WisdomTree Research
MARKET INSIGHTS [January 2013]

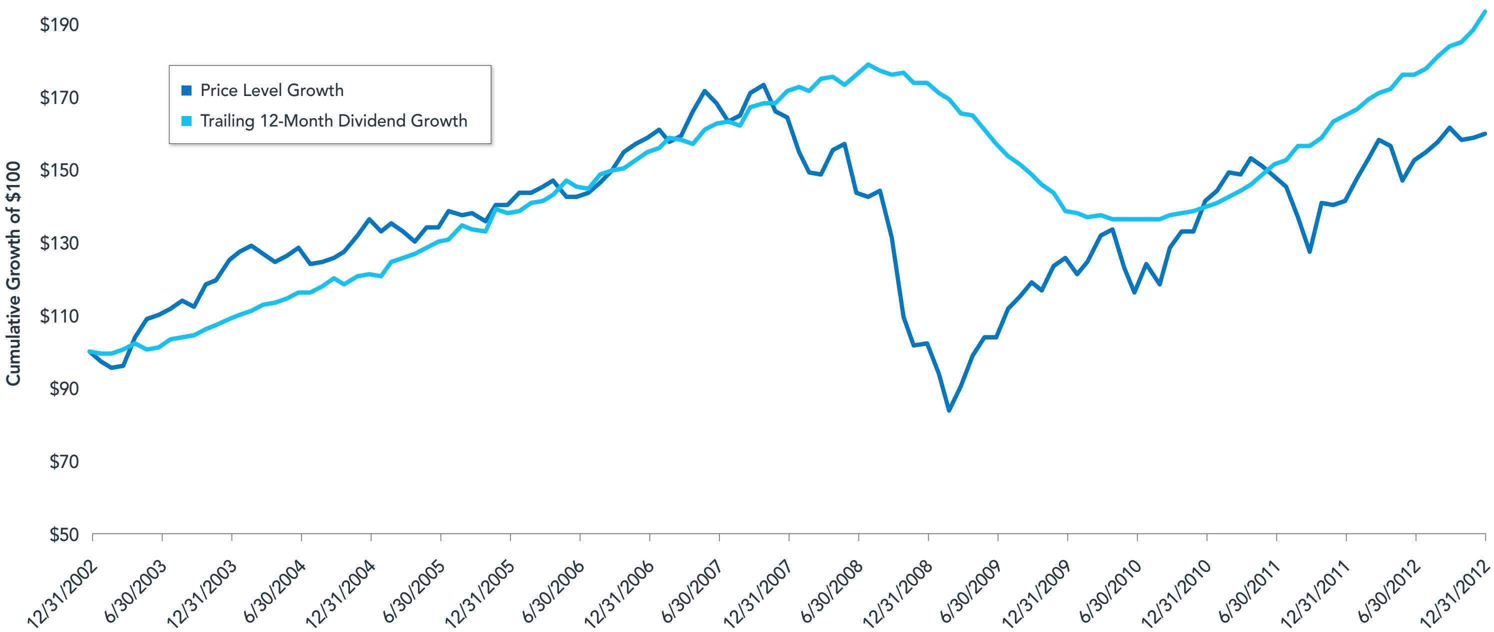
WisdomTree

Are Dividend-Paying Stocks Expensive?

BY JEREMY SCHWARTZ, CFA®, DIRECTOR OF RESEARCH
& **CHRISTOPHER GANNATTI, CFA®,** RESEARCH ANALYST

One of the most often posed questions about dividend-paying stocks of late is: Do valuation characteristics[1] indicate dividend payers are becoming expensive? We have now addressed this question in a few different commentaries, but we take another look here with a fresh approach. We believe an intuitive framework to answering this question could compare price performance (upward or downward movement of stock prices that does not account for dividend payments) to trailing 12-month dividend growth[2]. In figure 1 we use the S&P 500 Index, as it is one of the most widely followed measures of U.S. equity market performance. Additionally, as of December 31, 2012, approximately 88% of its weight was in stocks that had paid at least one dividend over the prior 12-month period[3]—meaning that dividend payers constitute a significant proportion of this index's weight.

