WisdomTree
RESEARCH

DGRC: APPLES-TO-APPLES, A TRUE CANADIAN CORE ETF

Authored by: Jeff Weniger (CFA®, Director, Asset Allocation)

It has become popular in recent years to talk of "disruption." Ride-sharing apps are "disrupting" the taxi industry, Amazon is "disrupting" traditional bricks-and-mortar retailing and so on. In our business, market capitalization-weighted[1] index funds have been taking assets from active money managers for decades. Disrupting them.

They better not get too comfortable; firms like WisdomTree are directly challenging them by self-indexing[2] in a way that emphasizes company fundamentals, not market valuation. DGRC, the ETF that tracks the WisdomTree Canada Quality Dividend Growth Index (Bloomberg: WTCDG), attacks the unsettling notion that "the market" should be defined by stock market capitalization.

The coming years will witness the "active versus passive management"[3] debate shift to a "passive versus passive" focus, with self-indexed Modern Alpha™ strategies offered by firms like WisdomTree duking it out against the old line index trackers. For those who study the decades of evidence showing that various Modern Alpha factors make a ton of sense relative to cap-weighting strategies[4], DGRC represents the single line item for an entire Canadian equity portfolio.

The WisdomTree Canada Quality Dividend Growth Index (WTCDG) makes its selections by screening for stocks that rank highly on return on equity (ROE), return on assets (ROA) and prospective earnings growth. After the stocks are selected, WisdomTree weights that list of companies by the dollar amount of their dividends. If all Canadian companies pay out, say, $50 billion in total dividends and "XYZ Corporation" pays out $1 billion of that total, it will be 2% of our Index[5]. For Canadian equities specifically, the Index's stock screen currently draws a line in the sand in cap weighting's grievous fault, the one that has trackers of the MSCI Canada Index[6] owning 39.4% and 20.5% in the financials and energy sectors, respectively.[7]

Further, because WisdomTree Indexes keenly focus on fundamentals with full transparency, we dig here into the underlying holdings of WTCDG and MSCI Canada to make an apples-to-apples comparison.

[1] Market capitalization-weighting: Market cap = share price x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.
[2] Self-indexing: An ETF strategy that entails tracking an index that was created by the ETF company itself instead of an outside index provider.
[3] Active: Funds that attempt to outperform the market by selecting securities a portfolio manager believes to be the best. Passive: Passive indexes take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.
[4] For example, Wharton Professor Jeremy Siegel, Senior Strategy Advisor to WisdomTree, found in *The Future for Investors* that from 1957 to 2016, the highest-yielding quintile of stocks outperformed the broad market by 230 bps per annum. The research was originally published in 2005, with updates to 2016.
[5] WTCDG and DGRC are rebalanced quarterly.
[6] MSCI Canada Index: A capitalization-weighted index that tracks the broad Canadian equity market.
[7] Source: WisdomTree and MSCI. Data as of 1/17/19

APPLES TO APPLES

To get started, consider the hypothetical example in figure 1, which shows two different indexes in a three-sector economy. The "Old Benchmark" is lucky; it has 40% of its exposure in an ostensibly cheap sector. That anchors the index price-to-earnings ratio (P/E)[8] at 14.5, even though two out of three sectors have P/Es higher than that. In contrast, the "Disrupting Benchmark" sectors trade at the exact same valuations as those of the Old Benchmark, but its sector weights are evenly balanced.

The result: the headline P/E ratio is higher for the Disrupting Benchmark, even though sector-level fundamentals are the same. Simple stuff, yes, but the fact that the arithmetic thus favours the Old Benchmark is not part of the thought process for many investors. A lot of people do just look at the headline P/E—but self-trickery can be costly.

Figure 1: The Misleading Nature of Headline Valuation Figures

			Price/Earnings Ratio	Contribution to Index P/E	Sector Growth Prospects
Old Benchmark	Sector 1	40%	10	4.0	Low
	Sector 2	30%	15	4.5	Medium
	Sector 3	30%	20	6.0	High
	Index P/E			14.5	
			Price/Earnings Ratio	**Contribution to Index P/E**	**Sector Growth Prospects**
Disrupting Benchmark	Sector 1	33.3%	10	3.3	Low
	Sector 2	33.3%	15	5.0	Medium
	Sector 3	33.3%	20	6.7	High
	Index P/E			15.0	

Source: WisdomTree. Exhibit is a hypothetical illustration.

