

# WHERE TO FOCUS IN THE DIVIDEND MARKET

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Over a decade ago, WisdomTree launched a family of dividend-weighted Indexes that were designed to manage [valuation risk](#) and increase the dividend income of an equity basket.

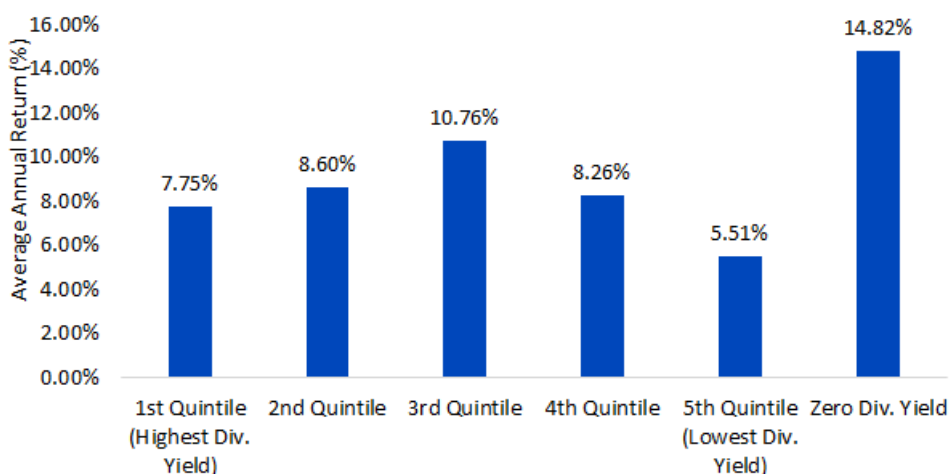
These Indexes appealed to my mentor, Professor Jeremy Siegel, under whom I studied at The Wharton School. He was concerned about the technology [bubble](#) in 1999 and 2000 and wrote an op-ed in the *Wall Street Journal* titled “Big-Cap Tech Stocks Are a Sucker Bet.” Siegel’s column listed nine stocks with triple-digit [price-to-earnings \(P/E\) ratios](#) that he thought could not justify their [valuations](#), no matter how optimistic analysts were for earnings over the following decade.

The market environment after the launch of our dividend-weighted Indexes was not particularly kind to a [value](#)-tilted indexing approach, for these reasons:

- [Growth](#) beat value, particularly in large caps.
- The best segment of the market was large-cap stocks that didn’t pay dividends.
- Market multiples rose.

Looking at the returns to the [S&P 500](#) over the last 12 years by dividend yield [quintiles](#) reveals the following:

## S&P 500 Index Non-Dividend Stocks Beat Highest-Yield Segment Last 12 Years



Source: WisdomTree Index attribution tool. Average annual total returns for the period 6/1/2006–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Concerns about equity markets today often are focused on elevated market valuation multiples or fears that we are late in the economic cycle and should be tipping into recession as the [Federal Reserve \(Fed\)](#) raises rates. Usually, pessimistic prognosticators start with how high the [cyclically adjusted P/E ratios](#) are and how that dooms us to terrible forward-looking returns that will start a downward drift when the Fed becomes too tight.

Having an index process that systematically and strategically [rebalances](#) back to the underlying *Dividend Stream*®—one that incorporates a strategic sell discipline when stocks have *rising* price-to-dividend ratios and a buy discipline when stocks have *falling* [price-to-dividend](#) ratios—is a useful way to manage valuation risk.

Where is this most interesting today? While large caps receive the bulk of attention—particularly for the well-known “[blue-chip](#)” dividend payers, I think valuations in traditional [market cap-weighted mid-cap](#) and [small-cap](#) indexes, where more unprofitable and fewer dividend paying companies also are found, are particularly worthy of focus. Below, I’ll focus on the mid-cap segment and how our dividend process results in a higher dividend yield.

### Reasonable Dividend Multiples?

To start, it is important to point out that valuations are not universally dramatically extended across the market. Below, I show the trailing and estimated P/E ratios across the WisdomTree Dividend Index family for large, mid- and small caps.

