

Why European Dividend Growth Companies Look Attractively Priced

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Investors anticipate a continued economic recovery in Europe and are flocking toward European investments. European markets still trade at a slight discount to their peers in the U.S.,¹ but there is a particular segment that we believe looks attractively priced: high-quality companies. **Valuation Analytics in European Equities** Usually higher-quality companies command premium market multiples and valuations because they are viewed as having more potential to quickly and sustainably grow their earnings and dividends. I introduced the new WisdomTree Europe Dividend Growth Index in our last [blog post](#), in which I discussed return on equity (ROE) and return on assets (ROA). WisdomTree uses these quality factors to help select the companies we believe have the best prospects for sustainable long-term dividend growth. The valuation of the WisdomTree Europe Dividend Growth Index, on a [price-to-earnings \(P/E\) ratio](#) basis, is only slightly higher than the broader European market indexes shown in the table below. Its dividend yield, another important valuation metric, is broadly in line with, if actually a little higher than, that of the MSCI EMU Index. This low valuation spread for a high-quality basket, in my opinion, makes this a particularly attractive time to consider these stocks to represent European equity exposures. **Why a Focus on Growth and Quality May Be Attractive Today**

European Equity Index							
	WT Europe Dividend Growth	WT Europe Hedged Equity	WT Europe SmallCap Dividend	FTSE Developed Europe	MSCI EMU	Euro Stoxx 50	S&P Europe 350
Price-to-Earnings (P/E) Ratio	14.9x	14.8x	15.0x	14.0x	13.9x	13.1x	13.9x
Median Long-Term Earnings Growth	8.5%	11.1%	12.7%	9.4%	11.2%	10.4%	9.5%
Dividend Yield	3.1%	3.3%	3.5%	3.4%	3.0%	3.3%	3.4%
Earnings Yield	6.7%	6.8%	6.7%	7.1%	7.2%	7.6%	7.2%
Earnings Retention	53.6%	51.1%	47.1%	52.6%	58.1%	57.2%	52.5%
Return on Equity (ROE)	25.3%	14.2%	15.4%	15.2%	12.4%	11.5%	15.6%
Return on Assets (ROA)	10.1%	5.1%	5.9%	5.4%	4.2%	3.9%	5.3%
Leverage	2.5x	2.8x	2.6x	2.8x	3.0x	3.0x	3.0x
ROE x Earnings Retention	13.6%	7.2%	7.2%	8.0%	7.2%	6.6%	8.2%

Sources: WisdomTree, Bloomberg, with data as of 3/31/2014. You cannot invest directly in an index. Past performance is not indicative of future results. Subject to change.

For definitions of terms and indexes in the chart, please visit our [Glossary](#). • **Drivers of Dividend Growth:**

The dividend discount model suggests that dividend growth is critically linked to earnings retention and return on equity. Simply stated, the potential future growth of dividends is determined by the fraction of earnings put back into the firm and how profitable those earnings are in their subsequent use. While there is no way to know what any firm's actual future dividend growth will be, I believe this metric is important when attempting to gauge a firm's future dividend growth potential. • **WisdomTree Europe Dividend Growth:**

The Index's ROE x earnings retention was 13.6%. None of the other European indexes score above 10% by this metric. This wasn't attributable to earnings retention—that was broadly similar across each index. ROE for the WisdomTree Europe Dividend Growth Index was—by virtue of its selection methodology—nearly 26%, which was at least 9% above the ROE of the next highest index shown. This illustrates how one of the great differentiators of the current constituent list is a focus on quality companies, with quality being approximated by ROE. **Blending WisdomTree's Indexes to Fine-Tune European Equity Exposure**

The WisdomTree Europe Dividend Growth Index is actually the third broadly focused European Index in our current lineup. Below are two crucial discussions regarding how it fits in with the WisdomTree Europe Hedged Equity Index and the WisdomTree Europe SmallCap Dividend Index. **Discussion 1: Currency Exposure** Currency hedging developed international equities is a theme that WisdomTree has written about [extensively](#), as we believe it is one of the most significant issues to think about when considering this segment of today's equity landscape. The cost to hedge the euro is minimal, yet we face the distinct possibility that the European Central Bank (ECB) could act to support its economy, which could lead to a weaker euro against the U.S. dollar. I believe there is a chance that exposure to the euro could lead

to the potential for unrewarded volatility. To mitigate this risk, I advocate consideration of blends of the [WisdomTree Europe Hedged Equity Index](#), weighted equally, with either our [Europe Dividend Growth Index](#) or our [Europe SmallCap Dividend Index](#). Such equally weighted blends reflect the reality that very few people have a strong conviction which way the euro will move, especially over the short term. Combining some currency-hedged strategies with the new Europe Dividend Growth Index, as well as or in addition to the Europe SmallCap Dividend Index, can take some of that risk off the table. **Discussion 2: European Completion** The WisdomTree Europe SmallCap Dividend Index has relatively low overlap with either the WisdomTree Europe Hedged Equity Index or the Europe Dividend Growth Indexes and thus blends well with both of those Indexes from a completion standpoint.² European small caps are often more sensitive to the local economy than large-cap companies, many of which are global exporters. Small caps also make a good potential complement in sectors and types of stocks. **Conclusion** I believe the European variant of our dividend growth methodology provides a valuable addition to the universe of indexes tracking that region's stocks. For people who historically have appreciated a higher quality bias in their approach to U.S. equities, I believe the existence of a new option in Europe could be of particular interest. For those who think the European recovery is just getting under way, I believe this new Index should be well positioned to capitalize on the dividend growth opportunities in Europe. ¹Refers to the price-to-earnings (P/E) ratio of the MSCI Europe Index measured against the P/E ratio of the S&P 500 Index, with values as of 3/31/2014. ²Based on the constituents of the WisdomTree Europe Dividend Growth, Europe Hedged Equity and Europe SmallCap Dividend Indexes as of 3/31/2014.

Important Risks Related to this Article

Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance. Dividends are not guaranteed, and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time. Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility.