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# HOW A QUALITY APPROACH TO EUROPE PAID OFF OVER THE LONG TERM

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European markets are garnering attention again in 2017. Most of the flows have targeted broad [beta benchmarks](#) in simple execution of a regional allocation. For longer-term and strategic allocators who will hold positions in Europe for many years, WisdomTree believes focusing on a [factor approach](#) for European markets can add significant [value](#) and address some of the concerns investors might still have regarding the current set of stocks with high exposures in traditional [market cap-weighted](#) indexes.

## Long-Term Returns to a [Quality](#) Approach

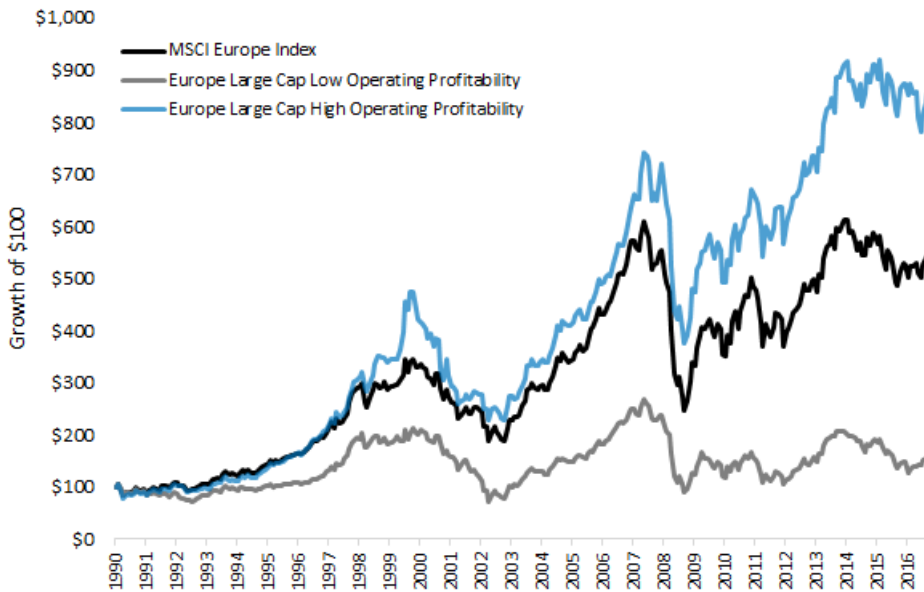
A growing line of academic research has focused on the “[quality factor](#).” The [Fama and French](#) three-factor model, which started off looking at just beta, size and value as three principal drivers of returns, added quality as a key additional factor that can influence returns. But what do we and Fama and French mean by “quality”? If we look to their formal definition, profitability is described as “annual revenues minus cost of goods sold, interest expense and selling, general and administrative expenses, all divided by book. We call this variable operating profitability, *OP*, but it is operating profitability minus interest expense.”<sup>1</sup>

The simpler variable and term people will be familiar with: [return on equity \(ROE\)](#) or profits over equity.

That is the same variable Warren Buffett often focuses on when he describes companies he is most interested in acquiring that deliver high ROE with little debt.

When we look at the returns to the European markets over the last 30 years, in the large-cap space, the difference between large-cap high-quality stocks and large-cap low-quality stocks is substantial: on the order of almost 7 percentage points *per year*. This leads to a dramatic long-term chart for European high-quality firms compared to European low-quality firms.

## Long-Term Returns to European Quality (ROE)



Source: Fama and French, 6/30/1990–3/31/2017. Past performance is not indicative of future results. You cannot invest directly in an 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.

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

### 5x5 Matrix of Size and Operating Profitability

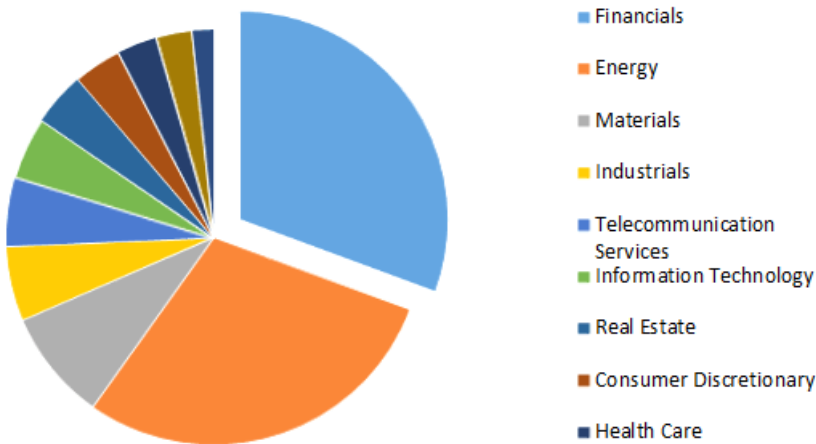
Fama and French have a 25-portfolio matrix where they show the returns for operating profitability across size segments. One of the most noticeable observations is how the returns to the lowest operating profitability segment are a sharp drop-off from even just the low operating profitability segment above it. That means some of the greatest advantages are found by just avoiding the junkiest profitable companies.