The estimated P/Es range from 15.6 in large caps to the mid-17s for mid-caps and small caps. Those are reasonable valuation multiples, particularly in the large-cap space, which is getting close to 5% combined return from both dividends and net buybacks. There does not have to be much greater future growth to take home close to a 5% real return with those types of current shareholder payouts.

### Valuations Across the WisdomTree Dividend Index Family

Dividend Index/Size Segment	P/E	Est. P/E	Div. Yield (%)	Net Buyback Ratio (%)
Large cap	18.64	15.58	2.74	2.14
Mid-cap	18.68	17.67	2.89	0.98
Small cap	19.11	17.46	3.72	-0.38

Source: WisdomTree; data as of 9/24/18. Past performance is not indicative of future results. You cannot invest directly in an index.

While strictly looking at the latest dividend yields would show the current dividend yield of many mid-cap indexes below their average yields since 2006, when factoring in the trend for [buybacks](#), the combined dividend and net buyback ratio for the [WisdomTree U.S. MidCap Dividend Index](#)—and, in fact, other traditional market cap indexes—is currently above their averages since 2006. This shows price appreciation over the last decade has been driven, in large part, by strong growth in both dividends and buybacks across the various mid-cap benchmarks.

Index	Dividend Yield	Avg. Since 2006	Shareholder Yld. (Div. Yld. + Net Buyback Yld.)	Avg. Since 2006
WisdomTree U.S. MidCap Dividend Index	2.85%	3.59%	3.81%	3.22%
Russell Midcap Index	1.54%	1.58%	2.76%	2.52%
Russell Midcap Value Index	2.07%	2.08%	3.27%	2.47%
S&P 400 Index	1.44%	1.48%	2.66%	2.27%

Sources: WisdomTree, FactSet, for the period 5/31/06–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

### Consistent Rules-Based Value Added

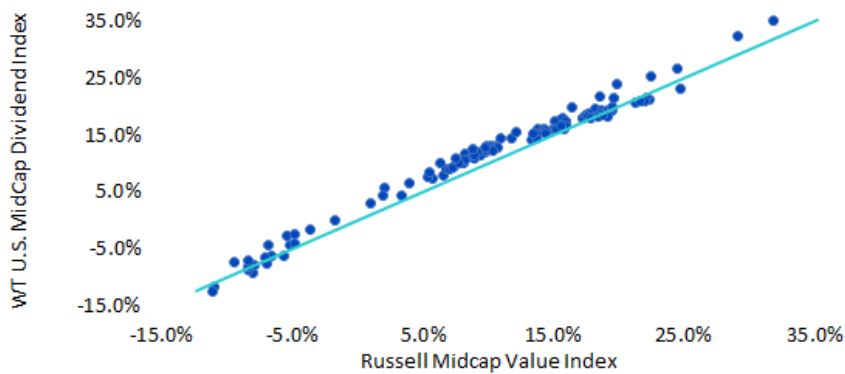
Also evident in the data is how a disciplined screening and rebalancing process—devoid of human emotion affecting allocations—in this dividend-weighted strategy has resulted in very consistent performance over the last 12 years our Index has been live.

The consistency chart below plots the returns of the [Russell Midcap Value Index](#) on the x-axis and the WisdomTree MidCap Dividend Index on the y-axis.

Approximately 85% of the rolling three-year return periods the WisdomTree Index outperformed the Russell Midcap Value Index, and when the Index underperformed, it was usually very close to the market return.

But we did find periods where the rolling three-year returns were meaningfully higher.

