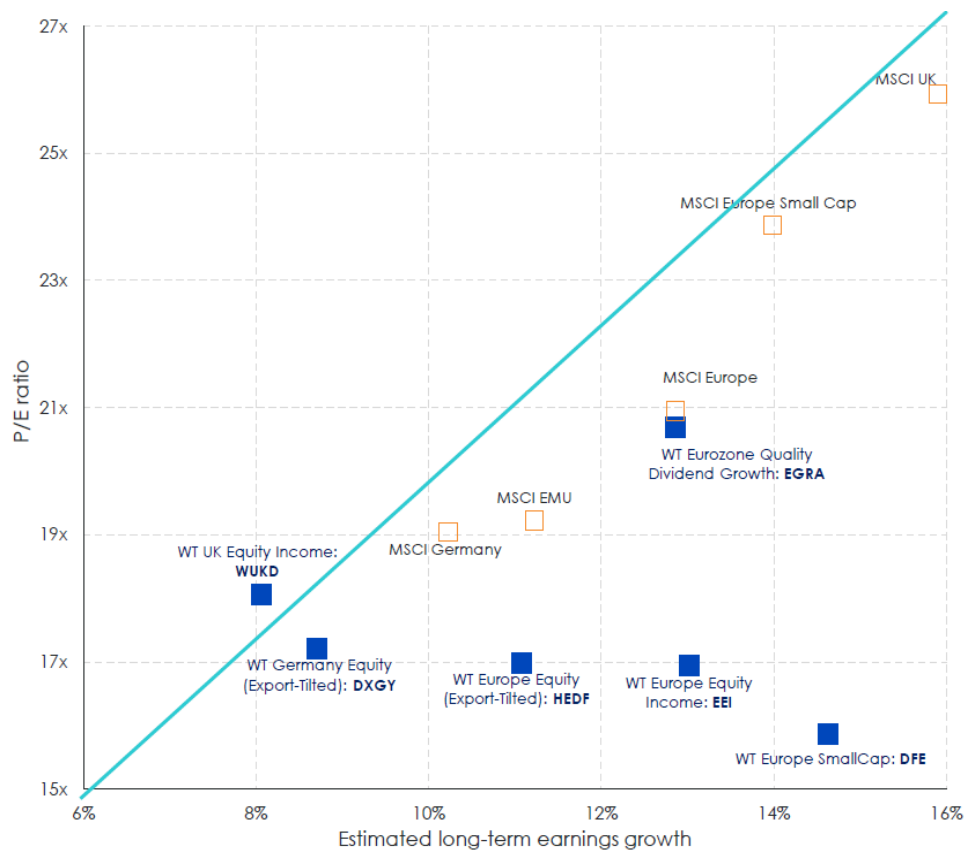

2017 EUROPEAN REBALANCE: BULLISH BETS IN SMALL CAP DIVIDEND PAYERS AND QUALITY DIVIDEND GROWERS

27 Jul 2017

WisdomTree's European equity ETF strategies¹ rebalanced in June. Emerging from the rebalance are stronger fundamentals against discounted valuations, which preserve the attractive yield and growth proposition of broad and small-cap dividends payers in Europe. Together, these diverse styles and strategies may allow investors to fine-tune their European exposure just as France's pro-growth, pro-EU reform agenda reawakens investor appetite for the region.

Part 1 of our rebalance series explores the valuation, style and country/sector opportunities on offer for our Eurozone Quality Dividend Growth (EGRA) and Europe SmallCap Dividend (DFE) strategies.

