

The unique advantages of dividends

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This blog is the second instalment of our new educational blog series on investment strategies and asset classes. You can access the first one [here](#). Today we address the case for dividend weighting.

Did you know that most indices—and the ETFs based on them—are market capitalization weighted (share price x number of shares outstanding)? This weighting method assumes that price is always the best measure of a stock's underlying value. Consequently, the more expensive a stock is, the more weight it gets in the index (and vice versa). However, history—and likely your own experience—has demonstrated that prices can and do deviate from underlying value for many reasons.

That is why at WisdomTree we choose to weight our indices by fundamentals. We believe that fundamentals, like dividends, can offer a more objective measure of a company's health, value and profitability than stock price alone. Consider that dividends have theoretical and empirical importance in determining a stock's value. Additionally, they:

- Cannot be manipulated by accounting schemes
- Provide a stream of income with the potential to grow
- May reduce volatility and offer protection during down markets—and more

The dividends of dividends

Consider that investors historically purchased stocks as much for their ability to provide income as for their potential to grow capital. Whether investing in large cap equities or small cap equities, dividend reinvestment was a powerful force on the capability to compound the growth of returns.

Figure 1a and 1b: The power of compounding returns: dividend reinvestment in large & small cap

Sources: Kenneth R. French Data Library, 30 June 1926 to 30 June 2018. Data takes the largest and smallest 30% of listed stocks in US markets based on market capitalization size. These are not calculated indices.

Historical performance is not an indication of future performance and any investments may go down in value.

The power of valuation control & rebalancing

It is worth noting that all dividends are not created equally. Wharton Professor and WisdomTree Senior Investment Advisor Jeremy Siegel has demonstrated that over time, stocks with higher dividends tend to

outperform those with low and no dividends. In the chart below, the S&P 500 was divided into five groups, or quintiles, each representing 20% of the dividend payers within the index. The quintiles are then ranked from those paying the highest dividends to those paying the lowest. This is done on an annual basis.

As you can see, the quintiles paying the high and highest dividends historically outperformed the S&P 500 as well as the low and lowest dividend payers by a range of 280%-680%, respectively, with lower volatility.

Figure 2: Dividend yield and relative performance: Quintile Charts from Jeremy Siegel's Research

Source: Siegel, Future for Investors. 2005, with updates to 2017. Period 12/31/1957-12/31/2017.

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Weighting by dividend

Weighting by dividend can help to generate more income and potentially magnify the impact dividends have on performance. In the hypothetical example below, the dividend-weighted portfolio is able to generate 30%+ additional income over the cap-weighted portfolio using the same stocks and the same initial investment.

Figure 3: Weighting by dividend

Source: Hypothetical illustration from WisdomTree.

We'll discuss more about the possible advantages of weighting by dividend as this educational blog series continues.

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