

# Case study: quality factor at work in the Eurozone

Published 11 June 2018

**Christopher Gannatti, CFA**

Global Head of Research

As the month of May comes to an end one word is on the forefront of equity investors' minds, particularly those with exposure to the Eurozone: volatility. Volatility has presented itself on the potential for trade wars, President Trump's announcements on the Iran deal, and the complex and ongoing issues surrounding Italy and the formation of the government.

## **Battle-testing the quality factor**

In periods where markets seem to run ever higher with minimal volatility and barely any corrections of 5% or more, it is difficult to make the case that the quality factor is needed within an equity exposure to add value. Momentum strategies fit the bill more appropriately in those types of scenarios.

Historically, we have seen that quality-oriented approaches tend to be at their relative best during periods of increased volatility and even market drawdowns.

May of 2018, with all its negative headlines, was a month to battle test WisdomTree's Eurozone Quality Dividend Growth strategy in real time.

**Figure 1: Year-to-date 2018: Eurozone quality has been strong**



Source: Bloomberg, with data from 31 December 2017 to 30 May 2018.

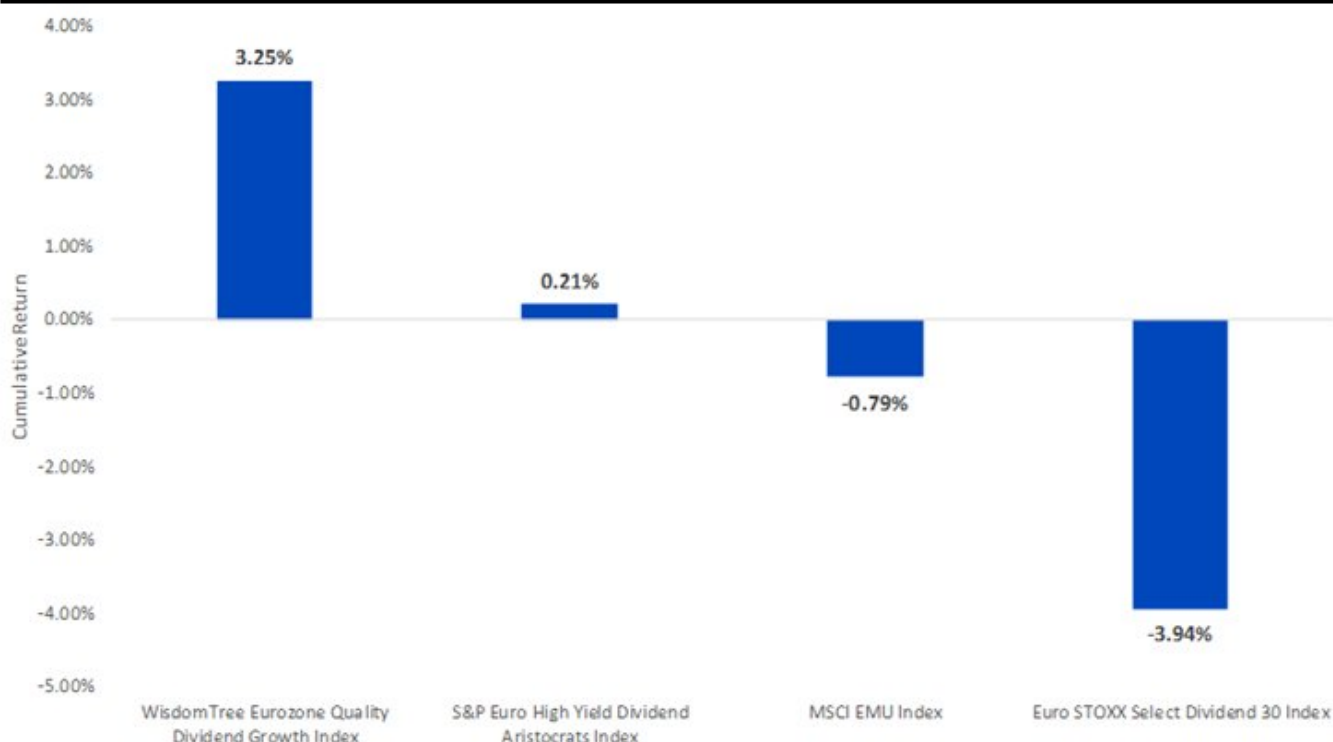
**Past performance is not indicative of future results. You cannot invest directly within an Index.**

For those following dividend-focused eurozone equity strategies in 2018, the performance environment has been challenging. The S&P Euro High Yield Dividend Aristocrats and Euro STOXX Select Dividend 30 Indexes both have a large following, but the key thing to remember is that, as of 30 April 2018:

- The S&P Euro High Yield Dividend Aristocrats Index had 40 constituents.
- The Euro STOXX Select Dividend 30 Index had 30 constituents.