FIGURE 1: S&P 500 INDEX: CUMULATIVE GROWTH OF A HYPOTHETICAL $100 MEASURED AT THE RATE OF PRICE PERFORMANCE VS. THE RATE OF TRAILING 12-MONTH DIVIDEND LEVEL GROWTH [12/31/2002—12/31/2012]



Source: Bloomberg
Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

[1] Valuation characteristics: Look at the relationship between stock prices and other financial characteristics, such as dividend payments or earnings.
[2] Trailing 12-month dividend growth: Dividends paid over the prior 12 months are added up and measured for increases or decreases over time.
[3] Source: Bloomberg.

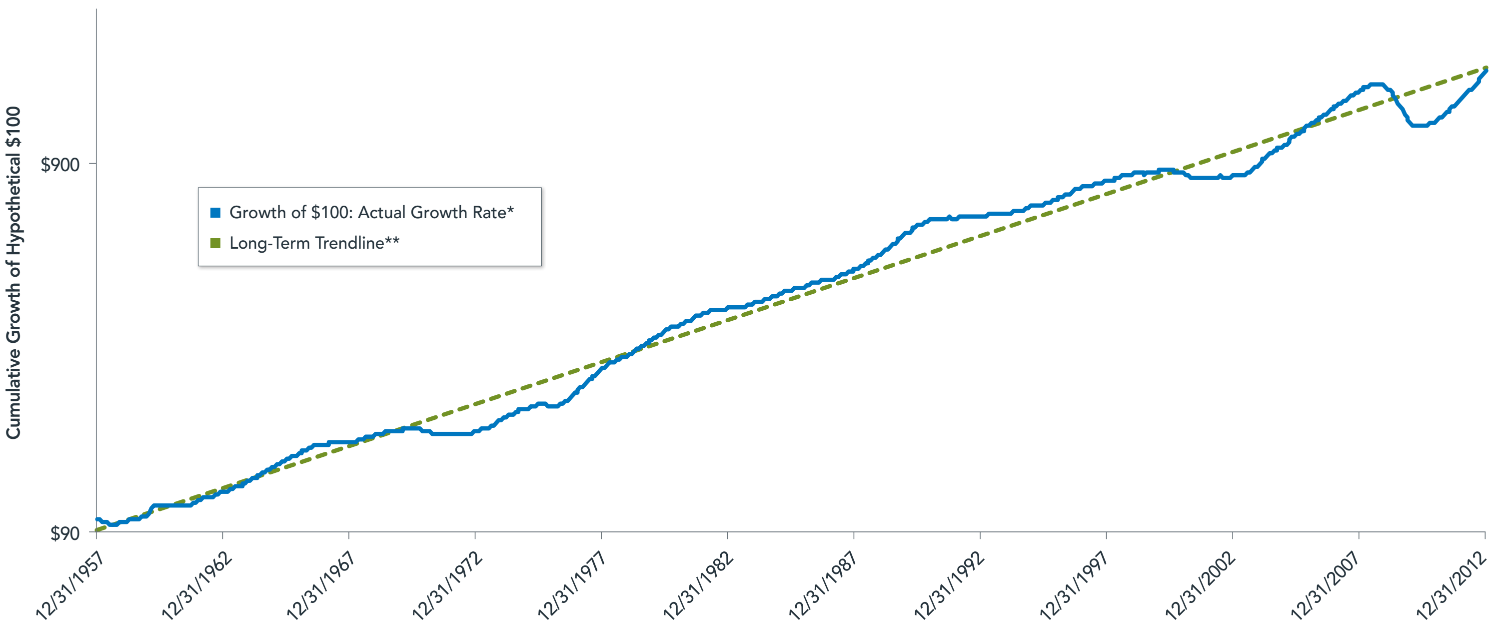
In figure 1, we see:

- **Over this period, the S&P 500 Index reached a peak price level in October 2007—specifically, a value of 1565 on October 9, 2007.[4]**
- **The global financial crisis of 2008–09 had an impact on both price performance and trailing 12-month dividend growth, reducing both significantly.**
- **The price level of the S&P 500 Index as of December 31, 2012, was 1426.[5] This means that, in price-terms, the S&P 500 Index must appreciate approximately 10% to reattain its October 2007 peak. Trailing 12-month dividend levels, on the other hand, have set a new high that was 15.1% above its value at the time prices were last at their peak.**

Bottom line: Price levels for the S&P 500 Index remain below their prior established October 2007 peak, but trailing 12-month dividends have grown significantly, surpassing where they were at that same point in time. This indicates that, as of December 31, 2012, the S&P 500 Index is generating a greater amount of trailing 12-month dividends, but doing so at what is actually a lower price level compared to its own history.

