INTERNATIONAL QUALITY DIVIDEND GROWTH: A 2018 REVIEW & 2019 OUTLOOK

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Some of our international equity strategies had a tough 2018. Let's do a deep dive on causes and drivers of returns, along with a review of our methodology and positioning in 2019.

Our quality dividend growth suite as a whole had a mixed year. While we underperformed in our overseas mandates—which is what we cover in this paper—other areas showed considerable outperformance. For example, the WisdomTree Canada Quality Dividend Growth Index outperformed in 2018, falling 5.75% while the S&P/TSX Composite Index returned -8.88%. That means investors, to the extent that they struggled in our international ETFs, have made up for that underperformance if they owned DGRC, which tracks the aforementioned Canadian index.

Nevertheless, in this piece we will focus on three TSX-listed tickers:

IQD: WisdomTree International Quality Dividend Growth Index ETF (Hedged Units)

IQD.B: WisdomTree International Quality Dividend Growth Index ETF (Non-hedged Units)

DQI: WisdomTree International Quality Dividend Growth Variably-Hedged Index ETF™

Figure 1 shows their performance.

FIGURE 1: Performance

Name	Ticker	1 Month	3 Months	1 Year	YTD	Since Inception
WisdomTree International Quality Dividend Growth Index ETF (Hedged Units)	IQD	-6.98%	-13.56%	-12.94%	-12.94%	2.97%
WisdomTree International Quality Dividend Growth Index CAD-Hedged		-6.96%	-13.47%	-12.02%	-12.02%	4.07%
WisdomTree International Quality Dividend Growth Index ETF (Unhedged Units)	IQD.B	-3.52%	-9.56%	-9.54%	-9.54%	3.55%
WisdomTree International Quality Dividend Growth Index CAD		-3.48%	-9.48%	-8.92%	-8.92%	4.40%
WisdomTree International Quality Dividend Growth Index Variably Hedged Index ETF™	DQI	-6.30%	-12.75%	-13.12%	-13.12%	2.37%
WisdomTree International Quality Dividend Growth Index Variably CAD-Hedged		-6.25%	-12.59%	-12.17%	-12.17%	3.55%
MSCI EAFE Index		-6.24%	-7.91%	-6.24%	-6.24%	6.69%

Sources: WisdomTree, Bloomberg as of 12/31/18.Inception date for WisdomTree funds is 7/12/16. Inception date for WisdomTree Indexes is 5/26/16. Inception date for MSCI EAFE Index is 3/31/86. Past performance is not indicative of future results. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or operational charges or income taxes payable by any unitholder that would have reduced returns. Performance of less than one year is cumulative total return.

STRATEGY DESIGN

The ETFs are rules-based, selecting components using return on assets (ROA), return on equity (ROE) and projected earnings growth. Weights are equal to each company's proportion of the total dividends paid by all eligible companies. For example, if the fictitious XYZ Industries has a $1.23 billion dividend, while the total of all firms is $100 billion, it will be 1.23% of our Index.

ASSESSING 2018 STOCK SELECTION

Running performance attribution for 2018, WisdomTree's sector allocations were accretive to performance, but the stocks selected in those sectors caused pain.

First, an area of respite: financials. The WisdomTree Indexes had a low single-digit weight in financials throughout 2018, whereas the sector is more than 20% of the MSCI EAFE Index. Given Italian bank solvency headlines and Deutsche Bank's travails, it was fortunate that the banks couldn't get past our profitability screens. Because we were light on banks and heavier on insurers and asset managers, our financials stocks declined "only" 7.3%, outperforming the loss of 12.4% for the MSCI EAFE Financials Index. In this case, we were able to avoid a troubled sector and also outperform with the picks we made within it.

But that was little solace given our struggles in communication services, consumer staples and consumer discretionary. The WisdomTree Indexes CAD's holdings returned -22.2%, -12.0%, -14.0% in those three, respectively. In contrast, the same sectors in MSCI EAFE returned -4.3%, -2.5% and -8.7%, respectively.

Here are the five stocks that were the biggest mathematical detractors for our indexes in 2018.