The truth is that, knowing nothing else beyond figure 1, the prudent investor would be well-advised to choose the Disrupting Benchmark for diversification. Yet in the real world, it doesn't work that way, does it? Many Canadians continue to refer to indexes like MSCI Canada and the S&P/TSX Composite[9] despite the drastic company-specific and sector-level concentrations inherent in them.

It's time for that to stop.

SECTOR BY SECTOR

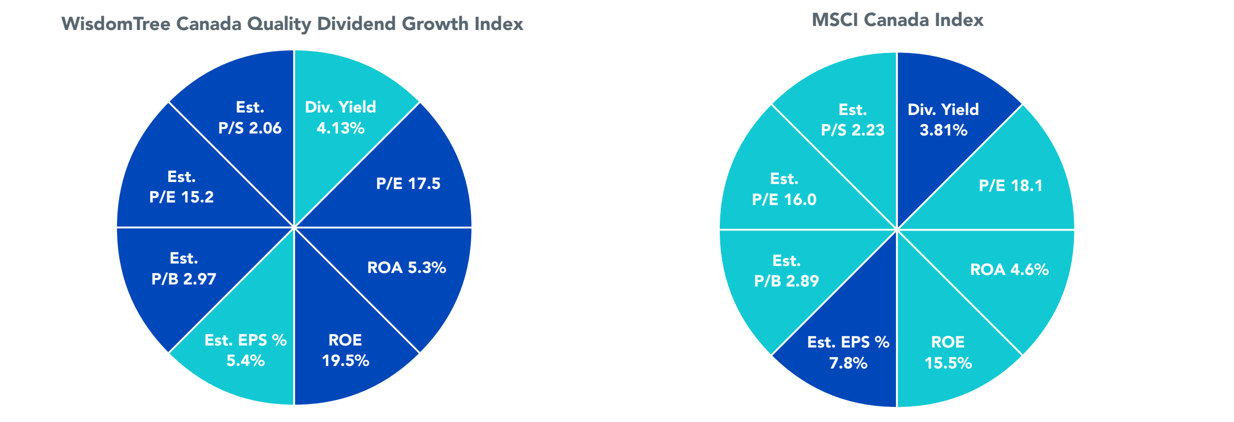
With nearly $2 of every $5 in the MSCI Canada Index tracking just financials, any index like WisdomTree's that has designs on knocking MSCI off its perch will run into a key roadblock: MSCI's financial sector trades at 10.0 times forward earnings and has a dividend yield of 3.9%. Its inclusion, especially when done in considerable size, pulls the index-level P/E down and the dividend yield up, making the index look more appealing than may truly be the case.[10]

[8] Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.
[9] S&P/TSX Composite Index: A capitalization-weighted index designed to measure market activity of stocks listed on the Toronto Stock Exchange (TSX).
[10] Source: Bloomberg.

See what happens? If another index has "only" 30% or, in our case, "only" 19.2% in financials, some investors will just look at headline fundamentals and incorrectly conclude that the MSCI Canada Index or some closet index-tracking mutual fund[11] is being accorded a satisfactory valuation.

Figure 2 shows the fundamentals[12] at the headline level, with dark blue/teal shading to reflect favourable/less favourable dynamics. WisdomTree still wins on 6 of 8 metrics, even before accounting for each index's unique sector weights.

Figure 2: WTCDG vs. MSCI Canada Index Fundamental Metrics



Sources: WisdomTree, Bloomberg. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change.

As we will soon see, WisdomTree's index gets the best of MSCI at the sector level too, demonstrating the consistency of the screen's methodology.

[11] Closet index-tracking mutual fund: A fund that is actively managed but has holdings that do not materially differ from its benchmark.

[12] Estimated price-to-sales (P/S) ratio: Bloomberg estimate of forward 12-month share price divided by per-share revenue. Dividend yield: A financial ratio that shows how much a company pays out in dividends each year relative to its share price. Estimated P/E ratio: Bloomberg consensus for next four quarters of the share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested. P/E ratio: The trailing four-quarter result for that ratio. Return on assets (ROA): Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them. Return on equity (ROE): Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. Est EPS %: Bloomberg estimate of earnings-per-share growth in the next four quarters. Estimated price to book: Bloomberg estimate of the share price divided by book value per share for the next four quarters. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

MSCI'S "11" SECTORS

The MSCI Canada Index technically has exposure to 11 sectors. Technically.

But "exposure" is in the eye of the beholder. The truth is that four sectors (financials, energy, basic materials and industrials) make up 79% of the index. Investors may wonder why a major, commonly followed index that tracks stocks in a G7[13] economy can only cobble together 21% in communication services, consumer discretionary, consumer staples, technology, utilities, real estate and healthcare—combined. We have been wondering the same.

