A SURPRISING QUALITY DISCOUNT IN THE U.S.

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Looking around the globe today, with interest rates in Europe and Japan at depressed, even negative yields, global investors are searching near and far to achieve positive cash flows from their assets. This global hunt for yield has implications across a variety of asset classes, creating a surprising valuation discrepancy in the U.S. dividend-focused market. The surprise is that quality stocks in the U.S. are trading at a discount valuation multiple compared to high-dividend stocks, while in the international markets—both developed and emerging markets—they are trading at a more significant premium valuation multiple that is warranted. To set up this analysis, we'll discuss WisdomTree's two distinct dividend strategies that are focused on opposite sides of the dividend market in every region: **"High Dividend":** In the spirit of the name, WisdomTree high-dividend Indexes sort their respective universes by the dividend yield and select the top 30% of dividend payers by their current dividend yield. The goal for these Indexes is to create more dividend-oriented cash flow today.[1] **"Quality Dividend Growth":** With a forward-looking set of stock selection factors, these Indexes try to identify companies that can grow dividends in the future. These Indexes use a combination of "quality" screens—historical three-year return on equity (ROE) and return on assets (ROA) combined with the expected earnings growth over the longer term. While still weighting indexes by their cash dividends, these Indexes seek growth of dividends instead of current yield.[2] When one screens for quality and growth factors, our expectation is that one should pay a higher price-to-earnings (P/E) multiple for these stocks. Businessman and investor Charlie Munger[3] has a great explanation for why companies with higher returns on capital (i.e., our quality Indexes' ROE screen) should justify a higher valuation:

> *Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result.*[4]
>
> *—Charlie Munger*

What is interesting across the global markets, you find that quality dividend indexes in emerging markets or the developed world, there is a significant quality premium over the high-dividend segments in the market currently. The quality premium Price to Earnings (P/E) multiple in the developed world is 31%, and the premium P/E multiple in the emerging markets is 39%.[5] Given the high returns on capital these quality companies are generating, one might be able to justify even further valuation premiums. But still there is a premium, and that is natural. In the U.S., however, quality stocks are actually trading at a 13% discount compared to U.S. high-dividend stocks. To me, this represents one of most interesting valuation opportunities in the global markets today. The WisdomTree U.S. Quality Dividend Growth Index might be among the most undervalued segments of the U.S. market compared to other opportunities, in my view.

	Estimated P/E Ratios			Shareholder Yield (Dividend+Net Buyback Ratio)		
	WT Quality Dividend Growth	WT High Dividend	Quality Premium P/E	WT Quality Dividend Growth	WT High Dividend	High Dividend Shareholder Yield Premium
United States	**16.6x**	**19.1x**	**-13%**	**5.7%**	**4.4%**	**-1.4%**
Developed International	**18.2x**	**13.8x**	**31%**	**3.0%**	**5.3%**	**2.3%**
Emerging Markets	**15.1x**	**10.8x**	**39%**	**3.6%**	**4.6%**	**1.0%**

Sources: WisdomTree, FactSet as of 8/30/16. Table shows the WisdomTree Quality Dividend Growth and WisdomTree High Dividend Indexes corresponding to the listed regions. Past performance is not indicative of future results. You cannot invest directly in an index.

Looking Beyond P/E Ratios for Valuation Levels: Dividend + Net Buybacks If one combines the dividend and net buybacks, this is a measure of total shareholder distributions that can also be used to evaluate the various markets. Given the higher growth profiles of the quality Indexes, one should expect high- dividend stocks to have a higher total shareholder yield. • In the developed international markets, the high dividend shareholder yield premium is currently over 2 percentage points ahead of the quality dividends, and in the emerging markets, this premium is 1 percentage point. • But in the U.S., the quality dividend growth index actually had a 1.4% total shareholder distribution advantage over the high-dividend strategy. • This advantage for quality stocks was primarily driven by the higher buyback ratio of this index Index (with net buybacks over 3% and dividend yield over 2%), compared to the 3.8% dividend and 0.5% buyback ratio of the high-dividend stocks. To summarize: the global search for yield has flooded the U.S. markets with investors seeking the potential safety of high-dividend stocks. While these stocks may continue to perform well if we have a further declining interest rate environment or we experience more market volatility—say from the U.S. presidential election results—I'd say that from a pure valuation perspective, I would prefer U.S. quality stocks as the most undervalued segment of the U.S. markets today. [1]References the following Indexes: the WisdomTree High Dividend Index, the WisdomTree International High Dividend Index and the WisdomTree Emerging Markets High Dividend Index [2]References the following Indexes: the WisdomTree U.S. Quality Dividend Growth Index, the WisdomTree International Quality Dividend Growth Index and the WisdomTree Emerging Markets Quality Dividend Growth Index [3]Charlie Munger is best known for his position as the vice chairman of Berkshire Hathaway. [4]From a speech Munger gave in 1995, available here. [5] Source: WisdomTree, FactSet as of 8/30/16.

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You cannot invest directly in an index.

DEFINITIONS

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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.

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

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.

Buyback : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

Shareholder Yield : A data point that references the combination of dividend yield and buyback yield.