These are fairly concentrated baskets of Eurozone equities. By contrast, the WisdomTree Eurozone Quality Dividend Growth Index had 99 constituents as of this date.

**Figure 2: The May 2018 period: Italy as a catalyst for volatility**



Source: Bloomberg, with data from 30 Apr. 2018 to 30 May 2018. Past performance is not indicative of future results.

***You cannot invest directly within an Index.***

Uncertainty surrounding the capability of Italy to form a government was the catalyst for major Eurozone equity market volatility in the month of May. Yet the WisdomTree Eurozone Quality Dividend Growth Strategy was able to still deliver a positive return of nearly 3.3%.

This compares to a 0.21% return for the S&P High Yield Dividend Aristocrats Index and a -3.94% return for the Euro STOXX Select Dividend 30 Index.

**All dividend strategies are NOT equal**

The WisdomTree Eurozone Quality Dividend Growth, S&P Euro High Yield Dividend Aristocrats and Euro STOXX Select Dividend 30 Indexes all have the word “dividend” in the title, but it is striking how different they truly are. We already mentioned the numbers of constituents, but additionally:

- **Index Weighting:** The WisdomTree strategy is weighed by cash dividends, meaning the companies that distribute the greatest amounts of cash receive the biggest weights. Both the S&P and the STOXX Indices are much more yield driven in the weighting schemes. We hesitate to say that either approach is good or bad—unfortunately in these matters things are rarely black and white. Yield driven weighting schemes deliver a higher dividend yield, which some investors may find interesting. However, companies with the highest yields may not necessarily have the healthiest balance sheets, strongest earnings growth or look positive on other quality-oriented attributes.
- **Financials Exposure:** With events in Italy, some investors have become quite sensitive to Financials weightings within their Eurozone equity positions. As of 30 April, the WisdomTree strategy had a less than 2.3% exposure to Financials. Now, within the MSCI EMU Index, a market capitalization-weighted benchmark for the Eurozone, the Financials exposure is more than 20.2%. The WisdomTree Eurozone Quality Dividend Growth Index actually penalizes firms in its ranking criteria that use high leverage, and Financials fit in this category. As of 30 April 2018:
  - The S&P Euro High Yield Dividend Aristocrats Index had a Financials exposure of 9.7%
  - While the Euro STOXX Select Dividend 30 Index utilizes a slightly different sector categorization schematic in its reporting, it is notable that 14.1% of the exposure was in Banks.
- **Italy Exposure:** Of course, we'd be remiss to not mention the country exposures of the 3 Indexes to Italy, as well as that of the MSCI EMU Index to get a sense of where Italy's market capitalization weight would place it on the spectrum. As of 30 April 2018:
  - The MSCI EMU Index had a 7.80% weight to Italy.
  - The WisdomTree Eurozone Quality Dividend Growth Index had a 6.46% weight to Italy.
  - The S&P Euro High Yield Dividend Aristocrats Index had a 13.0% weight to Italy.
  - The Euro STOXX Select Dividend 30 Index had a 15.6% weight to Italy.

### **Continue to look to quality for potential in volatile markets**

As of this writing, we cannot say for sure where the story in Italy will take us. What we can say is that the indexes mentioned in this piece all have defined, repeated, rules-based methodologies that apply at regular intervals. If markets are expected to be more volatile, why not focus exposure on firms with lower leverage, higher return on equity, higher return on assets and better forward-looking earnings growth expectations?

## Important Risks Related to this Article

### Important Information

**Marketing communications issued in the European Economic Area (“EEA”):** This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

**Marketing communications issued in jurisdictions outside of the EEA:** This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as “WisdomTree” (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

**For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.**

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.