

# EQUITY PRICES ARE MORE VOLATILE THAN THEIR FUNDAMENTALS

Jeremy Schwartz — Global Chief Investment Officer

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WisdomTree recently introduced the Emerging Markets Dividend Growth Index (WTEMDG) at a time when emerging market equities have been disappointing-performers lagging many of the other global equity markets regions<sup>1</sup>. In this blog, I provide some analysis on how much of the [volatility](#) in [emerging market equity](#) prices is tied to changes in the emerging market fundamentals, and I take a look at history to illustrate the relationship between volatility in the dividends and prices of emerging market equities. **Noisy Equity Prices** One reason WisdomTree believes a rules-based rebalancing program adds value is that equity prices contain an element of noise—equity prices often fluctuate more than the [fundamental fair values](#). To illustrate how equity volatility is higher than fundamentals, we compare the average annual volatility of equity prices to the average annual volatility of dividends. Whether one looks at the [MSCI Emerging Markets Index \(EM Equities\)](#) or the [S&P 500 Index](#) (U.S. Equities), the average annual volatility indicates that prices exhibit greater movements (both positive and negative) around their average level than do dividends. This is one indication that equity markets tend to overreact to changes in dividend levels, and we believe this creates the opportunity to rebalance a portfolio back to these fundamental metrics. **EM Equities vs. U.S. Equities—Price vs.**

**Dividend Behavior (6/30/1993–6/30/2013)**

Period	Equity Region	Average Annual Growth			Average Annual Standard Deviation	
		Price	Dividends <sup>1</sup>	Price-to-Dividend Multiple <sup>2</sup>	Price	Dividends <sup>1</sup>
20-Year	EM Equities	5.0%	7.5%	-2.3%	22.6%	16.7%
	U.S. Equities	6.7%	5.0%	1.6%	16.4%	8.3%
10-Year	EM Equities	10.9%	13.4%	-2.2%	23.8%	19.3%
	U.S. Equities	5.2%	7.5%	-2.2%	16.9%	11.1%

<sup>1</sup>Dividends: Refers to trailing 12-month dividends, which aggregate dividends paid over a prior 12-month period.

<sup>2</sup>Price-to-dividend multiple: Refers to the index price divided by the trailing 12-month dividends.

Sources: Bloomberg, MSCI

## Yet Emerging Market Dividends Are

**Volatile** Yet emerging market dividends behave differently than dividends from those in the United States. The dividend volatility over 20 years was twice as high for EM Equities as it was for U.S. Equities<sup>2</sup>. There is a different mentality in the United States than in the emerging markets when it comes to dividend policies. U.S. companies do not like to raise and lower their dividends; they often manage cash to maintain a certain dividend per share every quarter. By contrast, emerging market dividend growth often mirrors the behavior of earnings. We think the volatility of these dividends in EM Equities helps motivate our new dividend growth Index to focus on stocks that rank highly on our proprietary [quality](#) and [growth](#) selection factors. We believe that our stock selection factors can potentially help manage the volatility that we see in emerging market [Dividend Streams®](#). **The Link between Dividend Growth and Return: Valuation** While their dividend growth has disappointed recently, the emerging markets still possess some of the best prospects for economic growth over the long term. When investors get overly enthused about growth prospects, there is a tendency to overpay for this potential growth. From this perspective, it is interesting to contrast how the price-to-dividend multiple has changed with respect to U.S. Equities and EM Equities over the last 10 and 20 years<sup>3</sup>. Over the last 20 years U.S. Equities have seen trailing 12-month dividend growth of 5.0% and price appreciation of 6.7% per year<sup>4</sup>. This increase in price level was fueled by an expansion of 1.6% per year in the price-to-dividend ratio—or a valuation multiple of the market that measures the relationship between the index price level and the index's trailing 12-month dividends. In the

emerging markets, the price-to-dividend ratios have contracted over the last 20 years, as price growth lagged dividend growth by more than 2.2% per year over the period. These contracting valuation multiples (dividends becoming less expensive relative to prices) for the emerging markets are one reason why I believe that these stocks are attractive from their current valuation perspective. **Combining a Focus on Dividend Growth Stocks with Relative Value Rebalancing** WisdomTree believes that a focus on growth-oriented companies must be married with a disciplined focus on valuations, and when we consider dividend growth potential as a component of index methodology, we marry it with a sensitivity to valuation. Specifically, WisdomTree uses a rules-based rebalancing program that involves tying Index constituent weights back to the *Dividend Stream* to focus on valuations—as it does in all its dividend-based Indexes. While many dividend-focused indexes in emerging markets focus on yield and valuation, there is a dearth of options that focus on dividend growth. We believe that the WTEMDG approach with its flexibility to respond to growth represents the future of dividend growth indexing. ***Unless otherwise stated, data source is WisdomTree.*** <sup>1</sup>Refers to the MSCI Emerging Markets Index performance over the period 6/30/2010 to 6/30/2013, which has lagged that of the MSCI EAFE Index and the S&P 500 Index. <sup>2</sup>Source: Bloomberg, MSCI, 6/30/1993-6/30/2013 <sup>3</sup>Source: Bloomberg, MSCI, 6/30/1993-6/30/2013 <sup>4</sup>Source: Bloomberg, MSCI, 6/30/1993-6/30/2013

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## **DEFINITIONS**

**Volatility** : A measure of the dispersion of actual returns around a particular average level.&nbsp;

**Fundamental fair value** : What the share price of a firm would be if the sole determinant were the behavior of the underlying fundamental factor, an example of which would be the dividend per share.

**MSCI Emerging Markets Index** : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as “emerging markets” by MSCI.

**S&P 500 Index** : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor’s Index Committee designed to represent the performance of the leading industries in the United States economy.

**Quality** : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**Dividend Stream** : Refers to the regular dividends per share multiplied by the number of shares outstanding.