#1: BRITISH AMERICAN TOBACCO (SECTOR: CONSUMER STAPLES) TOTAL INDEX DETRACTION VS. MSCI EAFE: -2.08%

BAT stock halved in 2018, from £5,018 to £2,500.

Three drivers hit the stock: the Brexit cloud, surprisingly sharp drops in traditional tobacco consumption and fear the U.S. government will ban menthol cigarettes. Additionally, the tobacco majors were late to the "e-cigarette" trend, ceding monopolistic market share to Juul.

Bloomberg identifies elevated ROA and ROE for BAT of 41.8% and 108.3%, respectively, though those figures are anomalous. Nevertheless, the company has witnessed double-digit ROA and greater than 50% ROE since mid-2013. The Street anticipates earnings growth of 5% and 7% in 2019 and 2020, respectively. The stock went ex-dividend four times last year, paying £48.8 each time. The yield on 2018's closing price is 7.8%. The WisdomTree Indexes continue to identify BAT for inclusion, and its sizeable dividends make it our third-largest holding, at 4.35%. For context, it is 0.60% of the MSCI EAFE Index.

#2: INDITEX (SECTOR: CONSUMER DISCRETIONARY) TOTAL INDEX DETRACTION VS. MSCI EAFE: -0.46%

Our Indexes entered 2018 with about 2% in this operator of cheap chic fashion retailers, whose most recognizable brand is probably Zara. The stock slumped from €29.05 to €22.43 in 2018 due to the "Amazon effect." Our allocation to the company has ratcheted higher of late, making it more than 3% of our Index. It continues to screen highly on both ROA (17.0%) and ROE (28.2%). The Street anticipates EPS of €1.12 and €1.23 this year and next, up from €1.08 in 2018. Last year's dividends were €0.75, up from €0.68 in 2017.

#3: TOKYO ELECTRON (SECTOR: INFORMATION TECHNOLOGY) TOTAL INDEX DETRACTION VS. MSCI EAFE: -0.66%

Tokyo Electron got caught up in the raid on semiconductor companies last year. The stock slipped to ¥12,515 from ¥20,400 at the end of 2017. Throughout the year, our Indexes held a nearly 2% average weight in the company, while it averaged 0.18% in the MSCI EAFE Index.

It screens very highly on ROA (21.9%) and ROE (32.0%). Calendar 2018 EPS were ¥1,540, with the Street anticipating a fall this year to ¥1,280, followed by a rebound to ¥1,430 and ¥1,810 in 2020 and 2021, respectively.

The firm's dividend policy is particularly interesting; the last eight payments, delivered semiannually, were ¥68, ¥125, ¥112, ¥128, ¥224, ¥277, ¥347 and ¥413, in line with Prime Minister Shinzo Abe's economic plan for delivering shareholder-friendly dividend policies. The Street anticipates another ¥311 to go ex-dividend in March, followed by ¥460 for September shareholders. If this year's payments play out, they represent a yield of 6.2% on 2018's closing price.

#4: CONTINENTAL AG (SECTOR: CONSUMER DISCRETIONARY) TOTAL INDEX DETRACTION VS. MSCI EAFE: -0.46%

The WisdomTree Indexes entered the year with 1.44% in the German auto parts manufacturer, a considerable overweight relative to its 0.20% allocation in MSCI EAFE. The stock was hit by a midyear profit warning and the overhang from its exposure to global trade war fears. Its price fell from €225.05 to €120.75 during 2018. It remains more than 1% of our Indexes, even after the relative losses.

ROA is 7.7% and ROE is 18.1%; the Street anticipates that 2018 EPS of €14.10 will rise to €14.69 this year and €16.98 in 2020.

#5: YAHOO JAPAN (SECTOR: COMMUNICATION SERVICES) TOTAL INDEX DETRACTION VS. MSCI EAFE: -0.46%

The WisdomTree Indexes entered 2018 with 0.92% in the stock, about 88 bps more than the company's near-zero weight in MSCI EAFE. It closed 2017 at ¥517 but ended the year down about half, at ¥274. The company was beset by Altaba's selling down of its one-third stake.

