US equities: Is quality and growth now at a discount to the market?

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Growth at a reasonable price is something often desired by investors as they look for styles and factors that can deliver above average returns. Given that the S&P 500 Index is currently trading at high multiples, now is the time investors may wish to consider growth at a reasonable price. Let's explore how WisdomTree's methodology may offer a solution to this problem.

WisdomTree's Quality Dividend Growth indices seek to identify both quality and growth. Using a unique systematic-screening methodology, these indices are designed to deliver growth with the addition of a quality tilt, by focusing on a combination of attributes such as return on equity, return on assets and long-term expected earnings growth. With an investment universe consisting of dividend-paying companies, the strategy offers a multi-faceted approach to growth investing.

A key feature of the Quality Dividend Growth strategy is the focus on companies that, through higher retained earnings, may then deliver above average future dividend growth. Studies have shown that for broad global equities, dividend growth has made a significant contribution towards total returns. For example, over the past ten years, dividend growth has accounted for close to 60% of the total return of the MSCI All Country World Index. This has outstripped the broadly equal contribution from dividend income and valuation change.

Chart 1: Quality outperforms the S&P 500 over the long run

Source: WisdomTree, Bloomberg. Data as of 22/11/2017

S&P 500 differentiation

Applying the methodology to US stocks, WisdomTree's US Quality Dividend Growth Index selects the top 300 companies with positive dividend cover, high growth and quality rankings, and a minimum market capitalisation of $2bn. Growth is measured by long-term earnings expectations, while quality is defined by the three-year average return on assets and return on equity.

The WisdomTree strategy results in significant sector biases relative to the S&P 500 Index, as shown in the chart below.

Chart 2: Quality with a focus on growth

Source: WisdomTree, S&P. Data as of 31/10/17.

Although there is a focus on dividend-paying stocks, the strategy places an emphasis on quality and growth factors, as opposed to value. As a result, technology has the highest weight in the index at over 22%. This is modestly underweight compared to the S&P 500, which has a technology weighting of 24.5%. Another sector with a quality and growth tilt is healthcare, with a weight of 20.4% versus 14.1% for the S&P 500.

The highest overweight in the WisdomTree strategy is the Industrials sector, with a weighting of close to 20%, almost double that of the S&P 500. Both consumer-related sectors¾discretionary and staples¾are overweight in the WisdomTree index with a combined weight of 29%, an overweighting of 9.2%. The focus on quality also results in substantial underweight positions in sectors such as financials (-9.5%), and energy (-5.6%).

Chart 3: Growth and quality at a discount to the S&P 500

Source: WisdomTree. Data as of 31/10/2017

Earnings boost

In the current macro environment, in which interest rates have been rising on the back of strong economic growth, investors are potentially better placed by focusing on growth as a style. In this context, a quality tilt on the growth theme is a nuanced approach that positions investors effectively, with the focus on dividend-paying stocks providing a modest value exposure.

Naturally, valuations play an important role in growth investing. Typically, investors pay a significant premium for above-average earnings growth, and an even larger premium for quality. The advantage of the WisdomTree US Quality Dividend Growth Index is that it provides access to quality growth companies at a 5.7% discount to the P/E ratio of the S&P 500.

As we move towards the scenario of corporate tax cuts, the potential change to earnings for the Quality Dividend Growth strategy is likely to outstrip that of the S&P 500. To a certain extent this is down to the latter having a domestic profit exposure of 69.2% vs a 75.7% exposure for the WisdomTree strategy. The result is that if the current range of tax cuts are implemented, the P/E discount to the S&P 500 is expected to widen to over 6.5%. This potential shift in valuation would result in the WisdomTree index trading at an attractive multiple of 18.6x earnings compared to the S&P 500's ratio of close to 20x earnings. This emphasises the benefits of a strategy that can access quality growth at a reasonable price.

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