THE LOGIC

Consider a simple and unlikely scenario: three indexes with three different dividend growth rates, each experiencing the same price appreciation over several years.

Figure 1 shows the return experience with initial dividend yields of 3%, capital appreciation of 3% per year and dividend growth rates of 2%, 5% and 8%.

At the end of the horizon, Index A, the slowest dividend grower of the three, ends with a yield of 2.86%. This is considerably lower than the yield of the rapidly growing Index C. Logic says that the latter should trade at a valuation premium, not a discount (using the dividend yield) at the end of such a run. That is why this scenario is unlikely.

Look at what happens when we tease this scenario so all three indexes end each year with a 3% dividend yield, the same as they started.

In figure 2, a $100 investment tracking Index A grows to $127.99 due to index appreciation plus several years of reinvested dividends of $3 or more. Indexes B and C grow more, resulting in 8.15% and 11.24% total returns, respectively. Both results are considerably better than that of the lackluster Index A.

Such is the eighth wonder of the world—compound interest.
A driver of long-term compound returns is dividend growth. But what drives the driver? Corporate profitability.

Using a half-century of data, a strategy that identified the top 20% of stocks by profitability outperformed the bottom quintile by 409 basis points per year (11.55% vs. 7.46%). That's because profitability is the driver of dividend growth.

1 Source: Kenneth French Data Library 6/30/1963 – 12/29/2017
Return on equity (ROE): Measures a corporation’s profitability by revealing how much profit a company generates with the money shareholders have invested.

Asset turnover: Sales divided by total assets. A higher ratio indicates that a company can generate greater sales per dollar of assets than a company with a lower ratio.

Equity multiplier: Total assets divided by total equity.

CFA Program curriculum: The collection of study materials provided by the CFA Institute to candidates for its exams. Those who pass the exams may become Chartered Financial Analyst charterholders.

SPARKING THE DIVIDEND FLAME

A key to lighting a fire under dividend growth—future dividend growth, not past growth—is high return on equity (ROE). To figure out what can generate high ROE, enter the DuPont model.

The DuPont Corporation’s Donaldson Brown developed the concept a century ago: ROE can be broken into the interaction among profit margins, asset turnover and the equity multiplier, all discussed below. It’s an interesting story; Brown’s formula was so important that it led to the company taking a major stake in a young General Motors. In later decades, the DuPont method became a staple of finance textbooks and the CFA Program curriculum.

Figure 3: Equity Performance, Grouped by Profitability

Source: Kenneth French Data Library. Period based on availability of operating profitability returns sorted into quintiles, 6/30/1963–12/31/2018. Universe is U.S.-listed equities grouped by operating profitability. Past performance is not indicative of future results. Standard deviation (St. Dev.): measure of how widely an investment or investment strategy’s returns move relative to its average returns for an observed period. A higher value implies more “risk,” in that there is more of a chance the actual return observed is farther away from the average return.
THE FORMULA

The DuPont method splits ROE:

\[
\text{Return on Equity} = \frac{\text{Net Income}}{\text{Total Equity}} = \frac{\text{Net Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Total Assets}} \times \frac{\text{Total Assets}}{\text{Total Equity}}
\]

Notice that some denominators are also numerators. They cancel each other out, leading to income over equity, or ROE. If a firm wants to be profitable, it should have excellent margins and be efficient with its assets.

This is where the hand smacks the table.

To put some numbers together, if a company earns $1 per share and pays a $0.47 dividend, the percentage that gets sent to retained earnings, the retention ratio, is 53%. Now, multiply the retention ratio by ROE to get implied dividend growth:

\[
\text{Retention Ratio} \times \text{ROE} = \text{Implied Dividend Growth}
\]

If that company’s ROE is 10%, tie it in with the 53% retention ratio to get 5.3% implied dividend growth.

Let’s pick apart the WisdomTree U.S. Quality Dividend Growth Index using DuPont components, starting with profit margins (figure 4).
WisdomTree's Index has a 9.9% profit margin, about equal to that of the MSCI USA Index. If it is to have a higher ROE than the MSCI U.S. Growth and Value Indexes we will need to find operating efficiencies too.

Figure 5 covers asset turnover, a key operating metric and second component of the DuPont equation. At 52% for the WisdomTree Index, it is considerably higher than for the MSCI USA, indicating that firm assets tend to be well utilized.

The last DuPont component, the equity multiplier, indicates that our index owns companies that use a little less debt than the MSCI USA (figure 6). Essentially, the WisdomTree Index components didn’t have to leverage up in the quest for high ROE.
Now that we know ROE’s components, let’s put them together. WisdomTree’s resultant ROE is 22.8%; MSCI USA’s is just 15.0% (figure 7).

