

EUROPE & VOLATILITY: WHY WE FOCUS ON QUALITY

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03/22/2016

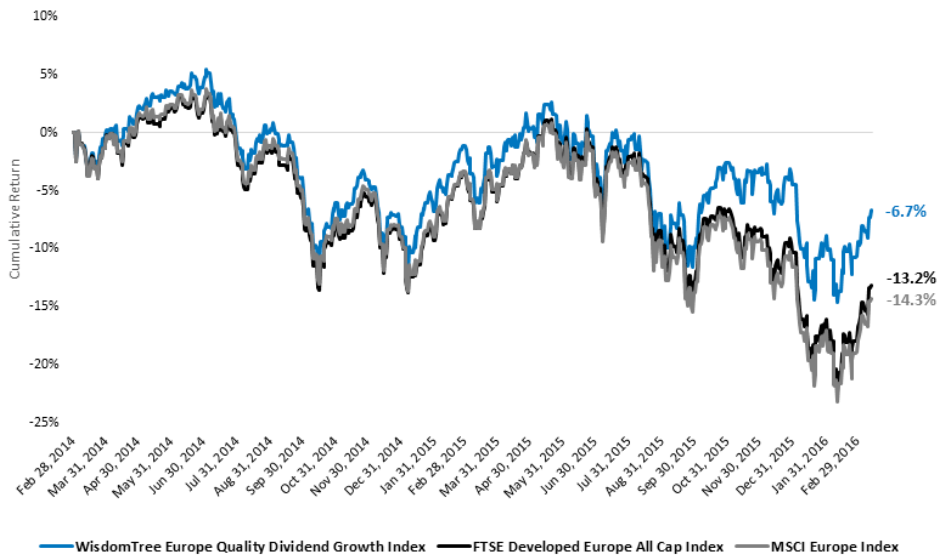
Thus far in 2016, we have seen much higher levels of [volatility](#) than the “norm” over the past few years. European equities have been no exception. As **Volatility Rises, Quality Becomes More Important** when sentiment is more positive, the array of strategies that have the potential to perform well tends to be wide-ranging. However, it is when conditions change that we think investors begin to seek signs of strength:

- 1. Stronger Earnings Growth Expectations:** Even if expectations of earnings growth tend to be adjusted downward across European equities, there will still be some firms that hold up better than others, and we believe focusing on this metric annually is important.
- 2. Stronger Profitability Metrics:** We believe that in tougher environments, firms with stronger [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#) could be better positioned to weather the changing economic conditions.
- 3. Lower Leverage:** Debt typically comes with the obligation of a regular payment of interest, so firms with less debt tend not to have this occurring regularly.

Bottom line: While European equities in general have been challenged of late, focusing on these metrics has in fact led to rather differentiated performance. **The Impact of the Quality Factor**

The fundamentally weighted [WisdomTree Europe Quality Dividend Growth Index](#) includes screens for ROE and ROA that resulted in a significant under-weight to Financials, a sector that has exhibited some volatility in both the upward and downward directions as policy at the European Central Bank (ECB) has evolved. The [MSCI Europe Index](#) is weighted by [market capitalization](#) and includes no such focus on the three quality metrics defined above. Below, we compared the performance of the WisdomTree Europe Quality Dividend Growth Index to both the MSCI Europe Index and the [FTSE Developed Europe All Cap Index](#) in order to look at more than one market capitalization-weighted measure of European equity performance. Since early 2014, the overall trend in performance has been mostly downward, with a few upward moves here and there. What struck us was that the WisdomTree Index opened up a relatively significant gap in performance during the most recent bout of downward volatility. As shown in the chart below, over this admittedly short period outperformance was in the neighborhood of 6.5% to 7.5% cumulatively over the two market capitalization-weighted indexes.

WisdomTree’s Quality Dividend Growth Has Delivered Divergent Performance since Inception



Source: Bloomberg, for period 3/3/2014 to 3/14/2016. Past performance is not indicative of future results. You cannot invest directly in an index.

The takeaway? In this current market we see a benefit to thinking about higher-quality exposures to European equities. If people believe that volatility could continue, focusing on higher long-term earnings growth potential, return on equity and return on assets could be of interest—especially since looking about these metrics tends to lead toward lower leverage.

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DEFINITIONS

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

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.

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.

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

Market Capitalization: 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.

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