

## The Importance of Dividends & Buybacks<sup>1</sup> Ratios for Gauging Equity Value **BY JEREMY SCHWARTZ**

Analysts who are the most bearish on the U.S. equity markets point to expensive valuation ratios on the S&P 500, notably the dividend yield,<sup>2</sup> being considerably below its long-term average. John P. Hussman, Ph.D., is well known for being in this bearish camp. Summarizing his case for the U.S. equity market Hussman wrote:

*Over the past 13 years, the total return for the S&P 500 [Index] has averaged just 3.23%. Why have stocks performed so poorly? One word. Valuation...*

*It is not a theory, but simple algebra, that the total return on the S&P 500 [Index] over any period of time can be accurately written in terms of its original [dividend] yield, its terminal [dividend] yield, and the growth rate of dividends.<sup>3</sup>*

Hussman then points out that the current dividend yield on the S&P 500 Index is just around 2%, when the average across time was considerably higher. Bob Shiller's research on the equity markets shows that from 1871 to 1982, the average dividend yield for the S&P 500 Index was above 5%.<sup>4</sup> Given that current dividend yields on the S&P 500 Index are well below that historical average, at face value, the bearish arguments may unwittingly scare investors out of the equity markets.

I believe Hussman's analysis fails to account for a critical market dynamic: share buybacks. Firms generally have three strategic ways they can utilize excess cash: firms can either pay dividends, engage in share buybacks, or use the cash for other investments, such as acquiring other companies. An increasing number of companies have opted to supplement their traditional dividend payments with share buybacks. In a share buyback, a company invests in itself by using cash to repurchase its shares from investors; this share buyback results in the company's reducing its shares outstanding. When one accounts for the combined cash that is being returned to shareholders from both share buybacks and dividends together, the market's valuation levels look more enticing.

### **DIVIDENDS OR BUYBACKS: WHAT'S THE DIFFERENCE?**

Firms have engaged in increased share buyback activity over recent years. While theoretically buybacks function in very similar ways as dividends as a method of returning cash to shareholders, there are some key differences between dividends and buybacks. The key differences include:

#### **+ Distribution of Cash**

**:: Dividends:** All shareholders of a firm receive dividends when they are distributed.

**:: Buybacks:** A select group of investors sells shares back to the company, either in the open market or during a period in which investors receive the option to sell all or a portion of their shares back to the company within a certain time frame, known as a "tender offer" period. Only those who elect to sell their shares back to the company during the buyback program receive cash, and there is risk that if investors defer selling to the future that stock prices will move lower.

<sup>1</sup> Share buybacks are defined as a company's using cash to repurchase shares from investors, thus reducing the company's shares outstanding.

<sup>2</sup> The dividend yield of the S&P 500 is defined as index dividends per share divided by index price.

<sup>3</sup> Hussman, John, "No Margin of Safety, No Room for Error," October 11, 2010. <http://www.hussmanfunds.com/wmc/wmc101011.htm>.

<sup>4</sup> Source: Robert Shiller. <http://www.econ.yale.edu/~shiller/>.

### + Timing of Benefit

:: **Dividends:** The benefit, or the cash received, from dividends occurs at the time the dividends are paid and therefore reflects a historical measure.

:: **Buybacks:** The benefit from share buybacks—a reduction in shares outstanding—is a benefit that applies to future distributions. Even though only a portion of shareholders sell their shares back to the company, the reduction in shares benefits all the remaining shareholders; the total future cash distributions by the firm are divided in the future amongst a smaller shareholder base.

### + Transparency

:: **Dividends:** Once firms state their intention to pay a regular dividend, the vast majority in the United States follow through with that commitment unless there is an extraordinary downturn in business prospects.

:: **Buybacks:** Firms announce plans to buy back stock that often are not carried through to execution.

In pure finance theory, when it comes to weighing the pros and cons of the features of dividends and buybacks outlined above, share repurchases are often a preferred method for returning cash to shareholders. Investors like share buybacks because they support higher stock prices<sup>5</sup> and one can choose the timing of share sales (and tax consequences) at a point in the future; dividends, by contrast, are taxed at time of distributions and the investor has no choice for when it receives the dividends.