### Figure 7: WisdomTree Index vs. MSCI Indexes, DuPont Equation

<table>
<thead>
<tr>
<th>Index</th>
<th>Profit Margin</th>
<th>Asset Turnover</th>
<th>Equity Multiplier</th>
<th>Return on Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>WisdomTree U.S. Quality Dividend Growth Index</td>
<td>9.9%</td>
<td>52%</td>
<td>4.4</td>
<td>22.8%</td>
</tr>
<tr>
<td>MSCI USA</td>
<td>10.0%</td>
<td>33%</td>
<td>4.6</td>
<td>15.0%</td>
</tr>
<tr>
<td>MSCI U.S Growth Index</td>
<td>11.4%</td>
<td>66%</td>
<td>3.0</td>
<td>22.9%</td>
</tr>
<tr>
<td>MSCI U.S Value Index</td>
<td>9.3%</td>
<td>25%</td>
<td>5.1</td>
<td>12.1%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Sources: Bloomberg, WisdomTree, as of 02/28/19. Past performance is not indicative of future results. You cannot invest directly in an index.

### NOW, DIVIDEND GROWTH

Figure 8 shows that the WisdomTree Index pays out 66% of its earnings as dividends, retaining just 34%. But that 34% then gets reinvested at an ROE of 22.8%. The result is that, even though little is reinvested back in the businesses, the WisdomTree Index’s implied dividend growth is 7.8%, which is only a little shy of the 9.4% growth implied for the MSCI USA Index. But the big driver for MSCI’s “advantage” is the large earnings retention of the cap-weighted MSCI USA index.

### Figure 8: WisdomTree vs. MSCI Indexes, Implied Dividend Growth

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>WisdomTree U.S. Quality Dividend Growth Index</td>
<td>22.8%</td>
<td>✔</td>
<td>66%</td>
<td>❌</td>
<td>7.8%</td>
<td>❌</td>
</tr>
<tr>
<td>MSCI USA</td>
<td>15.0%</td>
<td>❌</td>
<td>37%</td>
<td>✔</td>
<td>9.4%</td>
<td>❌</td>
</tr>
<tr>
<td>MSCI U.S Growth Index</td>
<td>22.9%</td>
<td>✔</td>
<td>24%</td>
<td>❌</td>
<td>17.4%</td>
<td>❌</td>
</tr>
<tr>
<td>MSCI U.S Value Index</td>
<td>12.1%</td>
<td>❌</td>
<td>45%</td>
<td>❌</td>
<td>6.6%</td>
<td>❌</td>
</tr>
</tbody>
</table>

Source: Bloomberg, WisdomTree, as of 02/28/19. Past performance is not indicative of future results. You cannot invest directly in an index.
TO GET THIS STRAIGHT

Because of its big payout ratio, the WisdomTree U.S. Quality Dividend Growth Index yields 4.34%, about two points more than the 2.04% yield of the MSCI USA Index—and it has nearly the same implied dividend growth. The MSCI USA Index, yielding barely 2%, would need to grow rapidly for years on end to catch up. Interestingly, despite being so much more profitable, the WisdomTree Index is trading at 15.6x forward earnings, but the market is willing to pay more for the low-ROE MSCI USA, which has a multiple of 18.8x earnings.

Next, let’s use these concepts for international equities.

SECOND VERSE, SAME AS THE FIRST

Figure 9 shows the DuPont model for the WisdomTree International Quality Dividend Growth Index compared to the MSCI EAFE Index of developed economy equities. In this case, the WisdomTree Index combines robust profit margins and efficient use of assets to generate a 20.1% ROE, considerably ahead of the 9.6% reading on this measure for the MSCI EAFE Index.

<table>
<thead>
<tr>
<th>Index</th>
<th>Profit Margin</th>
<th>WisdomTree Higher Margins than MSCI EAFE?</th>
<th>Asset Turnover</th>
<th>WisdomTree Higher Sales per Assets than MSCI EAFE?</th>
<th>Equity Multiplier</th>
<th>WisdomTree Lower Debt Financing than MSCI EAFE?</th>
<th>Return on Equity</th>
<th>WisdomTree Higher ROE than MSCI EAFE?</th>
</tr>
</thead>
<tbody>
<tr>
<td>WisdomTree International Quality Dividend Growth Index</td>
<td>13.1%</td>
<td>67%</td>
<td>2.3</td>
<td>20.1%</td>
<td></td>
<td>9.6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>7.7%</td>
<td>19%</td>
<td>6.7</td>
<td>13.2%</td>
<td></td>
<td>8.1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI EAFE GROWTH INDEX</td>
<td>8.5%</td>
<td>39%</td>
<td>4.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI EAFE VALUE INDEX</td>
<td>7.3%</td>
<td>14%</td>
<td>7.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: Bloomberg, WisdomTree, as of 02/28/19. Past performance is not indicative of future results. You cannot invest directly in an index.
Now, multiply the 20.1% ROE by the 46% earnings retention ratio (equal to 100% minus the 54% payout ratio) to find implied dividend growth of 9.2% for the WisdomTree Index (figure 10). This compares favorably to the 4.3% growth implied for the MSCI EAFE Index.