Call it what it is: a flaw in index construction, a flaw in our industry's way of thinking, a flaw in the way the false idol of market capitalization has been sold to investors as the end-all and be-all for core beta exposures. It's a dangerous game, and it is perpetuated daily by our industry's rigid thinking.

Canada as a nation doesn't have a problem with bank dominance or oil and gas dominance; the truth is that most people do not punch a timecard in those two sectors. But the stock market: that's a different story. Most Canadians, from the largest pension funds down to individuals, invest in the banks and the oil companies, and heavily. The problem lies not in Canada, but in the money management industry. It lies in how the status quo defines the "broad market" and how society has been herded into the same top-heavy investment strategies by the army of market cap-weighting theologians.

SOLVING THE PROBLEM: A SECTOR LOOK-THROUGH

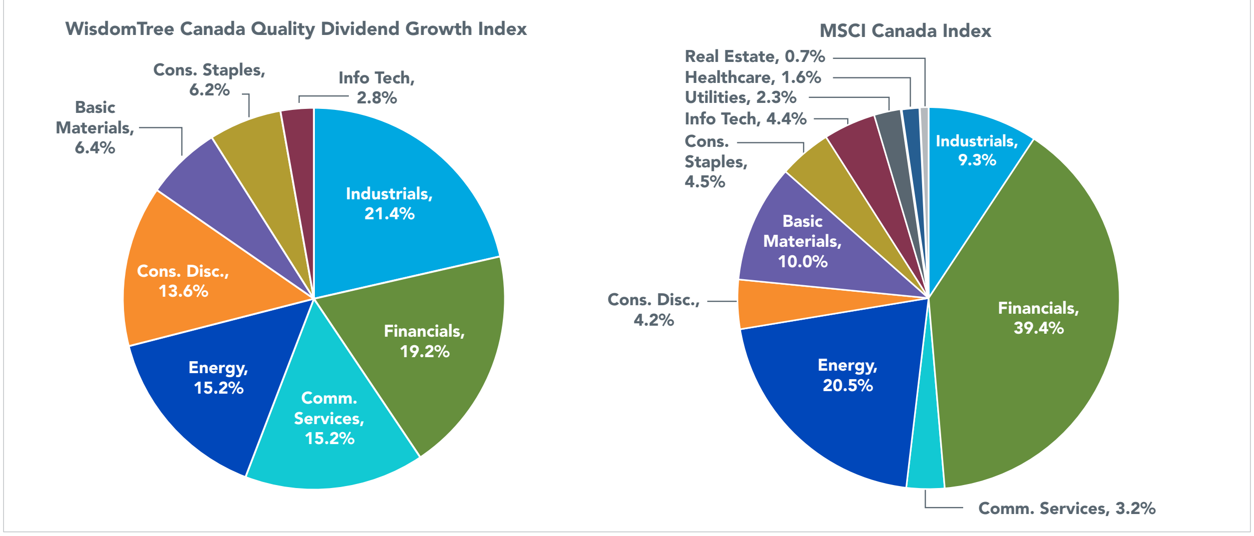
Nothing in the WisdomTree Canada Quality Dividend Growth Index's methodology has anything to do with market capitalization weighting. That's fortunate, because about 1/12th of MSCI Canada is in RBC alone. In indexes such as the large-cap S&P/TSX 60 Index[14], a company like RBC's weight is even higher, pushing near double digits as a percentage of the index. An example for perspective: Apple is about 3% of the S&P 500.[15]

In contrast to the methodologies of the common MSCI and S&P Indexes, the WisdomTree process has exposure—real, tangible, manageable exposure—in eight sectors, each with a weight that currently ranges from 3% to 21% of the total.[16]

Figure 3 shows the diversified nature of the sector mix in WTCDG relative to the painfully concentrated status quo.

[13] G7: The Group of Seven industrialized nations (Canada, the U.S., the UK, Germany, France, Italy and Japan).
[14] S&P/TSX 60 Index: A market capitalization-weighted index of the 60 largest Canadian companies.
[15] Source: Bloomberg.
[16] Sector exposures and weights will vary from current levels.

Figure 3: Sector Composition, WTCDG vs. MSCI Canada



Source: Bloomberg, WisdomTree. You cannot invest directly in an index. Subject to change.