In practice, however, firms do not consistently implement a share buyback program at the regular quarterly frequencies that firms pay cash dividends. On balance, whether firms use their cash for share buybacks or dividends, investors at worst should be indifferent and at best might prefer firms to undertake share buybacks. The key point to realize is that firms are distributing cash to shareholders by both dividends and share buybacks, and one must account for both of them when gauging the valuation levels of the market.

## **AGGREGATE U.S. SHARE BUYBACKS ARE NOW HIGHER THAN AGGREGATE U.S. DIVIDENDS**

In the United States, share buybacks have surpassed dividends in terms of aggregate distributions to shareholders. WisdomTree has two U.S. equity families. One family, the WisdomTree Earnings Indexes, is generally based on the profitable companies in the United States, and the other, the WisdomTree Dividend Indexes, is generally based on the dividend payers in the United States. Analysis of the buyback levels on these indexes reveal some key insights about what types of companies are issuing buybacks. This analysis is solely meant to be used as a commentary on how firms are distributing their cash to shareholders and the resulting implications for the overall valuation levels of WisdomTree's indexes and the markets covered by them.

+ **Dividend Stream:** The total aggregate dollar value of dividends paid for the WisdomTree Dividend Index as of December 2010, was \$247 billion.

+ **Buybacks:** The total aggregate share buybacks over the prior 12 months for the WisdomTree Earnings Index as of December 31, 2010 was \$306 billion, about 24% higher than its trailing 12-month dividend stream.

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<sup>5</sup> Share buybacks support higher prices because they reduce the shares outstanding for a company, and assuming the same total dividends or earnings, increase the per-share dividends or earnings of a firm. Assuming no change in the valuation ratios, the growth in per-share earnings or dividends should lead to a higher stock price.

- + The buybacks for the WisdomTree Dividend Index were \$240 billion, about \$66 billion below those of the WisdomTree Earnings Index. The higher level of buybacks for the Earnings Index is largely a result of technology companies preferring buybacks over dividends and the fact that technology stocks comprise the largest weight in the WisdomTree Earnings Index but are less represented in the WisdomTree Dividend Index. Technology sector companies comprised \$80 billion of the \$300 billion in buybacks from the Earnings Index total, or approximately 26%.

**DIVIDEND & BUYBACK RATIOS ON WISDOMTREE INDEXES** [ as of December 31, 2010 ]

U.S. Dividend Family	Inception Date	Trailing 12-Month Buybacks (billions)	Trailing 12-Month Dividends (billions)	Dividend Yield	Buyback Ratio	Dividend & Buyback Ratio	1-Year Return	Since Index Inception Return
<b>WisdomTree Dividend Index</b>	6/1/06	\$240.00	\$247.00	3.22%	2.06%	5.28%	17.31%	1.50%
<b>WisdomTree Equity Income Index</b>	6/1/06	\$47.00	\$122.00	4.35%	1.41%	5.76%	18.16%	-1.17%
<b>WisdomTree LargeCap Dividend Index</b>	6/1/06	\$218.00	\$211.00	3.14%	2.21%	5.36%	15.58%	1.03%
<b>WisdomTree MidCap Dividend Index</b>	6/1/06	\$17.00	\$26.00	3.50%	1.21%	4.71%	22.71%	3.02%
<b>WisdomTree SmallCap Dividend Index</b>	6/1/06	\$5.00	\$10.00	4.19%	1.00%	5.18%	27.23%	2.45%
<b>WisdomTree Dividend ex-Financials Index</b>	5/1/09	\$68.00	\$119.00	4.10%	1.66%	5.76%	22.01%	34.91%
U.S. Earnings Family	Inception Date	Trailing 12-Month Buybacks (billions)	Trailing 12-Month Dividends (billions)	Dividend Yield	Buyback Ratio	Dividend & Buyback Ratio	1-Year Return	Since Index Inception Return
<b>WisdomTree Earnings Index</b>	2/1/07	\$306.00	\$247.00	1.92%	2.47%	4.39%	14.95%	-0.41%
<b>WisdomTree Earnings 500 Index</b>	2/1/07	\$276.00	\$217.00	2.00%	2.57%	4.57%	13.60%	-1.00%
<b>WisdomTree MidCap Earnings Index</b>	2/1/07	\$23.00	\$22.00	1.36%	1.90%	3.26%	26.10%	4.24%
<b>WisdomTree SmallCap Earnings Index</b>	2/1/07	\$7.00	\$8.00	1.37%	1.48%	2.85%	26.60%	2.78%

