THE FUTURE OF DIVIDEND GROWTH INDEXES

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We believe one of the single most notable foundations for the equity markets today is strong dividend growth. We detailed in our last market insight that the trailing average annual three-year growth in trailing 12-month dividends for U.S. equities (on the S&P 500 Index) for the three years ending March 31, 2013—at 13.59%—was at a record level going back all the way to 1957, the inception of the S&P 500 Index.[1] Capturing this strong dividend growth is a goal for many. There are a variety of exchange-traded funds (ETFs) that track the performance of indexes focused on dividend payers and attempt to screen for the best dividend growers. All the dividend growth-oriented indexes we've reviewed in prior commentaries and blogs rely on backward-looking criteria to identify consistent dividend growers—in other words, focusing on firms that deliver a pattern of consistent growth in dividends for a given period. We believe that a potential consequence of the methodology underlying these indexes is that they miss out on some of the dividend growth opportunities from firms that are newly initiating or re-initiating dividends. Many of these new dividend payers (such as Apple and Cisco) have been leading contributors to the record pace of dividend growth of the S&P 500 Index. **Introducing the WisdomTree U.S. Dividend Growth Index** The theme of U.S. dividend growth is one many are trying to capture, but we believe there were few good options specifically focusing on this subset of the broader dividend universe. We have created an Index that we believe includes selection factors designed to pick dividend-paying stocks with growth characteristics. We outline our selection metrics and rationale below: **Earnings Growth Expectations:** This criterion is pretty simple: Firms expected to grow their earnings faster, all other things being equal, should have greater potential to increase their future dividends faster. We understand that these are only estimates, but we believe that while there may be a lot of noise around a single company's precise earnings growth, in aggregate the companies with higher growth expectations—we believe—grow faster than those with lower expectations. **Quality Factor Rankings:** Our quality factor ranking is based on three-year historical averages for return on equity (ROE) and return on assets (ROA). We believe companies that generate greater profitability, controlling for any excessive use of leverage, should have a greater potential to increase their future dividends than firms demonstrating lower profitability metrics. • The three-year averages for ROE and ROA are used to smooth out the potential volatility in the numbers that can occur in any single year. Warren Buffett often says in his annual letters that he looks for "businesses earning good returns on equity while employing little or no debt." Since high leverage implies the use of debt, our use of a quality ranking that incorporates both ROE and ROA enables us to mitigate the use of leverage as a sole driver of what may superficially appear to be a high ROE figure. Two of our favorite quotes from Warren Buffett and his business partner on this "quality" factor: **"Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."** – *Warren Buffett, Berkshire Hathaway Inc., Annual Report, 2008* **"We've really made the money out of high quality businesses . . . If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result."** - *Charlie Munger at USC Business School in 1994* **Key Characteristics of WisdomTree's "Dividend Growth" Companies** Now that we've discussed some of our rationale behind our Index constituent selection, let's compare the characteristics of our approach to some other indexes of U.S. equities.

WisdomTree U.S. Dividend Growth Index Key Characteristics (3/31/2013)

	Long-Term Earnings Growth Expectations	ROE	ROA	Leverage	Earnings Retention	ROE x Earnings Retention
Qualifiers	13.0%	23.2%	9.3%	2.50x	68.9%	16.0%
Non-Qualifiers	7.4%	11.7%	3.5%	3.32x	60.1%	7.0%
S&P 500 Index	10.6%	13.5%	3.0%	4.56x	67.5%	9.1%
WisdomTree Dividend Index	9.0%	13.7%	2.9%	4.74x	53.4%	7.3%
NASDAQ U.S. Dividend Achievers Select Index	10.5%	22.5%	8.7%	2.59x	59.5%	13.4%

Sources: WisdomTree, Bloomberg
Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions in this chart, please refer to our Glossary. • **Higher Growth Expectations:** The average long-term earnings growth estimates were over 5 percentage points higher for qualifiers to this index than for non-qualifiers. They were also higher than the S&P 500 Index and the WisdomTree Dividend Index, two indexes included to represent broad measures of U.S. equities that do not target potential dividend growth as part of their construction processes. • **The ROE/Dividend Connection:** The ROE for the NASDAQ US Dividend Achievers Select Index was almost 10 percentage points higher than the ROE of the S&P 500 index. To us, this indicates that ROE is a key attribute of companies that are consistently raising their dividends (as a 10-year consecutive annual dividend growth is required for inclusion into this index). This is another reason we have included ROE as a selection criterion for the WisdomTree U.S. Dividend Growth Index. • **Lower Leverage:** The qualifiers to the U.S. Dividend Growth Index employ less leverage to operate their businesses than both the non-qualifiers and the broader equity market measures. **Conclusion** While there is no way to know what will happen in the future with certainty, we believe that our dividend growth methodology applies a framework to selecting stocks with growth characteristics. We have focused on variables that we believe are key drivers of dividend growth. Given the record dividend growth that is occurring in the U.S. equity markets and the dynamic nature of the drivers of that dividend growth, we believe the backward-looking screens of many methodologies are likely to miss some of today's best dividend growth opportunities. *View Jeremy Schwartz discuss dividends* (Video) *Read our Dividend Growth series here.* [1]Source: Professor Robert Shiller, Yale University, 2013.

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You cannot invest directly in an index.

DEFINITIONS

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.

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.

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

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.