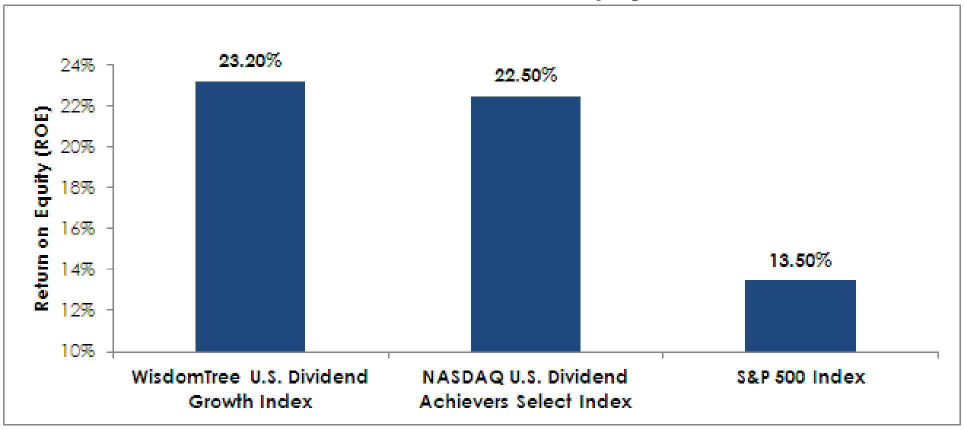
THE CONNECTION BETWEEN DIVIDEND GROWTH AND RETURN ON EQUITY

Jeremy Schwartz — Global Chief Investment Officer
06/05/2013

We have been writing a lot about the new methodology we have created to focus on dividend-paying stocks with growth characteristics. A key element of our new methodology was to select a basket of dividend payers that we believe have prospects for above-average dividend growth—but to select those stocks without relying on backward-looking screens for dividend history. This new methodology uses a combination of factors to select stocks within the dividend growth opportunity set. In this short piece, we want to dive into the finance theory and empirical reality that we believe links dividend growth to return on equity (ROE), as return on equity is one of the factors we focus on in our selection process. **Profits and Dividends** Profitability relates to how much money a firm can make after accounting for the various expenses and inputs required to generate those earnings. Ideally, little money is spent, few resources are used, and a lot of money is made. One very important profitability metric relates profits to equity, termed return on equity (ROE). Equity is the money that the owners of capital (i.e., the shareholders) have invested in the business—and a higher ROE means that more profits are being made relative to their cumulative investment in the firm. **The Dividend Discount Model (DDM)—The Finance Theory Link** In the finance literature, return on equity is critically linked to dividend growth and intrinsic value of companies through the dividend discount model (DDM).[1] The DDM for stock valuation states: **The Value of a stock = DPS (1) / (R-G) Where: • DPS (1) = Dividends per share expected to be received in one year • R = The required rate of return for the investment • G = Growth rate in dividends = ROE x earnings retention[2] (or 1 minus dividend payout ratio) The growth rate equals the return on equity times the reinvestment rate**; simply stated, the growth of dividends is determined by what fraction of earnings is put back into the firm and how profitable those earnings are in their subsequent use. When earnings are put back into the firm in this way, they accumulate as part of the equity capital held by the shareholders. A high ROE over time indicates that this money is being used efficiently, generating more profits. Considering the aforementioned framework, we believe that it makes a compelling case for how a sustainable dividend growth rate is linked in finance theory to ROE. **Dividend Growers Display Higher ROE - Empirical Reality**

Return on Equity as of 3/31/2013



Sources: WisdomTree, Bloomberg
Data as of 3/31/2013, the date of Screening for initial constituents for the WisdomTree U.S. Dividend Growth Index. Past performance is not indicative of future results. You cannot invest directly in an index.

The S&P 500 Index is possibly the most widely followed benchmark of the performance of U.S. equities. It is market capitalization weighted and does not focus on dividend payers or dividend growers in any way. Both the WisdomTree U.S. Dividend Growth

Index and the NASDAQ US Dividend Achievers Select ("Achievers Select") Index do focus on dividend growth, and all their constituents must pay dividends. • In our explanation of the DDM, we linked ROE to dividend growth from a finance theory perspective. We also demonstrated that the data makes a strong case that companies with a long history of dividend growth display high returns on equity (as seen by the 22.5% ROE exhibited by the constituents of the Achievers Select Index). Both the Achievers Select and the WisdomTree U.S. Dividend Growth Index have similarly strong ROE. In WisdomTree's case, ROE is a selection factor, so its above-market ROE is not surprising. But the Achievers Select Index gets to a similar result by starting with a selection base driven by companies that have increased their dividends for 10 consecutive years. • Notably, the ROE of the S&P 500 Index, which does not focus on dividend growth, is much lower. We could have made a similar chart based on return on assets—which is another gauge of profitability that WisdomTree has used to identify its dividend growers opportunity set. The difference between return on assets and return on equity is simply leverage—and WisdomTree uses both variables in its selection process to balance the fact that, although we believe that return on equity is the ultimate bottom line for equity investors, we recognize that some companies use leverage to ramp up their ROEs. **Conclusion** It's really very simple: If you're looking for potential dividend growth, one strategy could be to follow past dividend growers. The Achievers Select Index follows such a methodology. But focusing on companies with 10 years of history of dividend growth is a strategy that potentially limits the responsiveness to shifting trends in the dividend universe. The WisdomTree U.S. Dividend Growth Index focuses on ROE as part of its selection process, as we believe it is a key indicator for companies that can deliver dividend growth over time. *View Jeremy Schwartz discuss dividends* (Video) *Read our Dividend Growth series here.* [1]William L. Silber & Jessica Wachter, "Equity Valuation Formulas," New York University, 2013. [2]Earnings retention (or 1 minus dividend payout ratio): The dividend payout ratio is the dividend per share divided by the earnings per share. Since the earnings retention plus the dividend payout ratio must be added together to equal 100% of the earnings, 1 minus dividend payout ratio = earnings retention, the percentage of earnings not paid out as dividends.

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.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Intrinsic value : Value of a firm based on its operations, business practices and profitability, which may or may not be closely related to the value of that same firm based on its equity share price.

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.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

WisdomTree U.S. Dividend Growth Index : A fundamentally weighted index designed to track the performance of dividend-paying companies in the U.S. that WisdomTree believes have the potential to increase their dividends due to certain factors, which include estimated earnings growth, return on equity and return on assets. Weighting is by indicated cash dividends.

NASDAQ US Dividend Achievers Select Index : Designed to track the performance of dividend-paying companies in the U.S. that have increased their annual dividend payments for the last 10 or more consecutive years.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.