Sources: WisdomTree, Bloomberg, S&P. Past performance does not guarantee future results. You cannot invest directly in an index. The Buyback Ratio is a market valuation measure used to gauge what percentage of index market value is being reduced by share buyback activity of firms. The Dividend & Buyback Ratio aggregates the dividends and buybacks together to represent a market valuation metric based on two common ways (dividends and buybacks) that firms distribute cash to shareholders.

Because share buybacks function largely in the same theoretical way of returning firm cash to shareholders as paying dividends, an evaluation of the market's valuation ratios more appropriately includes analysis of the dividend yield and share buyback ratios. The buyback ratio for the index is calculated in a similar fashion as a dividend yield is calculated.<sup>6</sup>

Key highlights of data as of December 31, 2010:

- + The buyback ratio of the WisdomTree Earnings Index at 2.47% is about 30% greater than its dividend yield of 1.9%, and when dividends and buybacks are added together, the combined dividend and buyback ratio is 4.4%.
- + By contrast, the dividend yield of the WisdomTree Dividend Index at 3.2% is more than 50% greater than its buyback ratio of 2.1%. When dividends and buybacks are added together, the combined dividend and buyback ratio is 5.3%.
- + By these measures, the combined dividend and buyback ratio of the WisdomTree Dividend Index, at above 5%, implies that valuation levels for WisdomTree's indexes are reasonably similar to the historical norms of the S&P 500 Index, when buybacks were much less common practice.
- + Small caps had lower buyback ratios than large caps. Both within the dividend weighted and earnings weighted index families, small caps had approximately one percentage point of lower buyback ratios compared to the large caps.

<sup>6</sup> The calculation aggregates buybacks per share times index shares divided by the index market value (price per share times index shares).

## **WHY IS ANALYSIS OF DIVIDEND & BUYBACK RATIOS RARE IN THE INDUSTRY?**

If the dividend and buyback data is so important for monitoring the valuation levels of the market, one might ask why it is not a more common practice among index data providers. The fact is that data on index level share buybacks activity is currently not widely available (aside from insightful analysis provided by Standard & Poor's on the S&P 500 Index). To combat this dearth of data availability, WisdomTree began collecting data as of the trailing 12 months for the 2010 year-end on share buyback activity across its global index family, starting to help give context for how dividend and buyback ratios range in various parts of the world and U.S. markets.

Some key takeaways from this global analysis (all data below as of the trailing 12-month period as of December 31, 2010):<sup>7</sup>

- + United States-based firms engaged in significantly more share buyback activity than foreign firms. The total global aggregate buybacks of the WisdomTree Global Dividend Index were \$282 billion, of which the United States firms represented 85% of all global share buybacks.
- + The WisdomTree Global Dividend Index had a buyback ratio of just 0.70% compared to 2% for the U.S. WisdomTree Dividend Index and 2.5% for the U.S. WisdomTree Earnings Index.
- + The emerging markets engaged in more share buybacks than foreign developed markets and displayed higher buyback ratios than foreign developed markets. The aggregate share buybacks of the WisdomTree Emerging Markets Dividend Index was \$26 billion, compared to just \$14 billion from the WisdomTree DEFA Index, which is a dividend-weighted index of the developed world dividend payers.
- + The combined dividend and buyback ratio across WisdomTree's four regional equity income indexes is remarkably similar, all within a range of 5.6% to 5.9%. The U.S. Equity Income Index had the lowest dividend yield of the group at 4.35%, but its buyback ratio was the highest at 1.41%, giving it a combined dividend and buyback ratio in the middle of the range of the various regions.
- + Within the small cap segment of the market, the U.S.-based dividend index had the highest combined dividend and buyback ratio, at 5.2%. The second highest dividend and buyback ratio was for the Emerging Market SmallCap Dividend Index, which was higher than the developed international and Europe SmallCap Dividend Index.