The differences are stark. One represents the country we know and recognize, with a diverse group of classic Canadian firms. WTCDG currently counts as major components firms like Magna, Canadian National Railway, Sun Life and Rogers. It's a breath of fresh air from the tiring year-after-year stacking of RBC, TD, BMO, Suncor and Enbridge in the Top 10 lists of seemingly every Canadian equity mutual fund.

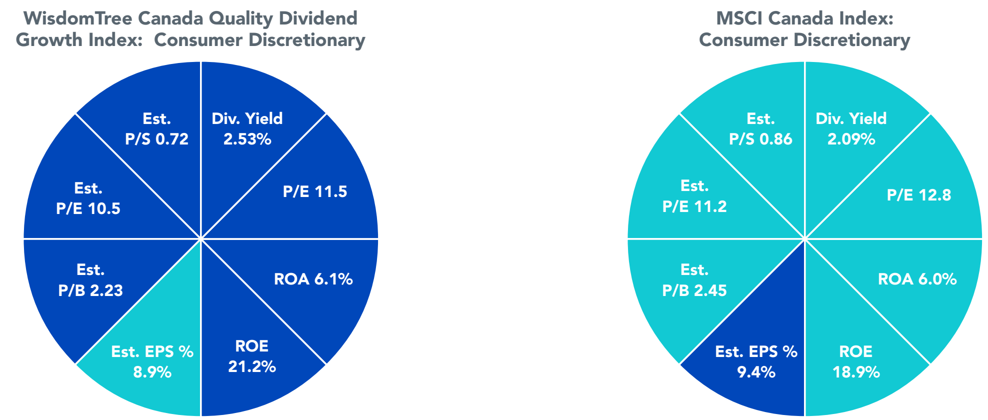
If money managers wish to be commoditized, the status quo will do them in as sure as day follows night. That's why WisdomTree is upending the system, thinking logically about sleep-at-night strategies, not perpetuating foolhardy hyper-concentration.

BREAKING IT DOWN, SECTOR BY SECTOR

When we compare WTCDG and the MSCI Canada Index in the eight sectors that WTCDG currently tracks, we see that the fundamental metrics we discussed above—estimated price to sales, dividend yield, P/E ratios, estimated price to book, estimated earnings per share, return on equity and return on assets—tilt favourably to companies identified by WisdomTree's fundamental process.

Figure 4 shows the first of the head-to head sector matchups. Discretionary, which constitutes 13.6% of our Index and 4.2% of theirs, stacks up "dark blue" for WisdomTree on seven of eight metrics.

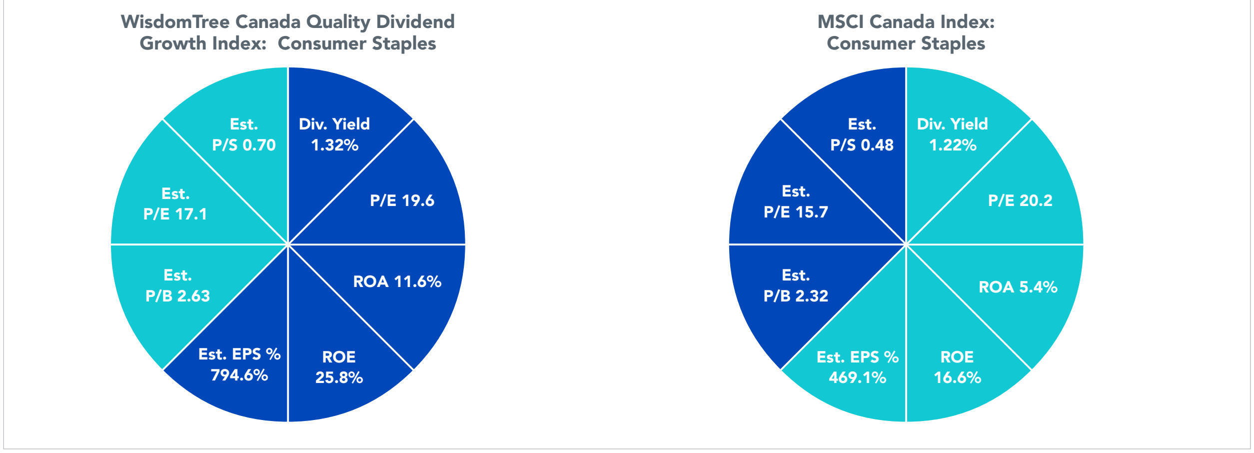
Figure 4: WTCDG Consumer Discretionary vs. MSCI Canada Consumer Discretionary



Sources: WisdomTree, Bloomberg. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change.