[4] Source: Bloomberg.
[5] Source: Bloomberg.

FIGURE 2: GROWTH OF A HYPOTHETICAL $100 AT GROWTH RATE OF TRAILING 12-MONTH DIVIDENDS FOR S&P 500 INDEX COMPARED TO LONG-TERM TREND [12/31/1957—12/31/2012]



*Actual Growth Rate: Actual rate of growth for trailing 12-month dividends for the S&P 500 Index from 12/31/1957 through 12/31/2012.
**Long-Term Trendline: Actual trailing 12-month dividends for the S&P 500 Index are measured and used to determine an overall trend for the period from 12/31/1957 to 12/31/2012. This is meant to indicate how actual trailing 12-month dividends may at times grow at faster or slower rates than their longer-term average.
Source: Professor Robert Shiller, Yale University, 2012.
Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

Additionally, we believe that trailing 12-month dividend growth for the S&P 500 Index has the potential to grow at higher rates than their long-term average measured from December 31, 1957, through December 31, 2012. We illustrate the long-term trendline of the trailing 12-month dividends for the S&P 500 Index, shown in figure 2, utilizing the growth of a hypothetical $100 to illustrate the actual rate of growth for trailing 12-month dividends, similar to our approach in figure 1.[6] The resulting long-term trendline is not meant as a prediction, nor does it imply that the growth rate must always adhere to it. Rather, it is meant to show a baseline as to how trailing 12-month dividends have grown over this period on an average basis.

+ **From October 31, 2007 through March 30, 2010 trailing 12-month dividends for the S&P 500 Index dropped approximately 20%. Prior to this point, from June 30, 2003 through October 31, 2007 they had grown nearly 13% on an average annual basis, which is a faster rate than is indicated by the long-term trend line. Of course, this is shown by the steeper slope of the blue line, actually crossing over the dashed green line during this period of time.**

[6] This is done by running a regression line through the series. A regression line attempts to create a formula that relates two series—in this case, time and dividend payments.

- **Some of this above-average growth in trailing 12-month dividends came from more companies paying dividends, for example Microsoft, which initiated a regular dividend payment during the 2003 calendar year. However, there was also what we now know to have been unsustainable trailing 12-month dividend growth from the financial sector firms in the S&P 500 Index.**
- **As a result of the financial crisis and veritable collapse of dividends amongst financial firms within the S&P 500 Index, the trailing 12-month dividend growth of the S&P 500 Index went from a value approximately 13.1% above its long-term trendline on June 30, 2008 to a value that was approximately 22% below this same trend on June 30, 2010.**
- **While it can never be viewed as a certainty, such a drop does indicate the potential to experience above-average growth in order to return back to rate of growth implied by the long-term trend. Trailing 12-month dividend growth for the S&P 500 Index relative to the long-term trend did in fact pick up from this June 30, 2010 low point, but levels were still approximately 3.4% below the long-term trendline as of December 31, 2012. Specifically, the actual trailing 12-month dividend growth rate of a hypothetical $100 led to a level of $1,746 as of December 31, 2012; had it adhered exactly to the rate observed for the long-term trendline, the level would have been $1,808.**

We recognize that there is no guarantee that trailing 12-month dividends will in fact return to a rate of growth consistent with this particular long-term trend. However, this data point gives us reason to believe that dividend growth at faster rates than the long-term trend would not be abnormal. Even though the actual growth of trailing 12-month dividends for the S&P 500 Index has been particularly strong in the past few years, we believe this analysis shows that dividends have the potential to continue exhibiting above-average growth—meaning growth at a faster rate than that of the long-term trendline. The stronger the levels of trailing 12-month dividend growth, the more support we believe there is for rising price levels on those stocks generating the trailing 12-month dividends for the S&P 500 Index.

A LOOK AT INDICATED DIVIDENDS[7]

WisdomTree can also look at this question by way of its WisdomTree Dividend Index, potentially the broadest set of U.S. dividend-paying equities currently in existence. This index is different from the S&P 500 Index in that all of its constituents must be regular dividend payers and these constituents are weighted on the basis of their indicated dividend streams[8]. The S&P 500 Index, on the other hand, weights its constituents on the basis of their market capitalizations[9].

