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# TWO NEW STRATEGIES FOR A CHANGING TAX REGIME

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Ever since the election, investors have celebrated the anticipated tax reforms of Donald Trump, sending U.S. markets higher, in particular small-cap companies that are deemed to benefit from a two-pronged focus:

First, Trump wants to “Make America Great Again,” and small-cap companies have more revenue from the U.S.

Second, because these small-cap companies have more revenue from the U.S., they stand to benefit disproportionately from tax cuts because they pay more U.S. taxes and they have less ability to capitalize on opening offices in locations around the world with lower tax rates.

We published an initial sensitivity analysis to look at how [various assumptions on tax rates might impact the earnings growth](#) and ultimate market [valuations](#) across a [market cap -weighted](#) index set of the [S&P 500](#), [S&P MidCap 400](#), and [S&P SmallCap 600](#)—along with WisdomTree Indexes.

## New Forward-Looking [Price-to-Earnings \(P/E\) Ratio](#) Analysis

We have continued to update our original analysis to also include domestic WisdomTree Indexes. Instead of looking at trailing 12-month P/E ratios, which are biased higher due to losses primarily in the energy sector, the analysis in this table is based on current estimates for this year’s earnings, which we do not believe include any impact from tax changes yet.<sup>1</sup> Of course, analyst estimates tend to be optimistic, but this gives us one way of looking at valuation not biased by losses in the energy sector.

## New Indexes Geared Toward Revenue Location: Well-Positioned for Tax Reforms

Moreover, WisdomTree recently simplified the methodology of two Indexes that had screened based on revenue location-Indexes that were focused on the U.S. domestic economy and U.S. multinationals but previously had a more complex weighting methodology that incorporated the [correlation](#) of each stock to the U.S. dollar. While that methodology had appeal to us, the primary purpose was more about creating baskets of U.S.-focused stocks and U.S. multinationals. The new weighting methodology emphasizes a valuation sensitivity in addition to the revenue location screen/factor.

In many ways, these Indexes are particularly relevant for today’s markets and tax changes on the horizon. Many of the tax reform proposals are geared to impact stocks

determined by whether they are U.S.-economy focused or more multinational based. Even prior to the election, we thought revenue location was an important factor for long-run trends based on changes in the U.S. dollar impacting global revenue differently than U.S. revenue. But with tax reforms lowering U.S. [effective tax rates](#), this will also be an important factor in the short run, as it will be the critical factor in explaining how much *relative* earnings growth results from corporate tax cuts that are planned.

### Lowering Tax Rates = Big Earnings Growth in Companies with More U.S. Revenue

The more earnings (and taxes paid) that come from the U.S., the greater the earnings growth should be from a tax cut, as by and large, the companies with revenue across the world already have lower effective tax rates.

Some highlights of this tax analysis:

- **Reasonable Valuations:** On a forward-looking P/E basis, broad market indexes like the S&P 500 actually appear reasonably priced, with P/E ratios that can be somewhere around 16 to 17 times earnings with a tax rate between 15% and 25%. This tax cut, along with good expected earnings growth this year, could meaningfully help valuations.
- **Small-Cap Benefits:** Small caps, because they have a higher percentage of revenue already in the U.S., consistently saw better earnings growth under the tax cut scenarios.
- **Earnings Weight Lowers P/E Ratios:** Yet for those worried about valuations, WisdomTree's earnings-weighted approach helps lower starting P/E ratios, even before potential tax cuts. When people say the mid- and small-cap spaces look expensive, we point to analysis from the table below that shows our mid- and small-cap earnings Indexes are expected to have P/E ratios that range from 13.6 to 15.6 times earnings with expected P/E ratios and further tax cuts.
- **New Domestic Economy Index Brings Greatest Earnings Growth from Tax Cut:** The newly positioned [WisdomTree U.S. Domestic Economy Index](#) had a weighted average of 97% of taxes paid coming from the U.S.—a full 27 percentage points more than the S&P 500, which had only 70% of taxes paid from the U.S. As a result, compared to all the Indexes on here, this set of stocks had the greatest increase in earnings from a tax cut—whether new rates are assumed to be 15% or 25%. Because this basket also includes an earnings-weighted element, the P/E ratios are expected to be 13.5 to 15.1 times earnings under rates of 15% to 25%. This is a fairly reasonably priced basket of U.S.-oriented stocks, in our view.
- **New Multinational Index Benefits Less:** The Index with the least pickup in earnings from a lower tax rate looks at companies where revenue is found abroad. This Index had the lowest percentage of taxes paid to the U.S.—less than 50%. As a result, the relative earnings growth compared to other indexes was significantly lower—about one-third of the earnings growth of the U.S. Domestic Economy Index. Yet due to the modified earnings-weighted approach of this index that also includes tilts toward companies with more revenue abroad, the P/E ratio of this Index is fairly similar to the S&P 500 P/E ratio, with a slight discount. These companies may be the ones where we see higher [dividend](#) and [buyback](#) growth if they are allowed to bring cash back from abroad at lower repatriation rates.

### Conclusion

The analysis presented herein will be a work in progress for us. As more details about Trump's policy become clear, we plan to update this scenario analysis on better models

to help clients understand where the market valuations might be impacted most by tax reform. Our newly positioned Indexes, particularly the U.S. Domestic Economy Index, could be quite interesting beneficiaries of changed policies.