**Manager Consistency 3-Year Rolling  
(6/1/06-8/31/18)**



# of Monthly Observations	# Outperform Benchmark	% Outperform Benchmark
112	95	85%

Index	WisdomTree Index Inception	Average Annual Total Returns as of 6/30/18				
		1-year	3-year	5-year	10-year	Since Inception
WisdomTree U.S. MidCap Dividend	6/1/06	12.67%	12.42%	13.66%	12.49%	9.64%
Russell Midcap Value		7.60%	8.80%	11.27%	10.06%	8.42%

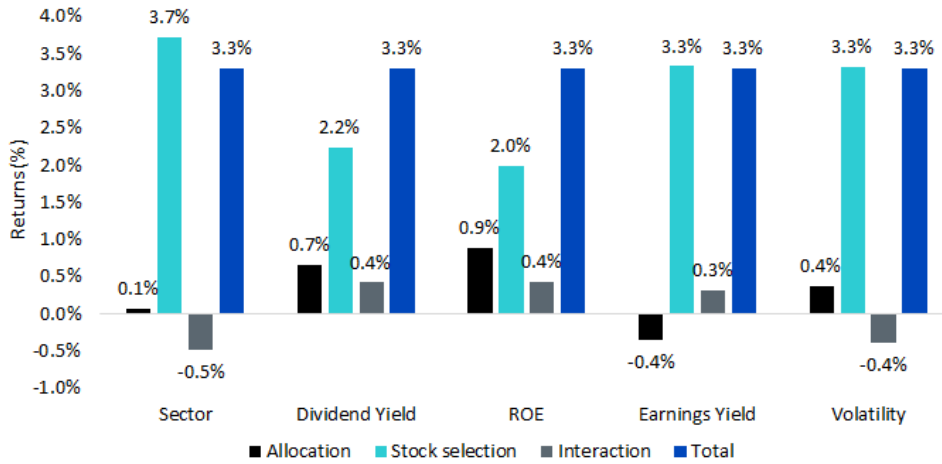
Sources: WisdomTree, FactSet. Past performance is not indicative of future results. You cannot invest directly in an index.

**Latest Performance Standout**

The latest three-year performance for the WisdomTree U.S. MidCap Dividend Index versus the Russell Midcap Value Index was one of the better three-year performance differentials for a dividend strategy compared with a traditional [price-to-book](#) value sorting strategy.

This is a little surprising given the general increase in interest rates that we have seen over the last three years, particularly from mid-2016. One can look at attribution and get a sense this outperformance was not from a differential in sector weights or other factors but, rather, better stock selection within most of the factors we examined. This is true whether one looks at sector weights, dividend yield quintiles, [ROE](#) quintiles, earnings yield quintiles or volatility quintiles

Attribution Shows Stock Selection Was Key Driver of Returns over the Last Three Years



Sources: WisdomTree, FactSet. Data for the period 9/1/15–8/31/18. Past performance is not indicative of futures results. You cannot invest directly in an index.

See more details on the [WisdomTree U.S. MidCap Dividend Index attribution](#).

When looking at past performance like this, one must wonder whether the differential will “[mean revert](#)” and underperform over the next three years. Our systematic process to lower weight to stocks that are seeing prices appreciate more than their dividends is one of the reasons we like this dividend-weighted process—it will de-risk and take chips off the table as its stocks get more expensive.

While most people look at large caps for dividends, we believe the track record of this mid-cap strategy shows these mid-caps are often overlooked.

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**

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You cannot invest directly in an index.

## DEFINITIONS

**Valuation risk** : The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.

**Bubble** : when market participants drive stock prices above their “fair value” in relation to some system of stock valuation.

**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.

**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.

**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 time.

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**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 a batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**Cyclically Adjusted Price to Earnings (CAPE) Ratio** : a valuation measure of the S&P 500 Index that is adjusted for inflation and takes into account cyclical fluctuations in market earnings relative to longer term averages.

**Rebalance** : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

**Price-to-dividend ratio** : Refers to the index price divided by the trailing 12-month dividends.

**Blue chip** : Stocks that have the reputation for quality, reliability and the ability to operate profitably in good times and bad.

**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.

**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.

**Buyback** : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

**Russell MidCap Value Index** : measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.

**Price-to-book ratio** : Share price divided by book value 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.

**Mean reversion** : The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.