- **In 2007, at the November 30 annual rebalance screening, the WisdomTree Dividend Index recorded what remained, until November 30, 2012, its peak level of $288.53 billion. At the November 30, 2012, rebalance**

[7] Indicated dividends: Dividends companies have indicated they will pay based on their most recent dividend announcements.
[8] Indicated dividend stream: Indicated dividend per share multiplied by the number of shares outstanding for each Index constituent. Large numbers lead to greater Index weights.
[9] Market capitalization: Share price x number of shares outstanding. Large values receive larger weights within a market capitalization-weighted index.

screening—5 years later—a new peak of almost $329 billion was achieved. This indicates approximately 14% cumulative growth in the indicated dividend stream over the period. Indicated dividends give what we consider one of best indicators of dividends to be paid by companies over the following 12 months, as these figures are based on the latest regular dividend declarations of constituent firms.

+ **While, as of November 30, 2012 indicated dividends are 14% above their prior peak, on a price basis the WisdomTree Dividend Index must rise approximately 14% in order to attain its prior peak achieved on October 9, 2007. As of December 31, 2012, this price level would still need to appreciate approximately by the same amount to attain this prior level, as the price level barely moved over the month of December 2012.[10]**
+ **To be fair, there are factors that can impact the indicated dividend stream but not the price level of the WisdomTree Dividend Index. For instance, if a company initiates a dividend, it will impact the indicated dividend stream but cannot impact the price level of the Index until after it is added. To cite an example: Apple, Inc., was added to the WisdomTree Dividend Index as a result of the November 30, 2012, Index screening. Apple's indicated dividend stream was nearly $10 billion—the third-largest among all the WisdomTree Dividend Index constituents.[11] Apple's price performance from November 30, 2011 (the prior screening date), to November 30, 2012, did not impact the price level of the WisdomTree Dividend Index, since Apple was not a constituent over that period.**
+ **Fortunately, we can also look at the Russell 3000 Index in terms of its price performance and trailing 12-month dividend growth. The Russell 3000 Index weights its constituents by their market capitalizations, and it is meant to be a broad measure of the performance of U.S. equities in general, not just dividend payers. It also does not add or subtract companies based on whether they indicate payments of regular dividends—thus directly addressing the aforementioned "Apple issue"—and it is the performance benchmark for the WisdomTree Dividend Index. Trailing 12-month dividends are approximately 16% above their October 31, 2007, levels, but prices would still have to appreciate approximately 6% to reattain their highs seen on that same date.**

To summarize the various frameworks we have now used to answer the question about dividend stock valuations, below are the key points that suggest dividend stocks are not expensive:

+ **As discussed in this piece, trailing 12-month dividend levels for the S&P 500 Index have reached a new peak level, while prices have not. This indicates to us that the market has generally become cheaper, because more dividends are being generated at lower price levels for this index. We also cited how this is true for the Russell 3000 Index, an even broader measure of the performance of U.S. equities.**
+ **Price-to-Earnings (P/E) Ratio[12] Comparison: If one considers a sector-by-sector comparison between the S&P 500 Index, which includes both dividend payers and non-dividend payers, and the WisdomTree LargeCap**

[10] Source: Bloomberg.
[11] Source: Bloomberg, as of 11/30/2012.
[12] Price-to-earnings (P/E) ratio: Share price divided by the earnings per share. Lower values indicate an ability to access greater amounts of earnings per dollar invested. Source: Bloomberg, as of 11/30/2012.

Dividend Index, which includes only dividend payers weighted by their indicated cash dividend streams, 9 of 10 sectors show that the sectors of the WisdomTree LargeCap Dividend Index had lower average P/E ratios than the respective S&P 500 Index sectors. The only exception was the Financials sector. Neither of these indexes directly aims to influence its average P/E ratios—either of component sectors or of the entire Index—as part of its underlying methodology.

+ **Sector Trailing 12-Month Dividend Yield Spread Analysis: On October 2, 2012, we released a piece entitled "Why We Believe High-Dividend Sectors Are Not 'in a Bubble.'" In this piece, the high-dividend sectors mentioned specifically were Telecommunication Services, Health Care, Consumer Staples and Utilities, and they were selected as being the four most heavily weighted sectors within the WisdomTree Equity Income Index. This Index selects stocks that are in the top 30% of the WisdomTree Dividend Index, ranked by their indicated dividend yields[13]. As of the November 30, 2012, Index screening, these four sectors remained the four most heavily weighted within the WisdomTree Equity Income Index, indicating to us that dividend-paying stocks within these sectors continue to exhibit relatively high indicated dividend yields. Since this Index has only about 6.5 years of live history, we utilized the S&P 500 sector sub-indexes for each of these sectors so as to be able to look at longer-term average levels. Additionally, we calculated each sector's trailing 12-month dividend yield spread[14] over the broad S&P 500 Index. When looking at average trailing 12-month dividend yield spreads for these four S&P 500 sector sub-indexes, we found that for the period from December 31, 1992, through December 31, 2012, only the S&P 500 Utilities Index exhibited a trailing 12-month yield spread below that of its 20-year average, meaning that its constituents have a greater potential to be expensive relative to their own history than do those of the S&P 500 Telecommunication Services, Consumer Staples or Health Care Indexes.**

