DO(N'T) DISCOUNT DIVIDEND PAYERS

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"Although earnings determine the amount of dividends paid by the firm, the price of the stock is always equal to the present value of all future dividends and not the present value of future earnings."

–Jeremy Siegel, Stocks for the Long Run[1]

The relationship between earnings and dividends is simple and important. Earnings dictate how much of a dividend companies can currently distribute to shareholders, and how much that dividend can grow over time.

These two variables, dividend per share (D_1) and implied dividend growth (g), are central to the Gordon Growth Model (GGM) for valuing stocks:

$$V_0 = D_1/(k - g)$$

V_0 = value of common stock at time 0 (i.e., today's stock price)

D_1 = dividend per share at time 1 (i.e., next year's dividend)

k = required rate of return (i.e., discount rate on equity)
g = implied dividend growth rate (i.e., sustainable dividend growth)

The relationship between earnings and dividend growth is summed up in the equation below, which uses return on equity (ROE) as the measure of earnings. Earnings retention tells us what percentage of earnings is being plowed back into the company rather than paid out in dividends:

ROE x Earnings Retention = Implied Dividend Growth Rate (g)

If we assume a constant earnings retention—a fair assumption when looking at companies in the aggregate—ROE is the key input to the implied dividend growth rate.

WisdomTree set out to incorporate this theory into screening and weighting securities in its innovative Quality Dividend Growth family.

Companies are screened on earnings (quality), both trailing earnings and earnings growth estimates, and then weighted by their cash dividends.

To summarize the logic and objective behind the methodology:

- Logic: Using inputs commonly used by active managers and academics for valuation to construct a trackable Index in a repeatable, rules-based fashion.

- Objective: Creating a more mean-variant efficient portfolio than a market cap-weighted approach, while typically offering a lower expense ratio and more consistent investment style than a high-cost active manager who may be subject to behavioral biases and style drift.

From Theory to Practice

Valuing companies based on dividends—taught in Finance 101 courses—is well-documented and understood. In practice, though, this theory has been stressed over the last decade.

Many of the best performing large-cap U.S. stocks over the past 10 years pay no dividends at all. And for many of these companies, this is despite having high profitability and hefty cash balances.

About 19% of the weight of the S&P 500 Index is in non-dividend payers—these companies would be ineligible for an indexing approach that screens on dividends.

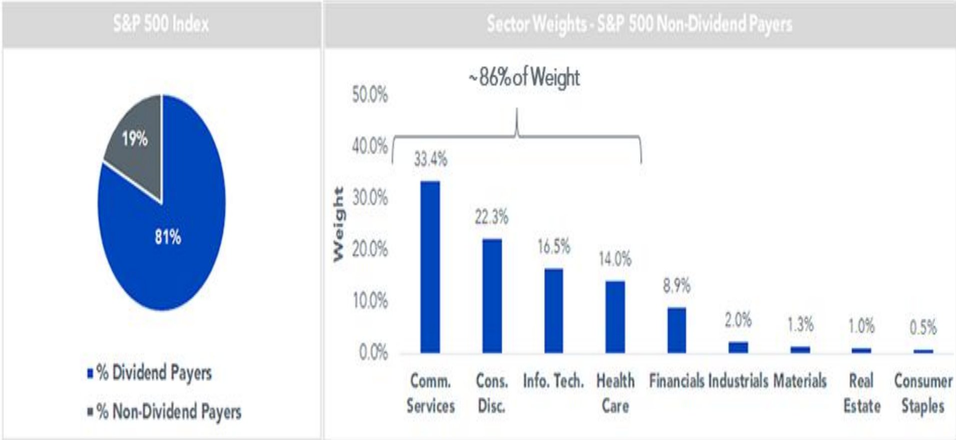
The chart below shows the fundamentals and sector exposures of that 19% that is excluded and compares the fundamentals to the WisdomTree U.S. Quality Dividend Growth Index (WTDGI) and the S&P 500 Index.

To no surprise, the non-dividend payers tilt toward growth, as seen by the sector exposures, the substantial price/earnings (P/E) premium and high profitability. Higher valuations and a shareholder yield of around 1% make future returns much riskier, in our view, than a broad basket (~300 stocks for WTDGI) of high-quality dividend-paying securities.

