IMPACT OF POTENTIAL TAX REFORM

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Corporate tax cuts were a focal point of Donald Trump's campaign—and Trump says lowering corporate taxes will be a priority in his first 100 days as president.

Based on the initial market response to Trump's victory, lowering tax rates looks to us like the most important factor driving the market.

Equity markets, of course, like it when taxes are cut. It naturally means more after-tax earnings that can be reinvested or distributed to shareholders—and, importantly, an improvement in valuation ratios that many think look extended under present circumstances.

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 400 and S&P 600—and across the sectors in those indexes. We have updated our original analysis to also include domestic WisdomTree Indexes; we also have updated our initial model for estimating the potential tax benefit that shows new results for the cap-weighted index family.[1]

Lower Tax Rates = Big Earnings Growth and Market Moves in Small Caps

To summarize the results, a simple model shows the following: the more earnings (and taxes paid) that come from the U.S., the greater the earnings growth would be from a tax cut, because by and large, the companies with revenue across the world already have lower effective tax rates.

Indexes with a higher percentage of profitable companies—and thus companies that pay more U.S. taxes—potentially stand to benefit more than indexes with more unprofitable companies.

The indexes with more revenue from the U.S. tend to be mid- and small-cap indexes.

Indexes Weighted by Profits Benefit More than Dividends

The WisdomTree Earnings Index family—which only includes profitable companies and weights companies based on profits—shows a potential improvement in earnings that is higher than the WisdomTree Dividend Index family.

Why?

We have examined the potential gains from lower tax rates across sectors, and the two sectors that stand out the *least* as beneficiaries are the Energy sector and Real Estate sector.

Companies in the Real Estate and Energy sectors tend to make up a bigger percentage of the dividend Indexes than the earnings Indexes.

Real estate investment trusts (REITs) already pay little taxes at their trust level if they distribute at least 90% of their income.[2] They thus also do not benefit as much from new policies.

A number of energy companies, particularly large-cap energy companies, have a global revenue base and pay more taxes overseas. They stand to benefit less from U.S. tax rate cuts and thus would see less meaningful increases in earnings and improvements in valuations. They also have depressed earnings today, so, based on the changes we modeled, they may not see much improvement from that side either.

Looking across the WisdomTree Index family below, we'd highlight the following:

- The broad market WisdomTree Earnings Index has about 10 percentage points more domestic taxes being paid than the WisdomTree Dividend Index (73.9% vs. 63.3%). Under an assumption of 15% tax rates, this would translate to potential earnings growth of 16.7% vs. 14.4%, or 2.3% higher with our model.
- Showing how important the WisdomTree earnings-weighted approach can be for lowering valuations and how much these can be improved with a reduction in corporate taxes—if Trump gets his desired 15% tax rate approved—a simple model shows potential gains in reducing price-to-earnings (P/E) ratios from a touch under 16 for a broad market earnings-weighted index or a large-cap earnings index to just 13.5 times earnings.
    - o Broad market index multiples at around 13 to 14 times earnings would be a very reasonable valuation for broad market exposures. Of course, actual tax cuts may not be as simple as lowering the effective corporate tax rates we are modeling here, but this analysis shows potential gains to be had and how markets may be reasonably priced,

particularly with an earnings-weighted approach.

o We also show the calculations at a reduction to 25%—a more conservative assumption, and even here the broad market multiples, on an earnings-weighted basis, would fall below 15 times, a fairly reasonable starting valuation.

• An example of indexes that benefited slightly less from tax rate reductions: the WisdomTree High Dividend Index currently has a meaningful position in energy stocks such as Exxon Mobil, and has a very high percentage of foreign revenue and foreign taxes compared to U.S. indexes; it also has meaningful exposure to REITs. In terms of the total tax exposure of the Index, it saw a 12.4% increase in earnings under an assumed 15% tax rate, compared to 14.4% for the broader WisdomTree Dividend Index or 16.7% for the WisdomTree Earnings Index.

• An example of indexes that benefited more: small-cap indexes with more revenue from the U.S. stand to benefit at greatest amounts across the WisdomTree Dividend and Earnings Index families. In contrast to the S&P 600, which would still have a P/E ratio above 25 under a 15% corporate tax rate scenario, we'd point out the WisdomTree SmallCap Dividend Index with a P/E ratio of 20.3, the WisdomTree U.S. SmallCap Quality Dividend Growth Index at 14.0 and the WisdomTree SmallCap Earnings Index at 10.6 times are reasonably valued small-cap indexes.

