HOW RISING RATES IMPACT DIVIDEND PAYING EQUITIES

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Since the beginning of the year, longer-term interest rates in the U.S. have risen considerably—mostly driven by the expectation that the Federal Reserve (Fed) would begin tapering its quantitative easing (QE) program. At its December meeting, the Fed did indeed announce it would begin scaling back purchases of both mortgage-backed securities and U.S. Treasury bonds by $5 billion a month and now would be on track to end its asset purchase program by the end of 2014—assuming no drop-off in economic performance in the coming months. Although more companies have begun paying dividends, the percentage of equities with a higher dividend yield than the 10-Year U.S. Treasury yield has declined. The recent rise in Treasury yields has impacted various income-oriented investment strategies, but not all strategies are the same. In the chart below, I look at how the relationship between the 10-Year Treasury and dividend-paying equities has changed over the past year, up until the most recent Fed announcement. **Relationship between Equity and Bond Yields**

Index	Date	10-Yr Treasury Yield	Dividend Yield Greater Than Treasury Yield Weight
S&P 500	12/31/2012	1.76%	67%
	12/18/2013	2.89%	24%
WisdomTree LargeCap Dividend	12/31/2012	1.76%	91%
	12/18/2013	2.89%	39%
WisdomTree Equity Income	12/31/2012	1.76%	100%
	12/18/2013	2.89%	74%
WisdomTree SmallCap Dividend	12/31/2012	1.76%	82%
	12/18/2013	2.89%	51%

Sources: Bloomberg, WisdomTree. Weight is the index percentage weight of stocks with an indicated dividend yield higher than the 10-Year Treasury yield. WisdomTree Index weights are based on the expected rebalanced weights. Past performance is not indicative of future results.

• **Rates Have Risen Rapidly –** Through December 18, 2013, the 10-Year Treasury yield has increased from 1.76% to 2.89%—a change of 113 basis points. To put this in context, rates still remain well below their monthly average of around 6.0% over the last 30 years. But as interest rates increase, they provide more competition for dividend-paying equities, especially higher-yielding equities. • **Dividend Yield Edge of Equities over Bonds Has Decreased –** Within the S&P 500 Index, the weight of dividend-paying equities with an indicated divided yield above that of the 10-Year Treasury has decreased dramatically, from 67% to 24%. WisdomTree Indexes have also seen a decline in weight, but the percentage with higher dividend yields is still higher due to the Index methodology that focuses on dividends. In particular, the annual rebalance back to the Dividend Stream® puts an emphasis on stocks with higher dividend yields, as weights are adjusted such that more weight is allocated to firms that grow their dividends faster relative to their prices. • **Small Caps for Income –** When investors think of dividends, they tend to think of mature large-cap companies as the primary source. As a result, I feel that many investors mistakenly overlook small-cap equities as attractive income options. I find it impressive that the WisdomTree SmallCap Dividend Index has more than twice the weight of the S&P 500 in stocks with a dividend yield higher than the 10-Year Treasury. WTSDI has over 50% of its weight in equities with a higher dividend yield than the 10-Year Treasury. **Conclusion** I believe one of the supporting points for equities during the last few years was the income advantage they provided compared to the traditionally low yields available in fixed income securities. There is still a healthy part of the broader market that can offer higher yields than U.S. Treasuries, but it is no longer the majority of stocks in the market. If one wants to focus on equities for their income potential, the dividend growth prospects are becoming a more important component of the returns—as equities not only offer the current dividend but also the future growth potential. As I discussed in an earlier blog post, this year was the fourth consecutive year of double-digit dividend growth, and I believe we will continue to see elevated dividend growth due to dividend payout ratios still being near historical lows. Now would be a good time to evaluate various dividend strategies, and I'd point out that compared to large caps, small caps had a greater percentage of stocks with higher yields than the 10-Year Treasury.

Important Risks Related to this Article

Dividends are not guaranteed and a company's future abilities to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time. Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

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Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

U.S. Treasury Bond : a debt security issued by the United States government.

Dividend : A portion of corporate profits paid out to shareholders.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Basis point : 1/100th of 1 percent.

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.

Indicated Dividend Yield : Indicated dividends per share are annualized and then divided by the current share price. High values indicate low prices relative to indicate low prices relative to indicated dividends.

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

WisdomTree SmallCap Dividend Index : A fundamentally weighted index measuring the performance of the small-capitalization segment of the U.S. dividend-paying market. The Index comprises the companies that constitute the bottom 25% of the market capitalization of the WisdomTree Dividend Index after the 300 largest companies have been removed. 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.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.