Next in line is consumer staples. WisdomTree's metrics are better on five of the eight metrics (figure 5).

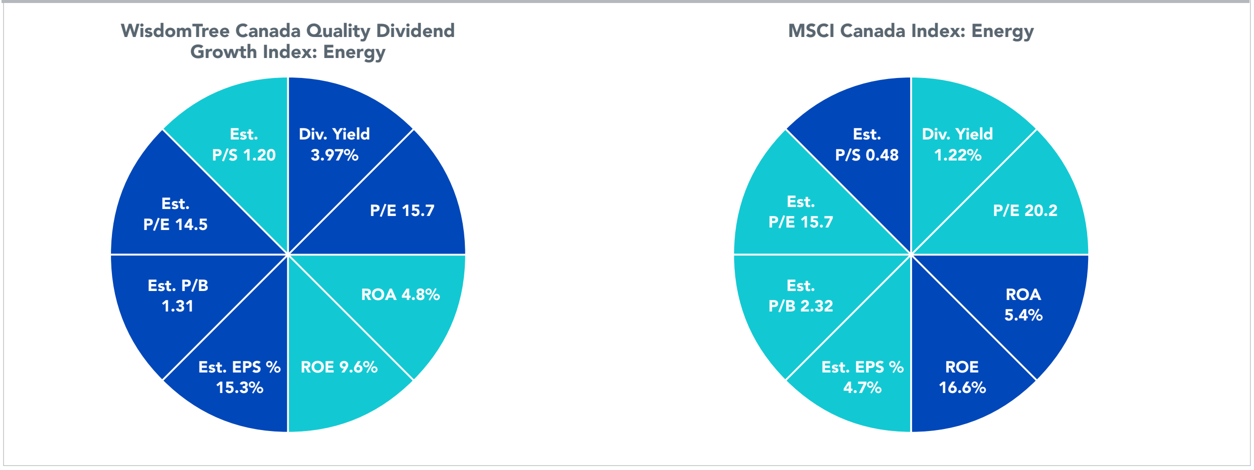
Figure 5: WTCDG Consumer Staples vs. MSCI Canada Consumer Staples



Sources: WisdomTree, Bloomberg. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change.

Next, energy, important because it represents 20.5% of MSCI Canada. Our holdings register more favourable on five of eight metrics here.

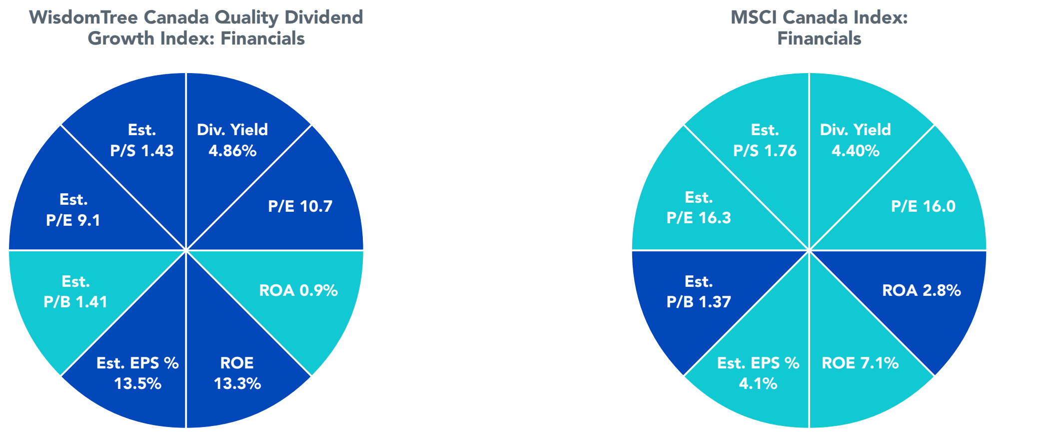
Figure 6: WTCDG Energy vs. MSCI Canada Energy



Sources: WisdomTree, Bloomberg. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change.

Now, financials, which is a 6-2 victory for WisdomTree. The WisdomTree holdings show up as being more expensive on estimated price-to-book but they are at a considerable price-to-earnings discount. Note that we have the lower P/E even though our index has none of the Big Five banks, all of which are trading for less than 11x earnings (figure 7).