THE FINAL POINT: THE MARKET ENVIRONMENT SUPPORTS DIVIDENDS AS A SOURCE OF POTENTIAL INCOME

When considering investments, one must always consider the opportunity cost, meaning the set of other options in which one could have allocated an investment. Many investors' ultimate goal today is to analyze different ways in which to use their investment portfolios to generate income. Traditionally, fixed income securities have been important contributors. While these securities certainly still have their place within portfolios, it is important to note the historic nature of the present-day period—namely that the last time the S&P 500 Index had a sustained trailing 12-month dividend yield that was higher than the yield to maturity[15] on a 10-Year Treasury Note[16] occurred in the late 1950s.[17] In fact, high-quality bonds

[13] Indicated dividend yield: Indicated dividends per share are annualized and then divided by the current share price, with higher numbers meaning that a firm is indicating that it intends to pay greater amounts of dividends per dollar of its share price.

[14] Trailing 12-month dividend yield spread: The trailing 12-month dividend yield for the S&P 500 Consumer Staples, Health Care, Telecommunication Services and Utilities Indexes are calculated, and then the trailing 12-month dividend yield for the broad S&P 500 Index is subtracted from them, indicating how much higher or lower the sector indexes' trailing 12-month dividend yield is compared to that of the S&P 500 Index. Higher values indicate a sector index's trailing 12-month dividend payments look less expensive than those of the S&P 500 Index.

[15] Yield to maturity: Measure of bond returns accounting for both the bond's potential price appreciation to its par value and its coupon payments. Higher yields to maturity, barring default, are indicative of greater potential returns.

[16] 10-Year Treasury Note: Debt that is an obligation of the U.S. government, maturing 10 years from the date on which it is issued.

[17] Source: Professor Robert Shiller, Yale University, 2012.

measured by either the Barclays U.S. Corporate Investment Grade Index or the Barclays U.S. Aggregate Bond Bond Index have yields to maturity fairly similar to the historically low level of the U.S. 10-Year Treasury Note (at 2.72% and 1.74%, respectively) as of December 31, 2012[18]. As long as this relationship exists and other traditional sources of income remain depressed, we will continue to see the potential for investors to look for dividend-paying stocks as income-generating options.

[18] Source: Bloomberg. As of 12/31/2012, the U.S. 10-Year Treasury Note yield was 1.76%.

Unless otherwise stated, data source is WisdomTree.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, call 866.909.WISE (9473) or visit wisdomtree.com. Read the prospectus carefully before you invest.

There are risks involved with investing. Investments focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Due to the investment strategy of certain Funds they may make higher capital gain distributions than other ETFs. Please see prospectus for discussion of risks.

S&P 500 Index: A capitalization-weighted index of 500 stocks selected by the Standard & Poor's Index Committee, designed to represent the performance of the leading industries in the United States economy. Russell 3000 Index: Measures the performance of the 3,000 largest U.S. companies based on total market capitalization. S&P 500 GICS Sector Indexes: Stocks within the S&P 500 Index are divided into 10 categories based on the GICS Sector classifications, leading to these 10 sector sub-indexes of the larger S&P 500 Index. The 10 sectors are: Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services and Utilities. When considering the performance of GICS Sectors within the U.S. equity market, these indexes are the most broadly used. Barclays U.S. Aggregate Bond Index: Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities as well as mortgage and asset-backed securities. Barclays U.S. Corporate Investment Grade Index: Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including corporate, local authorities, sovereigns, supranationals, taxable municipals, and non-native currency agencies.

WisdomTree Funds are distributed by ALPS Distributors, Inc.

Jeremy Schwartz and Christopher Gannatti are registered representatives of ALPS Distributors, Inc.