<sup>7</sup> Source: WisdomTree

**DIVIDEND & BUYBACK RATIOS ON WISDOMTREE INDEXES** [ as of December 31, 2010 ]

Regional Analysis	Inception Date	Trailing 12-Month Buybacks (billions)	Trailing 12-Month Dividends (billions)	Dividend Yield	Buyback Ratio	Dividend & Buyback Ratio	1-Year Return	Since Index Inception Return
<b>WisdomTree Global Dividend Index</b>	7/1/08	\$282.00	\$912.00	4.04%	0.70%	4.73%	11.60%	-0.41%
<b>WisdomTree Emerging Markets Dividend Index</b>	6/1/07	\$26.00	\$158.00	3.81%	0.46%	4.27%	23.37%	8.82%
<b>WisdomTree DEFA Index</b>	6/1/06	\$14.00	\$451.00	4.49%	0.08%	4.57%	4.31%	1.63%
<b>WisdomTree Dividend Index</b>	6/1/06	\$240.00	\$247.00	3.22%	2.06%	5.28%	17.31%	1.50%
Equity Income Indexes (High Dividend Yield Subset)	Inception Date	Trailing 12-Month Buybacks (billions)	Trailing 12-Month Dividends (billions)	Dividend Yield	Buyback Ratio	Dividend & Buyback Ratio	1-Year Return	Since Index Inception Return
<b>WisdomTree Emerging Markets Equity Income Index</b>	6/1/07	\$3.00	\$59.00	5.57%	0.32%	5.89%	24.92%	12.35%
<b>WisdomTree DEFA Equity Income Index</b>	6/1/06	\$4.00	\$268.00	5.67%	0.07%	5.74%	-1.54%	0.30%
<b>WisdomTree International Dividends ex-Financials Index</b>	5/1/09	\$1.00	\$154.00	5.50%	0.07%	5.57%	5.43%	26.76%
<b>WisdomTree Global Equity Income Index</b>	12/3/07	\$38.00	\$461.00	5.20%	0.35%	5.55%	6.52%	-7.14%
Small Cap Indexes	Inception Date	Trailing 12-Month Buybacks (billions)	Trailing 12-Month Dividends (billions)	Dividend Yield	Buyback Ratio	Dividend & Buyback Ratio	1-Year Return	Since Index Inception Return
<b>WisdomTree SmallCap Dividend Index</b>	6/1/06	\$5.00	\$10.00	4.19%	1.00%	5.18%	27.32%	2.45%
<b>WisdomTree Emerging Markets SmallCap Index</b>	8/1/07	\$0.60	\$19.00	4.36%	0.15%	4.51%	29.96%	8.51%
<b>WisdomTree International SmallCap Dividend Index</b>	6/1/06	\$1.60	\$29.00	4.27%	0.16%	4.42%	19.24%	3.59%
<b>WisdomTree Europe SmallCap Dividend Index</b>	6/1/06	\$0.10	\$8.00	4.03%	0.06%	4.09%	18.21%	1.19%
<b>WisdomTree SmallCap Earnings Index</b>	2/1/07	\$6.60	\$8.00	1.37%	1.48%	2.85%	26.60%	2.78%

Sources: WisdomTree, S&P, Bloomberg. Past performance does not guarantee future results.

The Buyback Ratio is a market valuation measure used to gauge what percentage of index market value is being reduced by share buyback activity of firms. The Dividend & Buyback Ratio aggregates the dividends and buybacks together to represent a market valuation metric based on two common ways (dividends and buybacks) that firms distribute cash to shareholders.

**HISTORICAL S&P 500 BUYBACK DATA**

Howard Silverblatt at Standard & Poor's publishes historical dividends and buyback data on the S&P 500 Index as far back as the last decade. As of December 31, 1999, buybacks had surpassed dividends but each was only slightly more than 1%, so the combined dividend and buyback ratio was just above 2%.

The collapse of the financial sector caused dividends to decline 20% from 2008 to 2010. Still, dividends increased cumulatively 45% over the last decade. Buybacks were more volatile than dividends over the decade but also increased significantly, and as of December 31, 2010, the S&P 500 Index level was still well below its 12/31/99 levels of 1469.

