WISDOMTREE'S NEW EQUITY INCOME EVOLUTION: COMPOSITE RISK SCORING

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One of WisdomTree's first strategies originally focused on higher dividend-yielding U.S. stocks. It ranked a universe of dividend-paying equities by dividend yield and then selected the top 30%.

The original WisdomTree U.S. High Dividend Index aligned with research conducted by Professor Siegel for his 2005 book, *The Future for Investors*.

Professor Siegel broke down the performance of the S&P 500 dividend-paying stocks into quintiles. Stocks with the highest dividends had a positive impact on performance—while also reducing risk.

Introducing a New Composite Risk Scoring

One challenge with focusing on stocks in the top 30% of yields is that some securities could be considered "value traps," or "cheap for a good reason."

Sometimes the highest-yielding companies have seen their share prices precipitously drop due to risk factors and poor outlooks for future profitability, which could then lead to future dividend cuts.

In the past, we have relied on diversification to limit exposure to these names.

But new research we've conducted on a composite risk scoring methodology gives us a reason to add a new risk filter to our high-dividend screening and weighting process.

New Risk Management Process

First, the top 30% of eligible dividend-paying companies are initially selected, as has been the process in the past.

However, under the new approach, these companies are then screened across three factors (value, quality and momentum), each meant to quantify a specific risk.

- The value factor is designed to lower weight to companies deemed expensive by other traditional measures of valuation
- The quality factor is designed to lower weight to companies with poor profitability metrics or declining measures of profitability
- The momentum factor is designed to lower weight to companies that have a high yield but only because their stock prices are declining

We use this composite score to help exclude companies that are signaling higher risk on other measures, so we refer to this as a composite risk score. The overlap of companies that pass the dividend yield screen AND score in the bottom 20% based on this composite risk scoring will be removed from the Index.

Higher Risk Companies Underperformed

Companies scoring low on the composite risk score have underperformed the broader markets and did so with much higher risk and higher tracking error relative to the benchmark.

	Return	Standard Deviation	Sharpe Ratio	Maximum Drawdown	Tracking Error	Information Ratio	Up Capture	Down Capture	Alpha	Beta
Universe Market Cap-Weighted	7.86%	14.51%	0.49	-49.46%	1.98%	-0.31	92.44%	95.25%	-0.19%	0.94
Bad Quintile Market Cap-Weighted	2.79%	20.36%	0.10	-67.94%	8.22%	-0.69	103.28%	125.35%	-6.34%	1.24
MSCI USA IMI	8.47%	15.30%	0.50	-50.78%	0.00%	0.00	100.00%	100.00%	0.00%	1.00

Sources: WisdomTree, MSCI, 6/30/07–11/30/19. Universe represents dividend-paying securities within the MSCI USA IMI that have a market cap above $200m and average daily traded value over $200,000 for the six months before screening. The Bad Quintile represents securities within that universe that score low on a composite risk score. Screening is done at the end of November each year, and securities are either market cap-weighted or dividend-stream-weighted. You cannot invest directly in an index. Weights subject to change. Past performance is not indicative of future results.

For definitions of terms and Indexes in the chart, please visit our glossary.

As of the most recent annual screening at the end of November 2019, there was also some noticeable difference in the fundamentals of these higher risk companies. There were 99 companies excluded as a result of the additional composite risk score. Looking at the chart below, you can see that while the excluded companies had substantially higher dividend yields, other metrics were much less favorable. The aggregate trailing P/E ratio for these excluded companies was 30x earnings, driven by the fact that more than one-quarter of the basket has negative trailing earnings. Looking at a standard quality metric like return on equity, we also saw substantially lower values. These companies also were net share issuers, diluting existing shareholders by issuing 3% of new shares outstanding.

Fundamentals Comparison: Initial Dividend Universe

	Number of Securities	Dividend Yield	Net Buyback Yield	Shareholder Yield	Price-to-Earnings (P/E) Ratio	% Negative Earners	Estimated P/E Ratio	Return on Equity (ROE)	Return on Assets (ROA)
Initial Dividend Universe	1374	3.09%	1.93%	5.02%	18.2x	1.74%	16.2x	13.91%	2.83%
High-Dividend Yield Subset	437	4.44%	0.81%	5.25%	16.9x	2.87%	15.0x	12.00%	2.81%
High-Risk Companies Aggregate	99	6.24%	-3.29%	2.95%	30.1x	26.59%	21.0x	5.71%	1.47%

Sources: WisdomTree, FactSet, as of 11/30/19. High Dividend Yield Subset is securities that pass the initial high dividend yield screen for the WisdomTree U.S. High Dividend Index, usually around top 30% by dividend yield of the starting universe. All baskets above assume securities are weighted by their indicated cash dividends. Weights subject to change.

For definitions of terms in the chart, please visit our *glossary*.

How Index Weighting Pushes Weight Toward Potentially Lower Risk Firms

Since its inception in 2006, the WisdomTree U.S. High Dividend Index has employed a process that weights companies on the basis of their indicated cash dividends. The new approach takes this as a baseline but incorporates the same composite risk scoring mechanism that we discussed earlier in this piece to adjust the initial dividend weighting. After the initial screening, companies selected that rank in the top one-third within the composite risk scoring framework would see their weights increase by 50%, whereas companies in the bottom one-third would see their weights decrease by 50%[1]. It is in this way that the existing constituents see their weights adjusted to better reflect differences in relative risk. On a fundamental basis, you still get a noticeably higher dividend yield through the selection and weighting, but it's slightly lower due to the exclusion of higher-risk companies. With this exclusion and weighting, though, you achieve a more favorable shareholder yield, return on equity and return on assets.

Index Fundamentals Comparison

	Dividend Yield	Net Buyback Yield	Shareholder Yield	Price-to-Earnings (P/E) Ratio	Estimated P/E Ratio	Return on Equity (ROE)	Return on Assets (ROA)
WisdomTree U.S. High Dividend	4.16%	1.48%	5.64%	15.43	14.03	14.31%	3.15%
S&P 500	1.82%	2.30%	4.12%	21.30	18.64	15.57%	3.62%
Russell 1000 Value	2.47%	2.02%	4.49%	18.03	15.62	11.11%	2.35%

Sources: WisdomTree, FactSet, as of 11/30/19. You cannot invest directly in an index. WisdomTree U.S. High Dividend Index uses constituent weighting based on most recent November 30, 2019 screening to reflect the latest index composition. Weights subject to change.

Conclusion: From High Dividend Yield to More Sustainable High Dividend Yield

Over the course of the more than 13 years that the WisdomTree U.S. High Dividend Index has been in live calculation, the tools available for application within equity index construction have evolved. We believe that this new approach better reflects the tools of risk mitigation available to index providers currently, while at the same time delivering on the desire for a basket of U.S. equities with higher levels of dividend yield.

[1]Companies ranking in the middle third by composite risk score will not have their dividend stream adjusted for weighting purposes.

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You cannot invest directly in an index.

DEFINITIONS

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

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.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Composite Factor Score (CFS) : Taking individual measurements of factor exposures, and combining them into a single measure meant to represent multifactor exposure for a certain asset. For example, in the case of the WisdomTree U.S. Multifactor Index, the composite factor score aims to measure factor exposures to Value, Quality, Momentum and Low Correlation as they relate to a single asset..

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.

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.

Diversification : A risk management strategy that mixes a wide variety of investments within a portfolio.

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.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

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