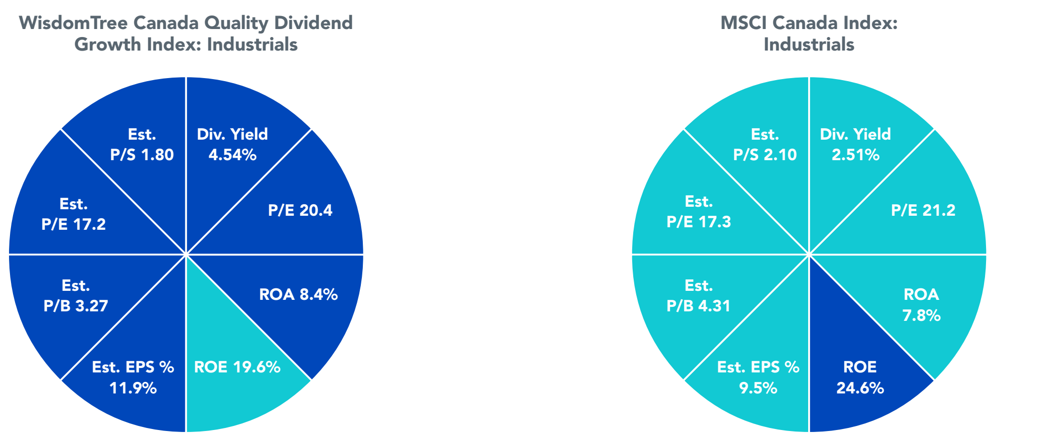
Figure 7: WTCDG Financials vs. MSCI Canada Financials



Sources: WisdomTree, Bloomberg. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change

Industrials represents more than 21% of WTCDG and 9% of the MSCI Canada index. WisdomTree wins on seven of eight metrics in this sector (figure 8).

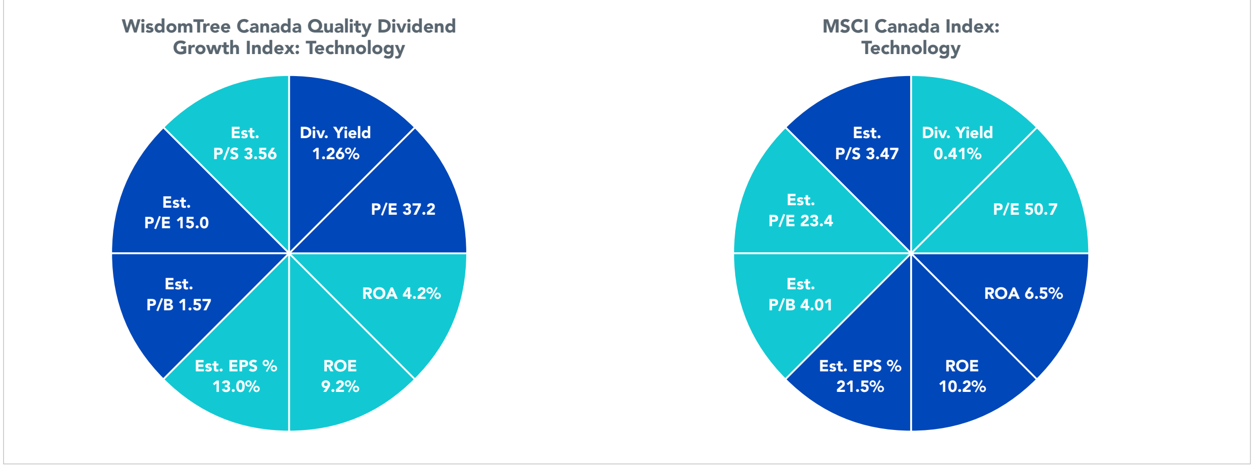
Figure 8: WTCDG Industrials vs. MSCI Canada Industrials



Sources: WisdomTree, Bloomberg. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change

Technology is a tiny index in this country. WTCDG has a less than 3% in the sector, while it is 4.4% of MSCI Canada. This sector is a rare example of a metrics "score" that is a draw.