Figure 1: Dividend payers offer stronger fundamentals and cheaper valuations vs. market-cap
P/E vs. estimated long-term earnings growth WisdomTree vs. benchmarks



Source: WisdomTree, Bloomberg. Data as at 30 June 2017

Annual Europe rebalance extracts deep value opportunities in small cap dividend payers and superior fundamentals from quality and growth stocks

Eurozone Quality Dividend Growth (EGRA) and Europe SmallCap Dividend (DFE) best encapsulate growth as an equity style. The former targets Eurozone dividend growers with a current bias towards new economy and IT sectors such as Amadeus, ASML Holdings and Essilor, whilst the latter captures the dividend-payers of pan-European small-caps with stocks as diverse as Tieto OYJ (Finnish IT), GAM holdings (Swiss Financial) and ENAV (Italian Industrials) as part of the basket.

Underpinning the investment case for these strategies are attractive valuations which compare favourably to market-cap peers. Driving their discount is the annual rebalance, a process which rotates out of expensive stocks and into stocks with share prices that better reflect their fundamentals. This helps to mitigate valuation risk and captures value opportunities within the European equity market. The annual rebalance is an integral part to WisdomTree’s screening, selection and weighting methodology to preserve the value-tilt of income strategies longer term.

Take WisdomTree’s Europe Small-Cap Dividend ETF (ticker: DFE) for example. It’s P/E ratio of 16x represents a substantial discount against MSCI Europe Small Cap’s 24x earnings multiple, as shown in Figure 1. The same can be observed for WisdomTree’s Equity Income strategies for Europe (EEI) and UK (WUKD) and for WisdomTree’s export-tilted strategies for Europe (HEDF) and Germany (DXGY).

That being said, assessing valuation multiples in isolation is insufficient. Equally important are the fundamentals driving the discount, and this is where DFE continues to

outshine its peer. With higher long-term earnings growth of 14.6% and higher profitability of 11.5% compared to MSCI Europe Small Cap (14% and 8.5% respectively), DFE's value basket is accompanied by stronger, not weaker, fundamentals post-rebalance. The long-term earnings growth expectations between WisdomTree's European equity income and export-tilted strategies vs market-cap peers are roughly on par, suggesting the discounted P/E ratios of WisdomTree to continue to be fundamentally attractive.

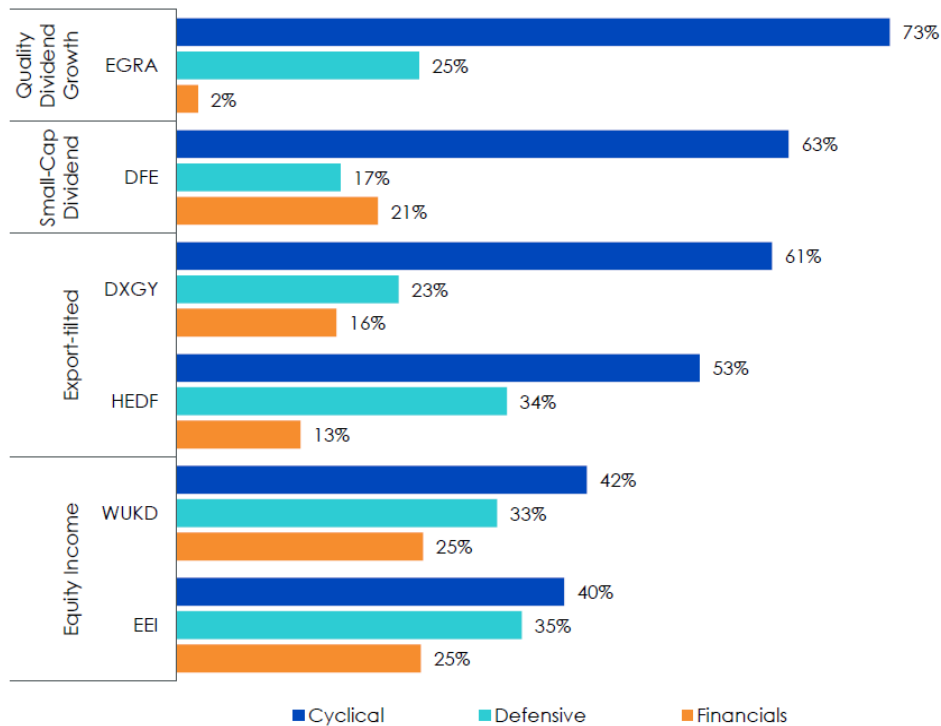
WisdomTree Eurozone Quality Dividend Growth ETF (EGRA) has also rebalanced towards stronger fundamentals. The evidence for this is the substantially higher long-term EPS growth expectations against MSCI EMU (see Figure 1) and unmatched profitability (ROE of 21%) across all strategies. Combined with EGRA's low pay-out ratio (42%), the strategy offers an implied long-term dividend growth of 12%²; easily surpassing other strategies and almost tripling that of its market-cap peer. Against these superior fundamentals stand the premium valuations accompanying this distinct strategy that screens for quality and growth stocks. Amidst an increasingly expensive-looking broader equity market that in recent years has struggled to meet, let alone beat, investors' expectations, a focus on quality and growth stocks may give investors better downside protection.