		Operating Profits				
		Lowest	Low	Mid	High	Highest
Size Segment	Smallest	2.46%	9.18%	10.17%	12.31%	10.46%
	Small	3.25%	7.66%	9.63%	10.11%	12.28%
	Mid	3.46%	7.46%	9.61%	8.38%	10.50%
	Large	2.40%	7.53%	9.57%	9.13%	9.18%
	Largest	1.74%	7.35%	7.76%	6.26%	8.57%

Sources: WisdomTree, Fama and French, 6/30/1990–3/31/2017.

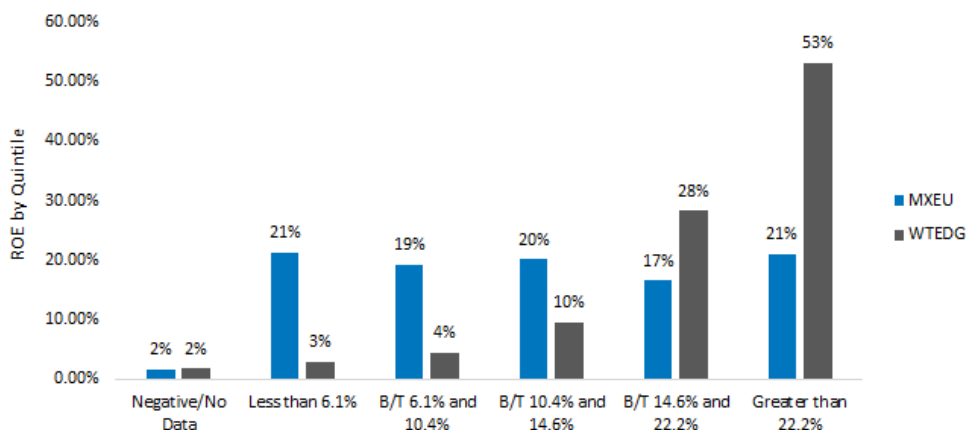
Where are these bottom-quintile ROE companies today? Predominantly among financials, energy companies, materials and industrials.

**Bottom-Quintile ROE Sector Market Cap Breakdown**



Sources: WisdomTree, FactSet, as of 3/31/17. Shows the percentage breakdown by market capitalization of the lowest-quintile return on equity for the MSCI Europe Index. Past performance is not indicative of future results. You cannot invest directly in an 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.

WisdomTree created its [Europe Quality Dividend Growth Index](#) in 2014, and it was designed to avoid the exposures in the bottom quintile of profitability shown above. When we look at different profitability buckets today for the [MSCI Europe Index](#) contrasted with WisdomTree’s approach, you can see how WisdomTree shifts the weight in exposures toward the top half of the market on a profitability metric like ROE.



Sources: WisdomTree, FactSet, as of 3/31/17. 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.

The returns of the [WisdomTree Europe Quality Dividend Growth Index and the ETF that tracks it after fees and expenses, EUDG](#), have been competitive since the launch of the Index three years ago—compounding [average annual returns](#) for both at more than 200 [basis points \(bps\)](#) per year ahead of the traditional market cap index. The research by WisdomTree and academics such as Fama and French shows that operating profitability can be an important factor in driving long-term returns. As investors position for a rebound in the long-term performance of European markets, we’d advocate for considering a quality-driven approach.

	Total Return (%)	Avg. Annual Returns (%)
WisdomTree Europe Quality Dividend Growth Fund	6.13%	2.00%
WisdomTree Europe Quality Dividend Growth Index	7.80%	2.54%
MSCI Europe Index	-0.21%	-0.07%

Sources: WisdomTree, Bloomberg, 5/30/14–5/30/17

**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 [www.wisdomtree.com](http://www.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.

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.

[Please click here for standardized performance of EUDG](#)

<sup>1</sup>See, for instance, the Fama and French paper “A Five-Factor Asset Pricing Model.”

**Important Risks Related to this Article**

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. This Fund focuses its investments in Europe, thereby increasing the impact of events and developments associated with the region, which can adversely affect performance. 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. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit, and the Fund does not attempt to outperform its Index or take defensive positions in declining markets. Please read the 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](#)

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## DEFINITIONS

**Beta benchmark**: Characterized by measuring the performance of a particular universe of equities without attempting to utilize selection and weighting to generate differences in performance relative to this universe.

**Factor-based**: Strategies that focus on groups of firms thought to share common attributes, be it in terms of their fundamentals or their share price behavior.

**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 time.

**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.

**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.

**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.

**Fama-French**: Refers to a factor-based model to describe stock returns developed by Eugene Fama and Kenneth French. Their original three-factor model breaks down the components of stock returns to market risk, company size and book to market ratio, or value.

**Return on Equity (ROE)**: Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

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

**Average Annual Returns**: Mean of annual yearly returns for the historical period

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