HOW DIVIDENDS HELP DRIVE LONG TERM RETURNS

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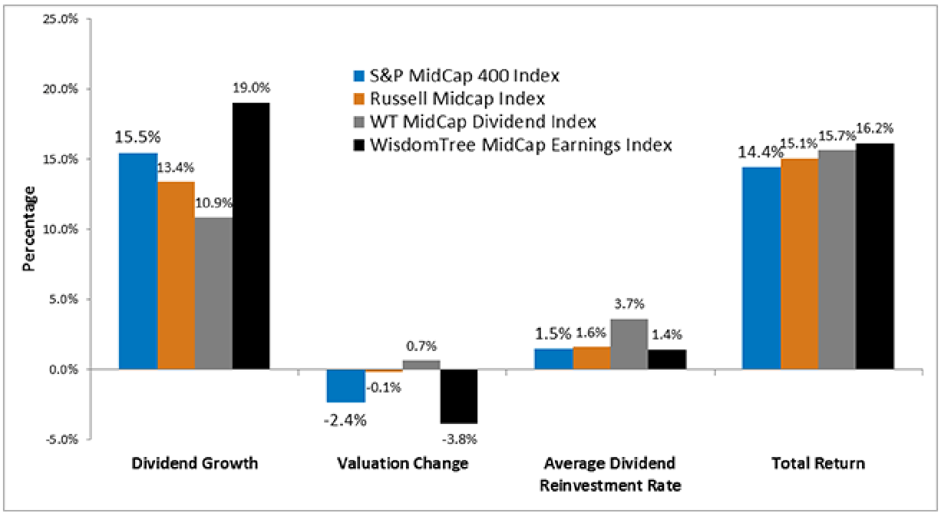
05/26/2015

At WisdomTree, we spend a lot of time researching and writing about trends in fundamentals, such as dividends or earnings, and one topic that always attracts a lot of interest is dividend growth. With regard to U.S. markets, we have continually made the case that above-average dividend growth has been supporting above-average market returns over the past few years. Also, we believe that the increase in net share buybacks could potentially lock in above-average dividend growth going forward. We typically make these points with regard to the broad U.S. equity markets, but today I would like to hone in on mid-cap equities. **The Dividend Decomposition Model** Equity fundamentals such as dividends or earnings are important characteristics that can influence returns over the long run. When considering dividends, one way to frame returns for an index is a mathematical decomposition of the total returns over any period into two sources:

+ **Price Returns:**
  - **Dividend Growth** • **Valuation Changes**

+ **Average Dividend Reinvestment Rate (Average Dividend Yields)** For dividends, higher dividend growth rates or higher dividend reinvestment rates (average dividend yields) typically support higher total returns. For valuation changes, if stock valuations rise, the return from valuation changes will be positive and increase total returns. Valuations in this context can be seen as rising price-to-dividend (P/D) ratios or declining dividend yields. If stock valuations fall (falling P/D ratios or rising dividend yields), the return from valuation changes will be negative and hurt total returns. **Five-Year Dividend Return Decomposition**



Sources: WisdomTree, Bloomberg, 4/30/10–4/30/15. Period was chosen to capture recent equity gains over longest standardized period available for all indexes displayed. Past performance is not indicative of future results. You cannot invest directly in an index.

- **Dividend Growth Rates Were Impressive,** with all indexes above displaying double-digit dividend growth. At 19%, the WisdomTree MidCap Earnings Index (WTMEI) recorded the highest dividend growth over the period, so it is no surprise that is also had the highest total return. One reason we believe WTMEI was able to generate such high dividend growth is the fact that the Index screens and weights eligible companies by profitability on an annual basis. In finance theory, the sustainable dividend growth rate is considered to be a combination of a company's profitability and its reinvestment rate (or 1 minus its payout ratio). Therefore, we believe WTMEI's focus on profitability and high reinvestment rate (low dividend yield) over the period led to higher dividend growth. • **Average Dividend Yields Matter;** the average dividend yield (current income) over the period can be just as important as the dividend growth (growth of income). The WisdomTree MidCap Dividend Index (WTMDI) was able to outperform both market cap-weighted broad indexes due to its higher average yield of 3.66%, and benefit from valuation changes over the period, even though it exhibited the lowest dividend growth over the period. Given the high average yield over the period, the lower dividend growth rate makes sense if you use the same finance theory logic as above, because a higher payout ratio (lower retention rate) can lead to a lower dividend growth rate (assuming everything else is equal). But the income generated from WTMDI over the period would have been double that of any of the indexes displayed above, which helped drive its total returns higher through the power of compounding. **Mid-Cap Valuations** We find it very interesting that even after the impressive gains above, the average valuation change for the mid-cap indexes displayed above was slightly negative over the period, indicating that the U.S. mid-cap market has actually become less expensive on a P/D ratio basis. WTMEI saw the greatest reduction in valuations, with its P/D ratio contracting by over 17%, as a result of dividends growing considerably faster than prices over the period. We take comfort in the fact that the overall valuations have not become overly stretched, but we still feel it is important to be mindful of fundamentals and to focus on indexes that follow a disciplined process of adjusting weight based on changes in relative value as well as in the relationship between fundamentals and price growth.

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You cannot invest directly in an index.

DEFINITIONS

Fundamental value : The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.

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

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

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

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.

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.

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

Payout ratio : The percentage of earnings paid to shareholders in dividends. Calculated as yearly dividends per share over earnings per share.

Relative value : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.