Because the prices were down and dividends and buybacks were each up significantly, the dividend and buyback ratios on the S&P 500 Index approximately doubled from 12/31/99 to 9/30/10. Note as of 12/31/08 the combined dividend and buyback ratio was over 7% and at the bottom of the market in March 2009, when the S&P 500 Index touched 666, the dividend and buyback ratio was over 10% of the index price.

## S&P 500, \$ U.S. BILLIONS

	Trailing 12 Months Data					Dividend & Buyback Ratio
	S&P 500 Index Price	Dividends (billions)	Buybacks (billions)	Dividend Yield	Buyback Ratio	
9/30/10	1141.20	\$200.02	\$260.27	1.94%	2.52%	4.45%
12/31/09	1115.10	\$195.61	\$137.64	1.97%	1.39%	3.36%
12/31/08	903.25	\$247.29	\$339.65	3.15%	4.33%	7.48%
12/31/07	1468.36	\$246.58	\$589.11	1.92%	4.58%	6.49%
12/31/06	1418.30	\$224.76	\$431.83	1.77%	3.39%	5.16%
12/31/05	1248.29	\$201.84	\$349.23	1.79%	3.10%	4.90%
12/31/04	1211.92	\$181.02	\$197.47	1.60%	1.75%	3.35%
12/31/03	1111.92	\$160.65	\$131.05	1.56%	1.27%	2.84%
12/31/02	879.82	\$147.81	\$127.25	1.82%	1.57%	3.39%
12/31/01	1148.08	\$142.22	\$132.21	1.36%	1.26%	2.62%
12/31/00	1320.28	\$141.08	\$150.58	1.20%	1.29%	2.49%
12/31/99	1469.25	\$137.53	\$141.47	1.12%	1.15%	2.27%

Source: S&P  
The December 31, 2010 S&P 500 buyback data not available at time of publishing.

## S&P 500 INDEX LEVEL TOTAL RETURNS [ as of December 31, 2010 ]

<b>1 Year:</b> 15.06%	<b>5 Year:</b> 2.29%	<b>10 Year:</b> 1.41% <sup>8</sup>
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At the beginning of this research piece, we cited a formula often used in setting return expectations for the equity markets that decompose the total return into three components:

- + The starting dividend yield +**
- + The growth rate of dividends +**
- + A factor representing the change in valuation ratio (or the change in the dividend yield from the beginning to the end of the period)**

There are a number of takeaways from our analysis of dividend and buyback ratios on WisdomTree indexes and how they fit into the above formula for the markets.

First, WisdomTree's dividend indexes were designed so that they allocate greater weight to the higher dividend-yielding stocks. The formula above is one way to state in simple terms the rationale behind that methodology. To start out with a higher initial dividend yield means that other lower dividend-yielding indexes must witness higher dividend growth over time to catch up. Of course, it is possible that the third term of the total return decomposition—a changing valuation ratio—could benefit the lower dividend yield strategy over the higher dividend yield strategy, but that outcome seems less likely.

<sup>8</sup> You cannot invest directly in an Index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the Index. Index performance assumes reinvestment of dividends, but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree Investments, its affiliates and their independent providers are not liable for any informational errors, incompleteness, or delays, or for any actions taken in reliance on information contained herein. Additional index information is available at [www.wisdomtree.com](http://www.wisdomtree.com).

The WisdomTree Earnings Index family is one set of indexes starting at a dividend yield deficit compared to the WisdomTree Dividend Index family that must make up the initial deficit with higher future dividend growth over time. The share buyback ratios for the earnings indexes are higher than those on the dividend indexes, which is one factor supporting higher dividend growth rates.

Finally, when I look at what the dividend and buyback ratios foretell for the overall market valuation ratios, I see a fairly attractive picture. John Hussman was bearish quoting the S&P 500 with a dividend yield close to 2%. But this commentary points out that one must include analysis of share buybacks. When one adds that into the S&P 500 dividends, the combined dividend and buyback ratio is closer to 4.5%. When I see the dividend and buyback ratio of the WisdomTree Dividend Index above 5%—and one adds on top of that any normal expectation for future dividend growth—I see a market that is very reasonably priced, especially when compared to the most common alternative asset class of choice: U.S. bonds.



