ENHANCED RISK SCREENING

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WisdomTree pioneered fundamentally weighted dividend indexing with the goal of delivering lower volatility, higher income and excess returns relative to comparable market cap-weighted indexes.

And we're constantly researching potential improvements to our indexes.

We recently developed several enhanced risk screens that we believe can mitigate the impact of "value traps" by screening out companies deemed most at risk of cutting dividends.

Why Now?

A few considerations:

- **Live Stress Tests for Dividends:** Two "once in a generation" stresses—the 2008 global financial crisis and the Covid-19 pandemic—as well as the acute oil price collapse in 2015-2016 provide a greater sample on how to mitigate tail risks in dividend portfolios.

- **Seminal Research:** Research published in recent years[1,2] has provided insights on how to mitigate risk in value-tilted dividend indexes. Some helped motivate elements in newly launched indexes like our Quality Dividend Growth family and our Multifactor family.

- **All-time Low Interest Rates:** Mitigating risk in dividend funds is becoming more critical as investors increasingly turn to equities for income as a replacement for all-time low yields on benchmark government treasuries.

Process and Rationale

We aim to mitigate exposure to the riskiest dividend payers in two ways:

- Screening out companies that rank in the bottom decile of our starting universe of publicly traded companies based on a composite risk score (CRS) of quality and momentum factors.

- Screening out companies that rank in the top 5% by dividend yield and also in the bottom 50% based on the CRS.

First, quality (earnings) is *the* key driver of dividend sustainability and dividend growth. A company with sagging profits may be able to cover its current dividend by issuing debt or reducing capital expenditures. But in the long run, profitability will dictate whether a company can maintain and grow dividends.

Second, a momentum screen provides an attractive complement to our dividend weighting process that generally gives greater weight to companies with higher dividend yields relative to their market cap weight. When lagging share prices drive yields higher, these companies tend to be the riskiest and least sustainable payers. Momentum is used as a check on companies that have had a precipitous drop in their share price coincide with a higher dividend yield.

In addition to screening out the riskiest decile of companies based on the CRS, we also include a screening of the highest-yielding companies that also have below-average risk scores. Often, prior to a dividend cut, market participants will price a dividend as unsustainable, causing shares to underperform and the yield to skyrocket.

Risk Scores

The CRS of quality and momentum is constructed as follows:

- **50% Quality**—Companies are ranked based on trailing 12-month profitability (static quality) as well as trends in profitability over the past three years (dynamic quality).
- **50% Momentum**—Companies are ranked by their 6-month and 12-month returns to capture medium- to long-term price trends.

All stocks (dividend payers or not) are ranked on this CRS across six distinct universes: three regions (U.S., developed international and emerging markets) separated between large-/mid-cap and small-caps. This allows for comparing stocks with more "like for like" peers.

The dividend yield rankings are similarly constructing within these six distinct universes. As we show in the charts below, companies in the bottom decile on CRS are removed, as well as the companies in the bottom half of the CRS that are also in the top 5% of the respective universe according to yield.

Weighting Adjustments

In addition to this screening process, which is applied to all of WisdomTree's dividend indexes, the core dividends and high dividends indexes (i.e., excluding quality dividend growth indexes) adjust dividend stream weights based on the same risk score. Companies ranking in the top two deciles on CRS have their dividend streams increased by 1.5 times.

The purpose of this adjustment is to give greater weight to companies that the risk score indicates are less risky, and thus have better potential to sustain and grow dividends.

Because WisdomTree's quality dividend growth indexes explicitly select constituents based on criteria of quality and estimated earnings growth, no adjustments are made to that dividend stream weighting.

A Natural Evolution

There continues to be intuitive rationale for giving greater weight to companies with the financial health to pay greater dividends, and clear structural tailwinds for dividend-paying securities in a world of historically low interest rates and aging demographics.

We believe this enhancement can help weed out companies most at risk of cutting dividends, and thus acting as a drag on the portfolio, as well as reducing volatility and down-capture.

We will be sharing more information on this topic on this blog in the coming weeks.

[1]Robert Novy-Marx, "The Other Side of Value: The Gross Profitability Premium," Journal of Financial Economics, 2013, vol. 108, issue 1, 1–28.

[2]Cliff Asness, Tobias J. Moskowitz, Lasse H. Pedersen, "Value and Momentum Everywhere," The Journal of Finance, June 2013, vol. LXVIII, no. 3, 929–985.

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You cannot invest directly in an index.

DEFINITIONS

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

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Excess Returns : refers to investment returns on a securities above that of a benchmark or index exhibiting similar risk characteristics.

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.

Risk screen : A process of filtering, or removing, companies that are eligible for an investment process based on certain risk parameters.

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.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Dividend yields : Refers to the trailing 12-month dividend yield. Dividends over the prior 12 months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

Composite risk score : A term that refers to combining multiple factors—for example quality and momentum—to quantify the potential riskiness of a security relative to comparable companies.

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.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

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

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.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund’s weight.

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

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

Core Earnings : Income generated by the company's daily operations rather than one-time events or market fluctuations.

Down Capture : Measure of the performance of an investment relative to a benchmark index during a down market.