ROA is 6.0%, ROE is 13.6% and the dividend yield is 3.2%. It trades for 13x forward earnings.

COUNTRY EXPOSURES

During the year, our Indexes averaged more than 21% in U.K. equities, about 6% more than the allocation in MSCI EAFE. Our holdings in the country witnessed a weighted-average loss of 11.3%, while MSCI EAFE's U.K. exposures were off 6.7%. We also had a rough run in Switzerland, not because we had an inordinate allocation to the country but because the stocks selected there were by-and-large poor performers relative to MSCI EAFE's Swiss mix.

France was a positive for WisdomTree. The ROA screen kept us out of Société Générale and BNP Paribas, which were each off more than a third given the view that European investment banking cannot compete with American peers. The same concept applied in the German banking system too, where our Index fortunately passed over Deutsche Bank and Commerzbank, among others.

OF INTEREST TO CANADIANS

We often point out to Canadians specifically that the combination of ROA, ROE and projected earnings growth screens have been shunning energy, financials and basic materials in recent years. This phenomenon occurs in our Canadian, U.S. and international ex-North America screens.

Consider the implications for anyone sitting on sizeable capital gains in RBC, TD, BMO, Bank of Nova Scotia or CIBC stock. Or, for that matter, consider the implications for anyone holding mainstream Canadian equity mutual funds, which tend to be dominated by those very companies, plus Enbridge, Suncor, TransCanada and the rest.

Does someone who is heavily invested in RBC and TD really need a large slug of more banks? The WisdomTree Indexes had average financials exposure of just 3.6% last year; in MSCI EAFE the average is north of 20%. Also, energy was barely 1% of our Indexes while it was 5.8% of the cap-weighted index. At 4.7% of the WisdomTree Indexes, basic materials was the closest to the market's overall 8% weight.

Last year, the sector that helped the WisdomTree Indexes the most was financials because it provided a double benefit: the sector was underweighted in a year that it was punished and its component stocks also declined by a smaller order of magnitude than those in the cap-weighted index. Our basic materials exposures were marginally accretive relative to MSCI EAFE, while energy was a hindrance because the sector had a better year, avoiding the come-apart that befell groups like tech and consumer discretionary in Q4.

DQI'S VARIABLE HEDGE

While many ETF firms offer foreign equities in unhedged or hedged currency forms, DQI, our variably-hedged ETF, falls somewhere in between.

DQI had a disappointing whipsaw year, where its performance was lower than both the hedged and unhedged strategies. Let's review how the variable currency hedge works and why that happened.

It uses three investment metrics:

1) **Purchasing power parity (PPP) valuation,** the concept that says goods and services should cost the same in EUR in Frankfurt or JPY in Tokyo as they do in CAD in Toronto.
2) **Interest rate differentials** between foreign currency bonds and CAD bonds, with lower yields signaling currencies that should be hedged.
3) **Momentum,** as gauged by the interaction of a short- and long-term moving average.

Using the Swiss franc (CHF) as an example, the metrics identify:

+ An expensive CHF vs. CAD—Valuation signal says **hedge CHF**
+ CHF short-term rates < CAD rates—Interest rate signal says **hedge CHF**
+ CHF trending higher vs. CAD—Momentum signal says **don't hedge CHF**

Two out of three said to currency-hedge, so 66.6% of the Index's CHF exposure gets the hedge. Rebalanced monthly, the ratio drifts as currencies advance and decline. Investors can see each currency's up-to-date hedge ratio on the website. In the case of CHF, its 68.45% hedge ratio is a couple of percentage points above 66.6%, due to market activity.

Because there are three metrics—interest rates, momentum and PPP (with the latter able to have a "half-way" reading of 16.67% when the metric is neutral)—possible hedge weights are 0%, 16.7%, 33.3%, 50%, 66.7%, 83.3% or 100%.

Figure 2 shows the aggregate hedge ratios that our models identified each month in 2018.