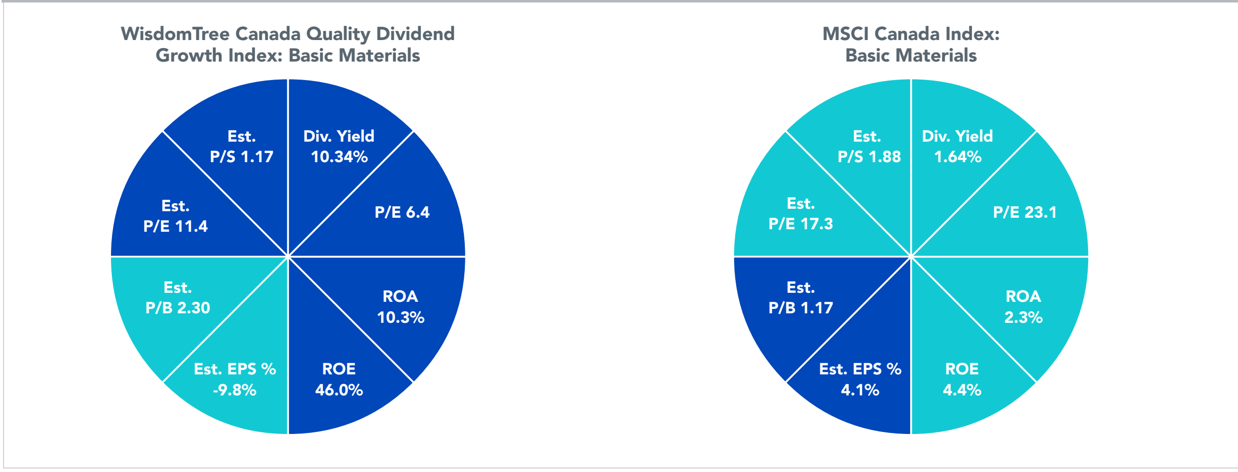
Figure 9: WTCDG Technology vs. MSCI Canada Technology



Sources: WisdomTree, Bloomberg. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change.

Nearing the end of our exercise, basic materials. This is another one with a 6-2 "score."

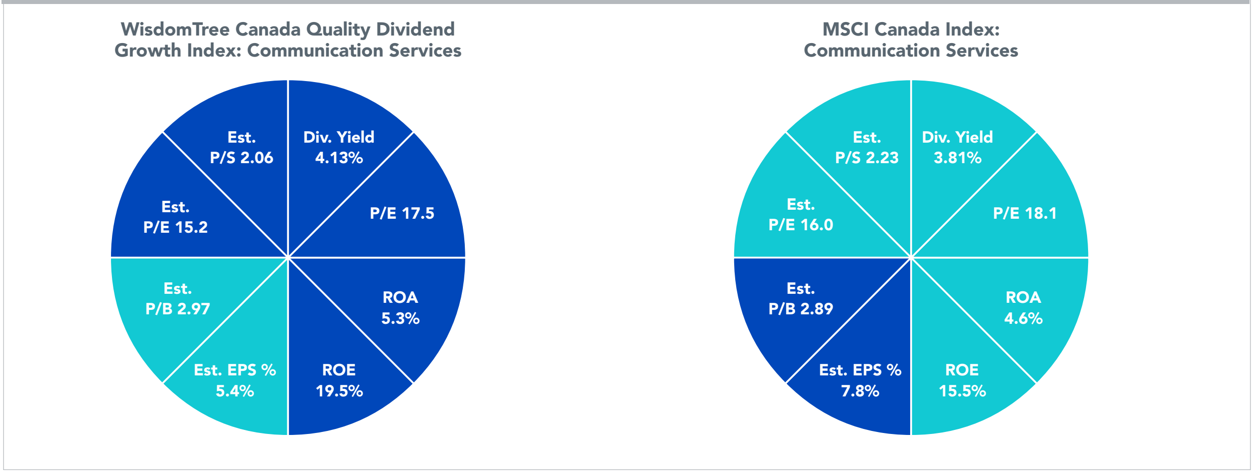
Figure 10: WTCDG Basic Materials vs. MSCI Canada Basic Materials



Sources: WisdomTree, Bloomberg. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change.

Last but not least is communication services. This sector represents just 3.2% of MSCI Canada but 15.2% of the WTCDG. Again, more dark blue pie slices for WTCDG than MSCI Canada.

Figure 11: WTCDG Communication Services vs. MSCI Communication Services



Sources: WisdomTree, Bloomberg. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change.

The lopsided metric-by-metric matchups are summarized in figure 12. At both the headline index level and the sector level, WisdomTree trumped MSCI on the majority of the metrics, winning in every sector except the one that was a tie.

The median result was the WisdomTree sector holdings winning by a score of 6 to 2; the average was 5.75 to 2.25.

The veil is lifted.

Figure 12: Summary of Sector Head-to-Head Matchups

	WTCDG	MSCI	"Winner"
Total Portfolio	7	1	WTCDG
Cons. Disc.	7	1	WTCDG
Cons. Staples	5	3	WTCDG
Energy	5	3	WTCDG
Financials	6	2	WTCDG
Industrials	7	1	WTCDG
Info Tech	4	4	=
Basic Materials	6	2	WTCDG
Communication Services	6	2	WTCDG
Sector Median	6.0	2.0	WTCDG
Sector Average	5.8	2.3	WTCDG

Sources: WisdomTree, Bloomberg. Scores represent the number of fundamental metrics that favoured one index relative to the other, using the eight metrics listed earlier in this report. You cannot invest directly in an index.

