S., the 10-Year Treasury yield of around 2.25% is now slightly ahead of the dividend yields of U.S. equities. In Europe, the average premium of equities over bonds is roughly twice as high as the U.S. equity premium. For example, Germany's earnings yield (inverse of P/E ratio) is 5.1% while the 10-year bund yield is .36%, resulting in an equity premium of 4.7%. A similar story exists for France, with an equity premium of 4.3%. The U.S. has an equity premium of 2.4%, about 230 basis points (bps) below that of Germany and 190 bps below France. What this means is that equity investors in Europe are paid a relatively higher premium than equity investors in the U.S.[1]

While we are excited about the prospects for European equities, we must be cognizant that not all of Europe's economic and political issues are behind us. One investment strategy that balances the valuation opportunity of Europe but screens for quality and growth characteristics may help increase the odds of successful outcomes.

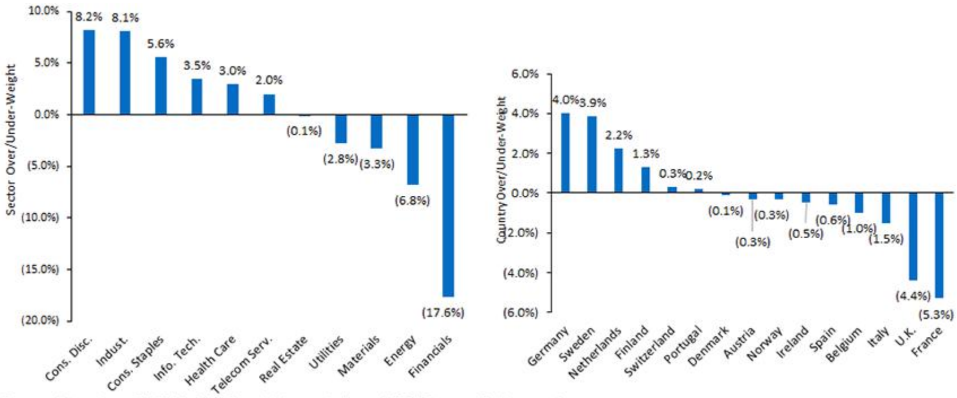
The Quality Tilt: Under-weight Leverage

Much has been said about the remarkable recovery of the financial sector since the 2007–2008 financial crisis. The U.S. financial sector, that is. A recent special report in *The Economist* focused on the relative weakness of European banks and the challenges that continue to lay ahead for the industry, not least of which is the European Central Bank's (ECB) easy money policies from which the rest of the European economy stands to benefit.[2]

With that in mind, investors should consider that the MSCI Europe Index currently has a 21% weight to the Financials sector. Compare that to the WisdomTree Europe Quality Dividend Growth Fund (EUDG), which is under-weight in Financials by 17.6%.[3] The Energy, Materials and Utilities sectors are also significant under-weights.

On the other hand, Consumer Discretionary, Industrials and Consumer Staples are the more significant over-weights.

Understanding EUDG's Exposures relative to the MSCI Europe Index



Source: Bloomberg, 5/10/17. EUDG weightings relative to MSCI Europe. Subject to change.

Quality and Growth Screens

The index that EUDG tracks selects companies for inclusion based on a 50-50 split that weights quality, represented by return on equity (ROE) and return on assets (ROA), and growth, based on expected earnings growth forecasts. This quality factor was constructed to incorporate profitable companies, as measured by ROE, that are not overly levered as measured by ROA. Financial institutions have a high degree of leverage, and are therefore given a limited weighting in EUDG. The similarly levered Energy sector, another industry with a high degree of uncertainty due to the direction of crude oil prices, is under-weight 6.8%.

The top sectors in which EUDG is currently over-weight—Consumer Discretionary and Industrials—are more cyclical sectors that could benefit from improved European and global economic growth.

Avoiding the "Sick Man of Europe"

EUDG has benefited year-to-date from being under-weight in France, the United Kingdom and Italy, three countries that still have big question marks lingering over long-term economic growth prospects.

Europe has long been a market of haves and have-nots. Northern Europe versus Southern Europe. Continental Europe versus the U.K. Avoiding the losers of the European economic recovery may be just as important as picking the winners.

But What about Growth?

Investors comparing the U.S. bull market to the current European experience may be thinking, "What has performed better than growth?" This is an important consideration, one that EUDG addresses with its tilt toward the growth factor bundled within a quality tilt. Rather than investing in growth stocks that are not tilted toward some measure of value, such as consistent dividend payments, EUDG tilts toward companies with high earnings growth forecasts, with expectations of also returning the highest dividend growth.

	WT Europe Quality Dividend Growth Index	MSCI Europe Index	FTSE Developed Europe All Cap Index
Forward P/E	19x	16x	18x
Dividend Yield	2.6%	3.3%	2.8%
ROE Est.	22.0%	8.8%	8.8%

Source: Bloomberg, as of 5/25/17. Past performance is not indicative of future results. 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.

When we look at the valuations underlying EUDG's index, we see P/E ratios that sell at a small premium –approximately 1 to 3 P/E multiple points higher compared to the MSCI Europe Index or the FTSE Developed Europe All Cap Index, and the dividend yields tend to be about 20 to 70 bps lower. But the key differentiator is quality characteristics. Bloomberg ROE estimates show 22.0% for the WisdomTree Europe Quality Dividend Growth Index versus 8.8% for both the MSCI and FTSE European indexes. ROE is a key variable that leads to better investment returns over long periods of time, and it's a variable Warren Buffett often describes as one of his main focal points for acquiring companies. With ROE advantages likely occurring in the quality dividend growth index, and with P/E multiples being very similar, we'd say quality offers an attractive relative opportunity set over the longer-run.

[1]Source: Bloomberg, 5/25/17.

[2]Source: "American Banks Have Recovered Well; Many European Ones Much Less So," The Economist, 5/6/17.

[3]Source: Bloomberg, 5/10/17.

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You cannot invest directly in an index.

DEFINITIONS

Bullish : a position that benefits when asset prices rise.

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.

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.

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

MSCI Europe Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of developed equity markets in Europe.

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.

10-year government bond yield : Yields on the 10 year government debt security.

Equity premium : the excess return that investors may receive over the risk free rate as compensation for taking on the relatively higher risk associated with equit.

Earnings yield : The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

German 10-year bund : a debt instrument issued by the German government with an original maturity of 10 years.

Basis point : 1/100th of 1 percent.

Easy money policies : Policies that have the goal of stimulating economic activity.

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.

Quality Factor : Excess returns achieved by companies exhibiting higher quality or profitability vs the market. Typically measured using operating profitability, return on equity and/or return on assets. .

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

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

FTSE Developed Europe All Cap Index : a market- capitalization index representing the performance of companies in developed European markets, including UK.

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.