Q1 2020: FACTORS IN REVIEW

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As focus has turned to first-quarter earnings announcements, investors are braced for further dividend cuts from S&P 500 I ndex constituents.

The greatest cuts are expected from within Consumer Discretionary, Energy and Real Estate—the sectors most directly impacted by the economy's shutdown. Some of these companies now have eye-popping dividend yields.

Below are a few examples of companies that Bank of America identified as having "insecure" dividends in an April 7th report. Schlumberger followed through with a 75% cut on April 17.

Ticker	Company	Sector	Yield
GM	General Motors	Consumer Discretionary	6.32%
SLB	Schlumberger	Energy	12.14%
SPG	Simon Property Group Inc.	Real Estate	12.32%

Sources: WisdomTree, Bloomberg, Bank of America, as of 4/13/20. Yield = indicated dividend yield. Companies chosen are largest market-cap companies from Consumer Discretionary, Energy and Real Estate sectors with insecure dividends from Bank of America report "How secure are your dividends?" 4/7/20.

The anticipation of severe dividend cuts contributed to a rare period of underperformance for high-yielding companies during the first quarter's market sell-off. Investors typically expect safety from high dividend payers. But only when those dividends are considered safe, of course.

Markets Rewarded Quality, Not Yield

Below we show quintile performance for S&P 500 constituents, which helps frame which factors were in favor and out of favor during the Q1 sell-off.

Based on the relative performance of the first and fifth quintiles, the quality and low volatility (low vol) factors outperformed, while value and yield lagged.

Historically, quality and low vol have tended to outperform during drawdowns. During periods of heightened uncertainty, investors prefer companies with higher profitability and lower volatility.

Value companies tend to struggle as markets price in a recession. These companies' share prices were lagging before the slowdown, as they were perceived as either distressed businesses in secular decline (bricks-and-mortar retail) or cyclical businesses with earnings at risk in a slowdown (Banks or Energy companies).

Of these four factors, only yield performed contrary to expectations during a sell-off.

S&P 500 Index Quintile Performance

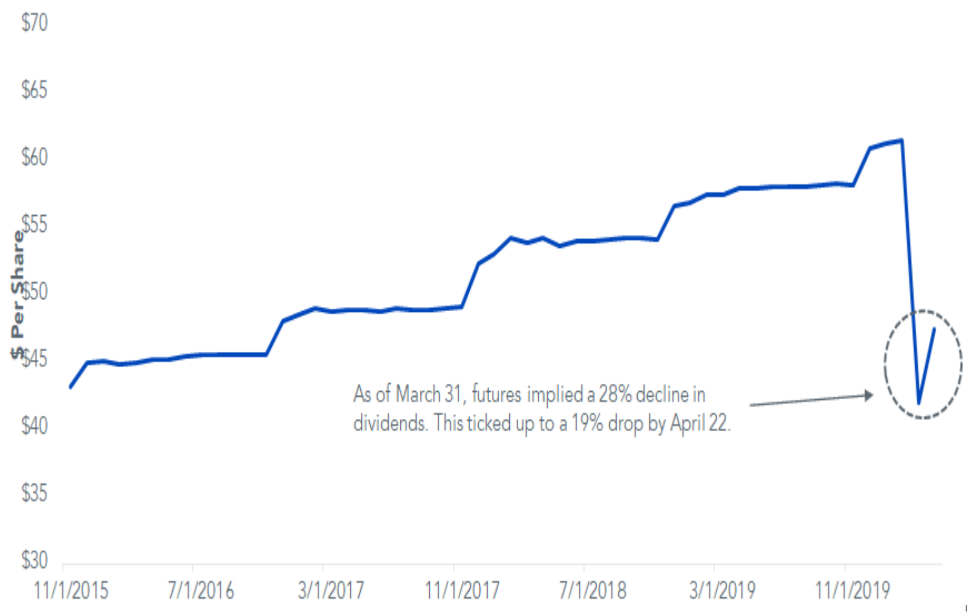
Quality		Value		Yield		Low Vol	
Return-on-Equity		**Earnings Yield**		**Dividend Yield**		**Volatility**	
1st Quintile	-14.66%	1st Quintile	-34.22%	1st Quintile	-30.18%	1st Quintile	-16.29%
2nd Quintile	-15.82%	2nd Quintile	-21.72%	2nd Quintile	-24.58%	2nd Quintile	-17.38%
3rd Quintile	-19.16%	3rd Quintile	-19.54%	3rd Quintile	-20.94%	3rd Quintile	-21.20%
4th Quintile	-27.06%	4th Quintile	-14.14%	4th Quintile	-16.24%	4th Quintile	-22.32%
5th Quintile	-24.81%	5th Quintile	-10.79%	5th Quintile	-15.55%	5th Quintile	-29.09%
Neg. Return	-40.89%	Neg. Earners	-46.90%	Yield	-12.53%	N/A	-
Total	**-19.60%**	**Total**	**-19.60%**	**Total**	**-19.60%**	**Total**	**-19.60%**

Sources: WisdomTree, FactSet, 12/31/19–3/31/20. 1st Quintile of Earnings Yield is the lowest P/E. 1st Quintile of Volatility is the least volatile. Low Vol uses trailing 12-month standard deviation. You cannot invest directly in an index. Past performance is not indicative of future returns.

The expectation of imminent dividend cuts contributed to the failure of the companies with the highest yields to provide downside protection. Investors believed high yielders were "cheap for a reason" and likely to cut their dividends as a result of the unprecedented shutdown of the economy, proving themselves to be value traps.

By the end of the March, S&P 500 dividend futures anticipated a nearly 30% decline in 2020 dividends. This figure has improved in recent weeks, possibly signaling that some of these high yielders have been oversold.