WTDGI boasted a few distinct advantages over the S&P 500 from a fundamentals perspective:

- A discounted P/E multiple
- Higher ROE and return on assets (ROA)
- Dividend yield advantage of 69 basis points (bps) and a shareholder yield of over 5%—a significant return of capital to shareholders in a low-rate environment
- Higher implied dividend growth (ROE x earnings retention)—included in the denominator of the GGM

S&P 500 and WisdomTree U.S. Quality Dividend Growth Index



	WT U.S. Quality Dividend Growth Index	S&P 500 Index - Non-Dividend Payers	S&P 500 Index
Estimated Price/Earnings	15.75	25.18	17.69
Return on Equity	22.80%	14.17%	15.96%
Return on Assets	5.19%	6.89%	3.73%
ROE x Earnings Retention	**12.89%**	**14.17%**	**10.01%**
Dividend Yield	**2.56%**	**0.00%**	**1.88%**
Net Buyback Yield	2.64%	1.28%	2.50%
Shareholder Yield*	5.20%	1.28%	4.38%

Sources: WisdomTree, FactSet as of 7/31/19. *Shareholder Yield = Dividend Yield + Net Buyback Yield. Subject to change. Past performance is not indicative of future results. You cannot invest directly in an index.

Real-Time Impact: The Quality Overlay to Dividends

You may be surprised to find that a dividend-based approach to U.S. equities could have kept pace with the S&P 500 over the past six-plus years—as we mentioned earlier, that 19% of stocks that do not pay dividends have performed very well! But WTDGI has mostly kept pace over its live track record. And through July 31, 2019, it has outperformed by 24 bps annualized.

If we look at the below dividend yield attribution for WTDGI versus the S&P 500, there is a clear relationship between higher dividend yields and lower category performance.

Since the inception of WTDGI, the highest-yielding quintile of the S&P 500 returned 9.73%. The lowest yielders returned 12.95%, and the non-dividend group returned 18.19%.

But if we look at the top two yielding quintiles within WTDGI, these higher-yielding securities with a quality overlay performed much better than those high-yield quintiles in the benchmark with no such quality filter. WTDGI banked 78 bps of positive stock selection combined from the first two quintiles.

Dividend Yield Attribution

WTDGI - WisdomTree U.S. Quality Dividend Growth Index vs. 500 - S&P 500 Index

Dividend Yield Attribution — As of: 7/31/2019

MTD | YTD | 1Y | 3Y | 5Y | Since Inception*

EXPORT EXCEL

	Attribution Component				Average Category Weight			Category Performance	
Category	Allocation	Stock Selection	Interaction	Total Attribution	Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
1st Quintile (Highest Div. Yield)	0.27%	0.49%	-0.54%	0.23%	15.59%	16.98%	-1.39%	11.92%	9.73%
2nd Quintile	-0.21%	0.29%	0.12%	0.19%	30.69%	22.17%	8.52%	11.88%	10.74%
3rd Quintile	0.19%	0.09%	-0.04%	0.23%	25.41%	17.03%	8.39%	14.96%	14.80%
4th Quintile	-0.03%	0.26%	0.06%	0.29%	20.68%	16.13%	4.55%	13.40%	11.71%
5th Quintile (Lowest Div. Yield)	-0.01%	0.16%	-0.06%	0.10%	7.60%	11.59%	-4.00%	14.40%	12.95%
Zero Div. Yield	-0.70%	0.16%	-0.18%	-0.72%	0.00%	14.56%	-14.56%	3.61%	18.19%
N/A	-0.07%	0.20%	-0.21%	-0.08%	0.02%	1.53%	-1.51%	6.02%	15.57%
Total	**-0.56%**	**1.64%**	**-0.85%**	**0.24%**	-	-	-	**13.04%**	**12.80%**

Sources: WisdomTree, FactSet. Returns from 4/30/13–7/31/19. Subject to change. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion

In hindsight, it's easy to see that being underweight non-dividend payers was a drag on performance over this period. But the substantial impact that dividends have had on long-run historical performance makes us reluctant to think this trend of outperformance will continue indefinitely.

The current balanced make-up between strong profitability metrics and discounted relative valuations for WTDGI, largely achieved by avoiding the more expensive non-dividend payers, gives us confidence in the merits of this approach for a core U.S. equity allocation going forward.

[1]Stocks for the Long Run, 2014, p. 149.

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You cannot invest directly in an index.

DEFINITIONS

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

Dividends per Share : The sum of declared dividends for every ordinary share issued. Dividend per share (DPS) is the total dividends paid out over an entire year (including interim dividends but not including special dividends) divided by the number of outstanding ordinary shares issued.

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

Earnings Retention : Proportion of a firm's earnings that are is not paid out to shareholders in the form of a dividend but rather reinvested back into the business. Higher numbers indicate a greater percentage of earnings are being reinvested.

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.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

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.

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.

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.

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.

Earnings multiple : another way of saying price-to-earnings multiple.

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.

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

Basis point : 1/100th of 1 percent.