Summary of Potential Tax Cut Impact Across Indexes

| Market Cap Indexes | % Domestic Taxes | Effective Tax Rate | 25% Tax Rate Analysis  |            |                             |                           | 15% Tax Rate Analysis  |            |                             |                           |
|--------------------|------------------|--------------------|------------------------|------------|-----------------------------|---------------------------|------------------------|------------|-----------------------------|---------------------------|
|                    |                  |                    | New Effective Tax Rate | Current PE | PE with 25% Corporate Taxes | Estimated Earnings Growth | New Effective Tax Rate | Current PE | PE with 15% Corporate Taxes | Estimated Earnings Growth |
| S&P 500            | 69.9%            | 28.2%              | 22.5%                  | 18.3       | 17.0                        | 7.8%                      | 16.9%                  | 18.3       | 15.8                        | 15.6%                     |
| S&P MidCap 400     | 75.1%            | 30.9%              | 24.3%                  | 20.9       | 19.1                        | 9.6%                      | 17.7%                  | 20.9       | 17.6                        | 19.2%                     |
| S&P SmallCap 600   | 79.4%            | 32.2%              | 24.9%                  | 21.6       | 19.5                        | 10.8%                     | 17.6%                  | 21.6       | 17.8                        | 21.6%                     |

  

| Dividend Index Family | % Domestic Taxes | Effective Tax Rate | 25% Tax Rate Analysis  |            |                             |                           | 15% Tax Rate Analysis  |            |                             |                           |
|-----------------------|------------------|--------------------|------------------------|------------|-----------------------------|---------------------------|------------------------|------------|-----------------------------|---------------------------|
|                       |                  |                    | New Effective Tax Rate | Current PE | PE with 25% Corporate Taxes | Estimated Earnings Growth | New Effective Tax Rate | Current PE | PE with 15% Corporate Taxes | Estimated Earnings Growth |
| WT LargeCap Dividend  | 65.7%            | 27.8%              | 22.6%                  | 17.3       | 16.1                        | 7.2%                      | 17.4%                  | 17.3       | 15.1                        | 14.4%                     |
| WT MidCap Dividend    | 76.1%            | 30.3%              | 23.7%                  | 20.5       | 18.7                        | 9.5%                      | 17.1%                  | 20.5       | 17.3                        | 18.9%                     |
| WT SmallCap Dividend  | 81.0%            | 31.2%              | 24.0%                  | 21.3       | 19.3                        | 10.5%                     | 16.8%                  | 21.3       | 17.6                        | 21.0%                     |

  

| Earnings Family      | % Domestic Taxes | Effective Tax Rate | 25% Tax Rate Analysis  |            |                             |                           | 15% Tax Rate Analysis  |            |                             |                           |
|----------------------|------------------|--------------------|------------------------|------------|-----------------------------|---------------------------|------------------------|------------|-----------------------------|---------------------------|
|                      |                  |                    | New Effective Tax Rate | Current PE | PE with 25% Corporate Taxes | Estimated Earnings Growth | New Effective Tax Rate | Current PE | PE with 15% Corporate Taxes | Estimated Earnings Growth |
| WT Earnings 500      | 75.0%            | 27.7%              | 21.8%                  | 16.1       | 14.9                        | 8.2%                      | 15.8%                  | 16.1       | 13.9                        | 16.4%                     |
| WT MidCap Earnings   | 79.2%            | 31.7%              | 24.5%                  | 17.2       | 15.6                        | 10.5%                     | 17.3%                  | 17.2       | 14.3                        | 21.0%                     |
| WT SmallCap Earnings | 85.6%            | 30.3%              | 22.9%                  | 16.5       | 14.9                        | 10.6%                     | 15.5%                  | 16.5       | 13.6                        | 21.3%                     |

  

| Earnings Family with Revenue Tilts | % Domestic Taxes | Effective Tax Rate | 25% Tax Rate Analysis  |            |                             |                           | 15% Tax Rate Analysis  |            |                             |                           |
|------------------------------------|------------------|--------------------|------------------------|------------|-----------------------------|---------------------------|------------------------|------------|-----------------------------|---------------------------|
|                                    |                  |                    | New Effective Tax Rate | Current PE | PE with 25% Corporate Taxes | Estimated Earnings Growth | New Effective Tax Rate | Current PE | PE with 15% Corporate Taxes | Estimated Earnings Growth |
| WT U.S. Domestic Economy           | 97.3%            | 33.0%              | 23.8%                  | 17.1       | 15.1                        | 13.7%                     | 14.6%                  | 17.1       | 13.5                        | 27.3%                     |
| WT U.S. Export and Multinational   | 45.7%            | 26.0%              | 22.6%                  | 17.5       | 16.7                        | 4.6%                      | 19.2%                  | 17.5       | 16.0                        | 9.1%                      |

Sources: WisdomTree, FactSet, Standard & Poor's, as of 2/28/17. You cannot invest directly in an index.

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

<sup>1</sup>Our precise calculations estimate an effective tax rate for each index and a new method for calculating this starting effective tax rate when companies have losses resulting in a lower starting effective tax rate and thus smaller improvement in earnings growth with new tax policy scenarios.

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.

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## DEFINITIONS

**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.

**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.

**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.

**S&P MidCap 400 Index**: provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

**S&P SmallCap 600 Index**: Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

**Price-to-earnings (P/E) ratio**: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**Correlation**: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

**Effective tax rate**: The average tax rate at which a corporation's pre-tax profits are taxed, taking into account all forms of taxation paid by the company.

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

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