S&P 500 Dividend Futures Contract



Sources: WisdomTree, Bloomberg, 11/30/15–4/22/20. You cannot invest directly in an index. Past performance is not indicative of future returns.

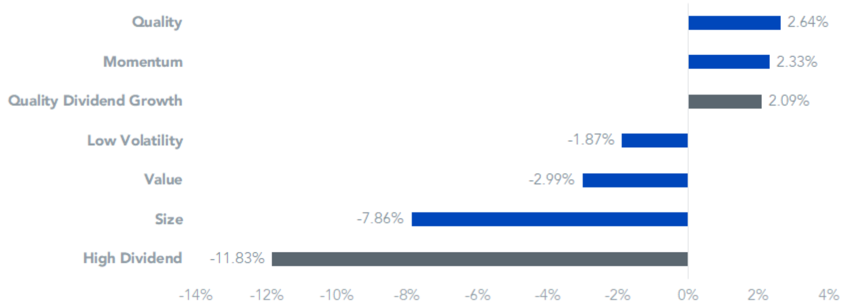
Dividend Growth Outperforms

The sell-off of the highest-yielding companies contrasts with the outperformance of quality dividend growth companies. Quality dividend growers don't have the highest dividend yields, but they do have strong profits which may allow them to sustain—and even grow—their payouts throughout a recession.

If we isolate performance during the peak-to-trough decline using factor indexes, we see a picture that is similar to the quintile performance. Although all the factor indexes experienced negative returns, on a relative basis quality outperformed, and value and high dividend underperformed. The low-volatility index outperformed by about 60 basis points (bps) for the quarter but lagged during the sharp sell-off.

The WisdomTree U.S. Quality Dividend Growth index outperformed the S&P 500 by 209 bps and outperformed the High Dividend index by 1,392 bps. Investors favored the steady and consistent cash flows of companies that have the earnings to support paying dividends during a negative shock to the economy.

Q1 Sell-Off: Index Performance vs. S&P 500 Index



Sources: WisdomTree, Bloomberg, 2/19/20–3/23/20. **Quality:** S&P 500 Quality Index. **Momentum:** S&P 500 Momentum Index. **Quality Dividend Growth**: WisdomTree U.S. Quality Dividend Growth Index. **Low Volatility**: S&P 500 Volatility Index. **Value:** S&P 500 Value Index. **Size**: S&P 1000 Index. **High Dividend**: S&P 500 High Dividend Index. Past performance is not indicative of future returns. You cannot invest directly in an index.

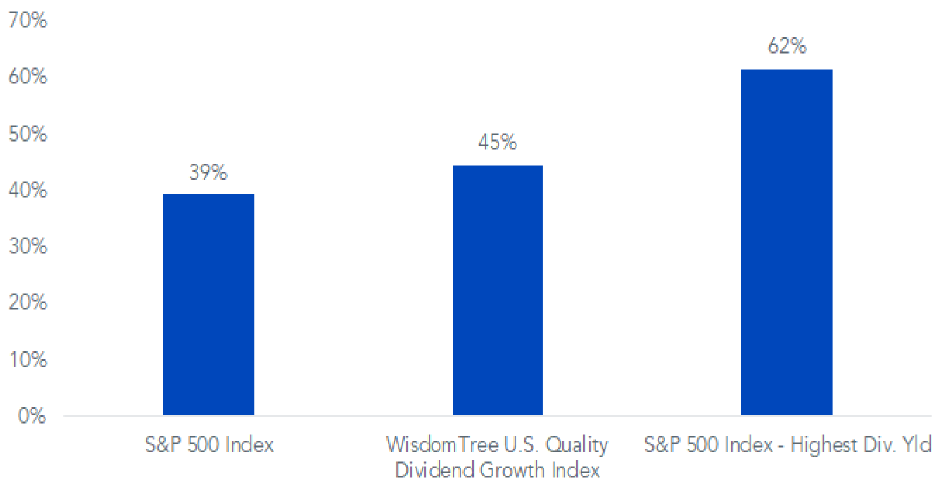
Measuring Dividend Safety

The payout ratio—dividends as a percent of earnings—is an important metric to track in an environment where earnings are expected to decline significantly.

A lower payout ratio indicates that the dividend is a smaller portion of earnings, so there is a greater cushion for earnings to fall while still allowing the company to maintain its dividend.

In the chart below, the bar furthest to the right shows the payout ratio on a portfolio of the highest 30% of yielders from the S&P 500. The WisdomTree U.S. Quality Dividend Growth Index, which screens for dividend payers with strong trailing profits and excludes those with dividend coverage ratios less than 1, has a payout ratio only modestly higher than the S&P 500. A slightly higher payout ratio for this index is expected with about 19% of the market cap of the S&P 500 not paying any dividend.

Dividend Payout Ratio



Sources: WisdomTree, FactSet, as of 3/31/20. You cannot invest directly in an index.

Conclusion: Quality Dividends for Heighted Volatility

During the market's latest sell-off, a strategy that sorts for quality dividend-payers—those that can maintain their dividend policies when times are tough, but also the capacity to grow them the fastest during a recovery—outperformed strategies targeting high yields.

It seems likely that markets will remain volatile for the near future, perhaps favoring the defensive characteristics that have been exhibited by quality dividend payers.

Contrary to historical patterns, high dividend yielders have failed as a safe haven so far. But the sell-off in high dividend yielders may prove an attractive entry opportunity if dividend cuts are not as dire as previously anticipated. Investors may also begin to snap up the shares of companies offering high dividends in an environment of all-time low Treasury yields.

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DEFINITIONS

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

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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 tim.

Quintile : One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

Low Volatility : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Dividend growth : The growth in trailing 12-month dividends for the specified universe.

Basis point : 1/100th of 1 percent.

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