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Index Descriptions: [The S&P 500 Index](#) is a capitalization-weighted index of 500 stocks selected by the Standard & Poor's Index Committee designed to represent the performance of the leading industries in the U.S. economy. [The WisdomTree Dividend Index](#) is a fundamentally weighted index that defines the dividend-paying portion of the U.S. stock market. [The WisdomTree Equity Income Index](#) is a fundamentally weighted index that measures the performance of companies with high dividend yields selected from the WisdomTree Dividend Index. [The WisdomTree LargeCap Dividend Index](#) is a fundamentally weighted index that measures the performance of the large-capitalization segment of the U.S. dividend-paying market. [The WisdomTree MidCap Dividend Index](#) is a fundamentally weighted index that measures the performance of the mid-capitalization segment of the U.S. dividend-paying market. [The WisdomTree SmallCap Dividend Index](#) is a fundamentally weighted index measuring the performance of the small-capitalization segment of the U.S. dividend-paying market. [The WisdomTree Dividend ex-Financials Index](#) is comprised of the 10 highest dividend-yielding companies in each sector, selected from 300 largest companies by market value in the WisdomTree Dividend Index outside financials. [The WisdomTree Earnings Index](#) is a fundamentally weighted index that measures the performance of earnings-generating companies within the broad U.S. Stock Market. [The WisdomTree Earnings 500 Index](#) is a fundamentally weighted index that measures the performance of earnings-generating companies within the large-capitalization segment of the U.S. Stock Market. [The WisdomTree MidCap Earnings Index](#) is a fundamentally weighted index that measures the performance of earnings-generating companies within the mid-capitalization segment of the U.S. Stock Market. [The WisdomTree SmallCap Earnings Index](#) is a fundamentally weighted index that measures the performance of earnings-generating companies within the small-capitalization segment of the U.S. Stock Market. [The WisdomTree Dividend Index of Europe, Far East Asia and Australasia \(WisdomTree DEFA Index\)](#) is a fundamentally weighted index that measures the performance of dividend-paying companies in the industrialized world, excluding Canada and the United States, that pay regular cash dividends and that meet other liquidity and capitalization requirements. [The WisdomTree DEFA Equity Income Index](#) is a fundamentally weighted index that measures the performance of companies with high dividend yields selected from the WisdomTree DEFA Index. [The WisdomTree International Dividend ex-Financials Index](#) is derived from the WisdomTree DEFA Index by selecting the 300 companies with the highest market values outside the financial sector and then selecting the 10 highest dividend-yielding stocks within each sector. [The WisdomTree International SmallCap Dividend Index](#) is a fundamentally weighted index that measures the performance of the small-capitalization segment of the dividend-paying market in the industrialized world outside the U.S. and Canada. [The WisdomTree Europe SmallCap Dividend Index](#) is a fundamentally weighted index that measures the performance of the small-capitalization segment of the European dividend-paying market. [The WisdomTree Emerging Markets Dividend Index](#) is a fundamentally weighted index that measures the performance of dividend-paying stocks selected from the following 19 emerging market nations: Argentina, Brazil, Chile, China, Czech Republic, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand, and Turkey. [The WisdomTree Emerging Markets Equity Income Index](#) is a fundamentally weighted index that measures the performance of the highest dividend-yielding stocks selected from the WisdomTree Emerging Markets Dividend Index. [The WisdomTree Emerging Markets SmallCap Dividend Index](#) is a fundamentally weighted index that measures the performance of primarily small cap stocks selected from the WisdomTree Emerging Markets Dividend Index. [The WisdomTree Global Dividend Index](#) is a fundamentally weighted index that comprises companies included in the WisdomTree Dividend Index, which measures the performance of dividend-paying companies in the United States, and the WisdomTree World ex-U.S. Index, which measures the performance of dividend-paying companies in developed and emerging markets outside the U.S. [The WisdomTree Global Equity Income Index](#) comprises the top 30% of the companies ranked by dividend yield from a universe consisting of companies included in WisdomTree Global Dividend Index.

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