FIGURE 2: WisdomTree Hedge Ratios vs. CAD

Effective Date	AUD	CHF	DKK	EUR	GBP	HKD	ILS	JPY	NOK	NZD	SEK	SGD
2-Jan-18	66.67%	100.00%	50.00%	50.00%	50.00%	50.00%	50.00%	83.33%	100.00%	50.00%	50.00%	50.00%
1-Feb-18	66.67%	100.00%	50.00%	50.00%	50.00%	50.00%	50.00%	83.33%	66.67%	50.00%	50.00%	50.00%
1-Mar-18	66.67%	66.67%	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%	66.67%	16.67%	50.00%	50.00%
2-Apr-18	33.33%	66.67%	50.00%	50.00%	50.00%	16.67%	50.00%	50.00%	66.67%	16.67%	50.00%	50.00%
1-May-18	66.67%	100.00%	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%	66.67%	16.67%	83.33%	50.00%
1-Jun-18	66.67%	100.00%	83.33%	83.33%	50.00%	16.67%	50.00%	50.00%	66.67%	50.00%	83.33%	50.00%
2-Jul-18	66.67%	66.67%	50.00%	50.00%	50.00%	16.67%	50.00%	50.00%	66.67%	16.67%	83.33%	50.00%
1-Aug-18	66.67%	66.67%	50.00%	50.00%	50.00%	16.67%	50.00%	50.00%	66.67%	50.00%	83.33%	50.00%
3-Sep-18	66.67%	66.67%	83.33%	83.33%	83.33%	16.67%	50.00%	50.00%	100.00%	50.00%	83.33%	50.00%
1-Oct-18	66.67%	66.67%	83.33%	83.33%	83.33%	16.67%	50.00%	83.33%	100.00%	50.00%	83.33%	50.00%
1-Nov-18	66.67%	100.00%	83.33%	83.33%	83.33%	16.67%	50.00%	83.33%	100.00%	50.00%	83.33%	50.00%
3-Dec-18	66.67%	66.67%	83.33%	83.33%	83.33%	16.67%	50.00%	83.33%	100.00%	16.67%	83.33%	50.00%

Sources: WisdomTree, Record Currency Management.

Most foreign currencies were hedged considerably in 2018. Why? Let's go through the three metrics.

The first metric is PPP, the valuation signal. Interestingly, all of the PPP signals we are generating today are the same as they were in January 2018, because, of the three metrics, this is the one that changes with the least frequency.

The three most expensive currencies, as identified last year by the OECD's measures of valuation, were the Australian dollar (AUD), Swiss franc (CHF) and Norwegian krone (NOK). The PPP signal says to hedge expensive currencies. Here is how those currencies performed relative to CAD in 2018, with all numerical amounts in Canadian dollars.

AUD: CAD appreciated from $0.982 to $0.961

CHF: CAD depreciated from $1.290 to $1.388

NOK: CAD depreciated from $0.1533 to $0.1578

AUD and NOK didn't move much, but CHF appreciated considerably.

The second metric is interest rate differentials. Recall that at the beginning of the year, the Bank of Canada's policy rate was 1.0%, on its way to the current 1.75%. Relative to most other developed economy central banks, this put the two North American economies' short-term rates higher than most others, many of whom still had (and have) policy rates that are zero or negative. Aside from the Antipodean nations, every currency received the "go hedge" signal on the interest rate metric. That will always be the case when CAD short rates are higher than another currency's short rates.

Historically, higher-yielding developed economy currencies have tended to appreciate against lower-yielding ones. It doesn't work every year; 2018 was one of those years.

Finally, we come to the third metric, momentum. In a recent whitepaper, Japan: Canada's Alter Ego, we identified CAD as the most economically-exposed of the G7 currencies, the one that is likely to appreciate the most when global growth is synchronized and decline the most when fear besets the market.

But think about how ever-changing investor sentiment was in 2018—the beginning of the year was characterized by relentlessly higher stock markets, followed by a mini-panic in February, a generally constructive environment for risk-taking in spring and summer, and finally, a collapse at the end of the year.

Such markets, where sentiment swings to and fro, is not conducive to momentum strategies.

Figure 3 shows the momentum signals (which are one-third of our input) that were generated for the various currencies relative to CAD. Notice that by August and September, generally subdued volatility and profitable stock markets had CAD appreciating relative to most of the other currencies, causing nearly every foreign currency to generate a negative momentum signal (orange). But that is almost exactly the moment that CAD turned and fell against many of them amid the market's comeuppance that began September 20.