Summary of Potential Tax Cut Impact Across Indexes

			25% Tax Rate Analysis				15% Tax Rate Analysis			
Market Cap Indexes	% Domestic Taxes	Effective Tax Rate	New Effective Tax Rate	Current P/E	P/E with 25% Corporate Taxes	Estimated Earnings Growth	New Effective Tax Rate	Current P/E	P/E with 15% Corporate Taxes	Estimated Earnings Growth
S&P 500	66.0%	28.5%	23.2%	21.1x	19.6x	7.5%	17.8%	21.1x	18.3x	15.1%
S&P 400	75.2%	30.9%	24.3%	26.1x	23.8x	9.6%	17.6%	26.1x	21.9x	19.3%
S&P 600	79.3%	31.9%	24.7%	30.8x	27.8x	10.6%	17.5%	30.8x	25.4x	21.3%
			25% Tax Rate Analysis				15% Tax Rate Analysis			
Dividend Index Family	% Domestic Taxes	Effective Tax Rate	New Effective Tax Rate	Current P/E	P/E with 25% Corporate Taxes	Estimated Earnings Growth	New Effective Tax Rate	Current P/E	P/E with 15% Corporate Taxes	Estimated Earnings Growth
WT Dividend	63.3%	28.5%	23.3%	20.1x	18.8x	7.2%	18.2%	20.1x	17.6x	14.4%
WT LargeCap Dividend	60.7%	28.3%	23.4%	19.4x	18.2x	6.9%	18.5%	19.4x	17.1x	13.7%
WT MidCap Dividend	76.7%	30.4%	23.8%	23.7x	21.6x	9.6%	17.1%	23.7x	19.9x	19.2%
WT SmallCap Dividend	81.7%	30.3%	23.2%	24.5x	22.2x	10.1%	16.2%	24.5x	20.3x	20.3%
WT U.S. Quality Dividend Growth	75.4%	27.9%	21.9%	19.3x	17.9x	8.3%	15.9%	19.3x	16.6x	16.7%
WT U.S. SmallCap Quality Dividend Growth	80.8%	32.0%	24.6%	17.1x	15.4x	10.9%	17.2%	17.1x	14.0x	21.8%
WT Dividend ex-Financials	64.4%	28.7%	23.4%	17.7x	16.5x	7.4%	18.1%	17.7x	15.4x	14.8%
WT High Dividend	55.0%	28.3%	23.8%	20.1x	19.0x	6.2%	19.4%	20.1x	17.9x	12.4%
			25% Tax Rate Analysis				15% Tax Rate Analysis			
Earnings Index Family	% Domestic Taxes	Effective Tax Rate	New Effective Tax Rate	Current P/E	P/E with 25% Corporate Taxes	Estimated Earnings Growth	New Effective Tax Rate	Current P/E	P/E with 15% Corporate Taxes	Estimated Earnings Growth
WT Earnings	73.9%	28.3%	22.3%	15.8x	14.6x	8.3%	16.3%	15.8x	13.5x	16.7%
WT Earnings 500	72.9%	27.9%	22.1%	15.9x	14.7x	8.0%	16.3%	15.9x	13.7x	16.1%
WT MidCap Earnings	78.7%	31.8%	24.6%	16.7x	15.1x	10.5%	17.5%	16.7x	13.8x	20.9%
WT SmallCap Earnings	85.6%	30.1%	22.7%	12.9x	11.7x	10.5%	15.4%	12.9x	10.6x	21.0%

Sources: WisdomTree, Bloomberg, with data as of 12/31/16. You cannot invest directly in an index.

Conclusion

The analysis presented herein will be an ongoing work in progress for us. As more details about Trump's policies become clear, we plan to update this scenario analysis with better models to help clients understand where the market valuations might be affected most by tax reform.

[1]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 a smaller improvement in earnings growth with new tax policy scenarios.

[2]See, for instance, Mark P. Cussen, "The Basics Of REIT Taxation," Investopedia.

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DEFINITIONS

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 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.

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

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.

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.