Overweight cyclicals to play the Eurozone's economic momentum and QE taper talk

A pro-growth French reform agenda comprising of labour market deregulation, tax reform and infrastructure spending could trigger EU-wide spill-over effects and reinvigorate domestic demand-led growth elsewhere in Europe. This in turn may convince the ECB to signal QE tapering sooner rather than later, especially if Eurozone growth is sustained and the Five Star Movement fades ahead of Italy's elections.

This backdrop favours cyclical, growth-oriented equities, whereby a bias in IT, Consumer Discretionary and Industrials provide the exposure to lower financially leveraged sectors to shock absorb a potentially higher rates environment while at the same time provide the exposure to highly operationally geared sectors that disproportionately benefit from a pick-up in consumer and investment spending.

Figure 2: Cyclical, domestic-growth tilted sector exposures of EGRA and DFE suit the positioning around Eurozone economic momentum
Sector exposure



Source: WisdomTree, Bloomberg. Data as at 30 June 2017. Defensives = Utilities, Telecom, Consumer Staples and Health care. Cyclical = Consumer Discretionary, IT, Industrials, Mining, Energy and Financials.

As shown in Figure 2, EGRA offers high exposure (73%) to cyclical sectors. Geographic exposure is also exclusively Eurozone-focused which, given its 21% weighting to French companies, may offer investors exposure to stocks that can potentially and directly benefit from Macron’s domestic reform push, including lower corporate taxes and more infrastructure spending.

DFE’s basket offers a different tilt, with the lower IT exposure offset by higher exposure to financials (14% vs EGRA’s 2%) thanks to deep value opportunities within Insurance and Real Estate. It also lacks EGRA’s Eurozone only focus, incorporating high weights towards the UK (27%) and the Nordics (23%). As such, the basket provides a broader bet on pan-European growth expectations and is likely to benefit from the prospects of a soft version of the UK’s exit negotiation from the EU.

Conclusion

The rebalance of WisdomTree’s European Equity ETFs have fundamentally strengthened the investment case of the different styles and strategies available for income-orientated investors seeking exposure to Europe. Both the valuations and the fundamentals underpinning them have improved on the back of the rebalance and compare favourably to market-cap based alternatives.

An improving outlook for domestic demand-led growth set against a rising rates macro backdrop suggest the cyclically tilted Eurozone Quality Dividend Growth and Europe SmallCap Dividend ETFs to have the best potential to deliver strong returns to investors.

Source

1 WisdomTree's Eurozone Quality Dividend Growth, Europe SmallCap Dividend, Europe Equity Income and Export-Tilted strategies

2 Based on Gordon-Growth Model: $ROE \times (1 - \text{Pay-out Ratio})$

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- [WisdomTree Eurozone Quality Dividend Growth UCITS ETF \(EGRW\)](#)
- [WisdomTree Europe SmallCap Dividend UCITS ETF \(DFE\)](#)
- [WisdomTree Eurozone Quality Dividend Growth UCITS ETF - EUR Acc \(EGRA\)](#)
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