<table>
<thead>
<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>WisdomTree International Quality Dividend Growth Index</td>
<td>20.1%</td>
<td>✅</td>
<td>54%</td>
<td>✅</td>
<td>9.2%</td>
<td>✅</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>9.6%</td>
<td>✅</td>
<td>55%</td>
<td>✅</td>
<td>4.3%</td>
<td>✅</td>
</tr>
<tr>
<td>MSCI EAFE GROWTH INDEX</td>
<td>13.2%</td>
<td>✅</td>
<td>47%</td>
<td>✅</td>
<td>7.1%</td>
<td>✅</td>
</tr>
<tr>
<td>MSCI EAFE VALUE INDEX</td>
<td>8.1%</td>
<td></td>
<td>60%</td>
<td></td>
<td>3.3%</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Bloomberg, WisdomTree, as of 02/28/19. Past performance is not indicative of future results. You cannot invest directly in an index.

FILLING CORE ALLOCATIONS WITH QUALITY DIVIDEND GROWTH

The WisdomTree Indexes discussed here are constructed to identify highly profitable companies. To pass our screens, they need to use their assets efficiently and post robust profit margins. The ETFs that track our quality dividend growth Indexes can thus be used to represent a portfolio's core exposure to U.S. and international developed equities. These include:

+ WisdomTree U.S. Quality Dividend Growth Fund: DGRW
+ WisdomTree International Quality Dividend Growth Fund: IQDG
+ WisdomTree Dynamic Currency Hedged International Quality Dividend Growth Fund: DHDG
Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, please call 866.909.9473 or visit WisdomTree.com to view or download a prospectus. Investors should read the prospectus carefully before investing.

There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty; these may be heightened in emerging or frontier markets. Some Funds invest in derivatives in seeking to obtain a dynamic currency hedge exposure. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. Derivatives used by a Fund may not perform as intended. Funds focusing their investments on certain sectors may be more vulnerable to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. As certain Funds can have a high concentration in some issuers, the Funds can be adversely impacted by changes affecting those issuers. The Funds invest in the securities included in, or representative of, their Indexes regardless of their investment merit, and the Funds do not attempt to outperform their Indexes or take defensive positions in declining markets. Due to the investment strategy of certain Funds, they may make higher capital gain distributions than other ETFs. Please read each Fund's prospectus for specific details regarding each Fund's risk profile.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits), even if notified of the possibility of such.

The WisdomTree International Quality Dividend Growth Index is a fundamentally weighted Index designed to provide exposure to dividend-paying developed market companies. The WisdomTree U.S. Quality Dividend Growth Index is a fundamentally weighted index that consists of dividend-paying stocks with growth characteristics. The primary starting screening universe for this index is the constituents of the WisdomTree U.S. Dividend Index with market capitalization of at least $2 billion. The Index is composed of the 300 companies in the WisdomTree U.S. Dividend Index with the best combined rank of growth and quality factors. The growth factor ranking is based on long-term earnings growth expectations, while the quality factor ranking is based on three-year historical averages for return on equity and return on assets. The Index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share.

The MSCI USA Index is designed to measure the performance of large- and mid-cap segments of the U.S. market. The MSCI USA Growth Index captures large- and mid-cap securities exhibiting overall growth-style characteristics in the U.S. The MSCI USA Value Index is a large- and mid-cap U.S. equity index aiming to capture securities exhibiting overall value-style characteristics. The Index screens for book value to price, 12-month forward earnings to price and dividend yield as value characteristics. The MSCI EAFE Index is a market cap-weighted index composed of companies that are representative of the developed market structure of developed countries in Europe, Australasia and Japan. The MSCI EAFE Growth Index is a market cap-weighted subset of stocks within the MSCI EAFE Index that have higher share prices relative to their earnings or dividends per share. The MSCI EAFE Value Index is a market cap-weighted subset of stocks within the MSCI EAFE Index that have lower share prices relative to their earnings or dividends per share.

Jeff Weniger is a registered representative of Foreside Fund Services, LLC.

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