Impact of Potential Tax Reform: Size and Sector Analysis

Published December 13, 2016

Jeremy Schwartz, CFA
Global Chief Investment Officer

Josh Russell, PhD, CFA
Quantitative Equity Strategist

Corporate tax reform was 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. Equity markets, of course, like cutting taxes—it naturally means more after-tax earnings that can be reinvested or distributed to shareholders.

In the first three weeks following the election, we can describe the returns simply: Small caps outperformed mid-caps, which beat large caps. The spread from large caps to mid-caps to small caps was 3% versus 7.5% versus 11.9% based on the S&P family of indexes, showing small caps won by almost 9 percentage points post-election in November.[1]

Lower Tax Rates = Big Gains in Small Caps

A number of factors currently support small caps over large caps. Part of Trump's "Make America Great Again" campaign focused on the U.S. economy, and small caps are more leveraged to U.S. economic growth than large caps, which typically have a broader global footprint.

But there is also a tax cut argument related to favoring small caps over large caps.

Small caps—being taxed more predominantly in the U.S. at higher rates than large caps with global earnings—should see a relatively higher increase in earnings from a reduction in U.S. corporate taxes.

We did some modeling across a variety of indexes and sectors to see who could stand to benefit from this potential corporate tax cut. To assess the impact of the U.S. corporate tax rate on a basket of stocks, we must determine two things: each company's effective tax rate and the percentage of taxes paid to the U.S. Because the effective tax rate—defined as income tax expense divided by operating income—is fairly noisy, we compute an effective tax rate from the three most recent annual statements. As we are dealing with indexes, we compute the effective tax rate as the sum of income tax expense divided by the sum of operating earnings. In doing so, we create a baseline for the current tax environment.

To determine the percentage of taxes paid in the U.S. for an index, we compare the sum of domestic income taxes paid to the sum of total taxes paid. For consistency, we consider the three most recent annual statements.

Once we have determined the aggregate effective tax rate and the percentage of taxes paid in the U.S., we can approximate a new effective tax rate under different corporate tax rates. We approximate the new effective tax rate to be the old effective rate minus the percentage of taxes paid in the U.S. times the change in the U.S. corporate tax rate.

A simple model shows this: The more earnings that come from the U.S., the greater the earnings growth

would be from a tax cut, as by and large the companies with revenue across the world already have lower effective tax rates.

Looking across large, mid- and small caps, it is clear that as one goes down the size spectrum, there is more revenue that comes from the U.S.

• We show approximately two-thirds revenue for large caps from the U.S., whereas U.S. small caps had almost 80% revenue from the U.S.

• Large caps historically had lower tax rates than small caps:

o The effective tax rate for the S&P 500—based on the last three years of data to smooth out some noise in profitability—was approximately 27.7%, whereas the effective tax rate for small caps was almost 32%.[2]

o We did simulations for what the new effective tax rate would be under both a 25% U.S. corporate tax rate as well as a 15% corporate tax rate that Trump has suggested wanting to implement.

o For large caps, we estimated approximately 9.1% earnings growth that comes from reducing tax rates to 25% and double that earnings growth (18.2%) with a lowering of corporate tax rates to 15%.[3]

o For small caps, we estimated small-cap earnings growth of 11.6% with a reduction in tax rates to 25% and again double that rate to 23.1% with a reduction in corporate taxes to 15%.[4]

o We expected to find small caps benefiting from the lowering in corporate tax rates more than large caps, but the actual difference—at least for market cap-weighted broad-based benchmarks—was not that substantial and would not necessarily explain the relative performance of small caps over large caps in November.

Summarizing this tax cut impact analysis more broadly: If Trump is able to lower corporate tax rates, especially to 15%, the valuations of the market would improve meaningfully.

Looking across sectors—and sectors within large-, mid- and small-cap stocks—those with some of the best growth in earnings are small-cap utilities and consumer discretionary stocks. Those are sectors that had the highest effective tax rates (being most local to the U.S. economy), so a lowering of tax rates helps them the most. Financials also had a large improvement, and small-cap financials the most among size segments.

By contrast, technology stocks tend to have the most global revenue and thus consistently had the lowest net benefit.

15% Corporate Tax Rate						
Index	% Domestic Taxes	Effective Tax Rate	New Effective Tax Rate	Current Price-to-Earnings (P/E) Ratio	PE with 15% Corporate Taxes	Estimated Earnings Growth
S&P 500 Index	65.8%	27.7%	14.6%	20.8x	17.6x	18.2%
S&P MidCap 400 Index	73.9%	31.1%	16.4%	25.9x	21.3x	21.5%
S&P SmallCap 600 Index	78.7%	31.9%	16.2%	30.3x	24.6x	23.1%

25% Corporate Tax Rate						
Index	% Domestic Taxes	Effective Tax Rate	New Effective Tax Rate	Current Price-to-Earnings (P/E) Ratio	P/E with 25% Corporate Taxes	Estimated Earnings Growth
S&P 500 Index	65.8%	27.7%	21.1%	20.8x	19.1x	9.1%
S&P MidCap 400 Index	73.9%	31.1%	23.7%	25.9x	23.4x	10.7%
S&P SmallCap 600 Index	78.7%	31.9%	24.1%	30.3x	27.1x	11.6%

Estimated Earnings Growth with 25% Corporate Tax Rate											
Index	Energy	Materials	Industrials	Consumer Discretionary	Consumer Staples	Health Care	Financials	Information Technology	Telecommunication Services	Utilities	Total
S&P 500 Index	3.3%	6.9%	9.0%	11.2%	9.7%	9.9%	11.1%	8.8%	13.4%	7.6%	9.1%
S&P MidCap 400 Index	N/A	9.9%	11.0%	13.0%	11.3%	11.8%	12.2%	7.9%	20.4%	12.1%	10.7%
S&P SmallCap 600 Index	N/A	9.8%	11.6%	13.6%	11.8%	12.9%	13.0%	7.8%	11.9%	13.9%	11.6%

Estimated Earnings Growth with 15% Corporate Tax Rate											
	Energy	Materials	Industrials	Consumer Discretionary	Consumer Staples	Health Care	Financials	Information Technology	Telecommunication Services	Utilities	Total
S&P 500 Index	6.6%	13.7%	18.1%	22.4%	19.4%	19.9%	22.2%	17.6%	26.8%	15.3%	18.2%
S&P MidCap 400 Index	N/A	19.9%	21.9%	26.0%	22.5%	23.5%	24.3%	15.8%	40.8%	24.1%	21.5%
S&P SmallCap 600 Index	N/A	19.6%	23.2%	27.2%	23.6%	25.7%	26.1%	15.5%	23.7%	27.7%	23.1%

The color scale represents the estimated earnings growth within each sector. The colors range from white to green where, white signifies the sector in the index that has the lowest estimated earnings growth and the dark green signifies the sector with the greatest estimated earnings growth, within each corporate tax rate.
"N/A" represents sectors in which earnings are negative.
Sources: WisdomTree, Factset, S&P as of 11/30/16.

[1]Source: Bloomberg, 11/8/16–11/30/16.

[2]Sources: WisdomTree, FactSet, Standard & Poor's, as of 11/30/16.

[3]Sources: WisdomTree, FactSet, Standard & Poor's, as of 11/30/16.

[4]Sources: WisdomTree, FactSet, Standard & Poor's, as of 11/30/16.