FIGURE 3: WisdomTree Momentum Signal vs. CAD (0% = Don't Hedge, 33.33% = Hedge)

Effective Date	AUD	CHF	DKK	EUR	GBP	JPY	NOK	NZD	SEK
2-Jan-18	33.33%	33.33%	0.00%	0.00%	0.00%	33.33%	33.33%	33.33%	0.00%
1-Feb-18	33.33%	33.33%	0.00%	0.00%	0.00%	33.33%	0.00%	33.33%	0.00%
1-Mar-18	33.33%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
2-Apr-18	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
1-May-18	33.33%	33.33%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	33.33%
1-Jun-18	33.33%	33.33%	33.33%	33.33%	0.00%	0.00%	0.00%	33.33%	33.33%
2-Jul-18	33.33%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	33.33%
1-Aug-18	33.33%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	33.33%	33.33%
3-Sep-18	33.33%	0.00%	33.33%	33.33%	33.33%	0.00%	33.33%	33.33%	33.33%
1-Oct-18	33.33%	0.00%	33.33%	33.33%	33.33%	33.33%	33.33%	33.33%	33.33%
1-Nov-18	33.33%	33.33%	33.33%	33.33%	33.33%	33.33%	33.33%	33.33%	33.33%
3-Dec-18	33.33%	0.00%	33.33%	33.33%	33.33%	33.33%	33.33%	0.00%	33.33%

Sources: WisdomTree, Record Currency Management.

Here is how CAD performed for the year relative to the three major currencies, all of which had aggregate hedge ratios of 50% or 83.33% at various points in 2018. They all rallied against CAD.

JPY: CAD depreciated from ¥89.66 to ¥80.41

EUR: CAD depreciated from $1.509 to $1.564

GBP: CAD depreciated from $1.699 to $1.740

No metric is foolproof, but consider the methodology we are employing: a model that says hedge expensive currencies, hedge currencies that offer paltry yields and hedge currencies that are in a state of decline. Philosophically, we are very comfortable with the currency logic of DQI.

INTERNATIONAL QUALITY DIVIDEND GROWTH POSITIONING

Heading into 2019, our strategies' notable sector overweights relative to MSCI EAFE include consumer discretionary (18.2% vs. 11.2%), health care (18.6% vs. 11.3%) and industrials (20.0% vs. 14.3%). The large underweights are in energy (1.7% vs. 5.9%), financials (3.8% vs. 19.4%) and utilities (0.0% vs. 3.8%).

Geographically, take note of countries in Scandinavia this year. Danish stocks are 10.6% of the WisdomTree mix, while they are 1.8% of MSCI EAFE. Also overweight are Sweden (5.7% vs. 2.4%) and Norway (2.1% vs. 0.7%). In Western Europe, the U.K. is also overweighted (20.0% vs. 14.8%), meaning the portfolio would seemingly benefit from a Brexit resolution, while it would suffer if the drama continues.

For DQI (the one with the variable currency hedge), the heavily or completely hedged currencies in early 2019 are the Norwegian krone, Swedish krona, U.K. pound, Swiss franc and Australian dollar. Every other currency is near the 50% "half hedge," with the exception of the Hong Kong dollar, which has drifted from the 16.67% hedge ratio to 18.18%. In other words, the metrics are generally bearish on most developed currencies relative to CAD this year too. If they fall as a group, that would help our strategy, while CAD weakness would have the opposite effect.

Unless referencing year-end 2018, all figures herein refer to data as of 1/3/19. Also, all performance references, unless referencing currency-hedged or Variably Hedged™ mandates, apply to the WisdomTree International Quality Dividend Growth Index CAD and MSCI EAFE Index CAD. Data from Bloomberg.

MSCI EAFE Index: is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan. MSCI EAFE Financials Index: captures large- and mid-cap representation across 21 of 23 developed markets countries around the world, excluding the U.S. and Canada. All securities in the index are classified in the financials sector as per the Global Industry Classification Standard.