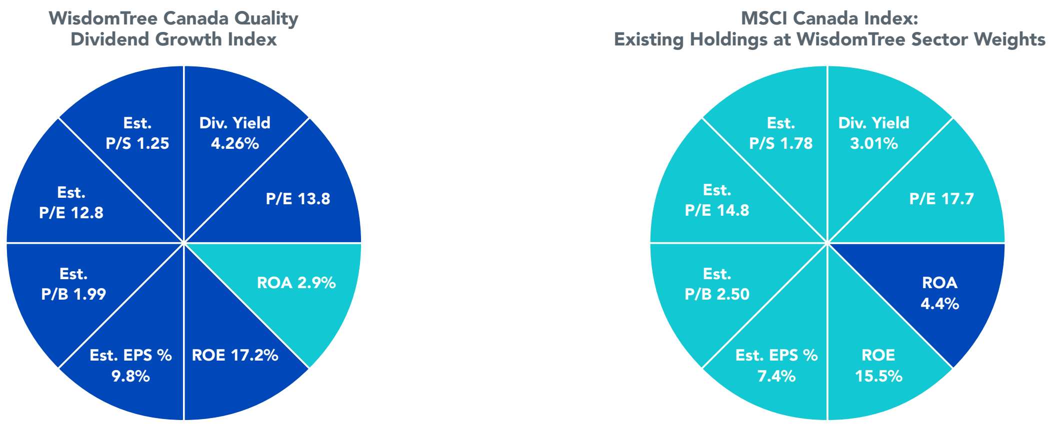
THE PORTRAIT OF MSCI CANADA IF IT WERE SECTOR DIVERSIFIED

This exercise brings us to the next logical inquiry: What would MSCI Canada look like if the holdings remained the same but the *sector weights were the same as WTCDG*? For example, what if MSCI Canada held the exact same banks that it owns now, in the same proportion to each other, but the sum of its financial company stocks were not so dominating?

What happens is the game changes.

This is the deep apples-to-apples comparison that must be assessed—and WisdomTree's diversified Canadian core Index wins on seven of the eight metrics when we equalize for sector weights too.

Figure 13: WTCDG vs. MSCI Canada Using WisdomTree Sector Weights



Source: WisdomTree, Bloomberg. MSCI Canada using WisdomTree sector weights reconfigures the Index so that the same companies remain held in their existing intra-sector proportions, but the sector weights themselves are equal to WTCDG's weights. For example, energy constitutes 20.5% of MSCI Canada and 15.2% of WTCDG, so MSCI's energy proportion in this exercise would be equal to the WisdomTree weight of 15.2%. Dark blue = more favourable than other index; teal = less favourable. You cannot invest directly in an index. Subject to change.

A THOUGHTFUL APPROACH TO CANADIAN EQUITIES

Canada is so much more than big banks and oil companies, yet who would know it by looking at this country's legacy mutual fund businesses? While passive managers tracking top-heavy cap-weighted indexes are loaded with the banks and energy companies, many so-called "active managers" hold the exact same companies in their funds, frightened into closet tracking the mainstream benchmarks because of career risk.

DGRC, the WisdomTree Canada Quality Dividend Growth Index ETF, which tracks WTCDG, can be used in place of cap-weighted index trackers and any active managers that are out there charging large fees for the tedious uniformity of Canadian sector hyper-concentration.

WisdomTree is doing things differently. We are looking across the Canadian market and putting together indexes that make sense fundamentally, which is why people get into this business in the first place. This is the logical direction for core equity investing in the coming decades.

Unless otherwise stated, all data in this report as of 01/17/19.

The WisdomTree ETFs listed on the Toronto Stock Exchange are managed by WisdomTree Asset Management Canada, Inc. Commissions, management fees and expenses all may be associated with investing in WisdomTree ETFs. Please read the relevant prospectus, which is available at www.wisdomtree.com, before investing. WisdomTree ETFs are not guaranteed; their values change frequently, and past performance may not be repeated. Nothing in any commentary should be considered a recommendation to buy or sell a particular security. Tax, investment and all other decisions should be made, as appropriate, only with guidance from a qualified professional.

Publication date: 3/13/2019