Introducing Dividend Growth Indexes Not Reliant on Historical Dividend Trends

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

We believe one of the most notable foundations for the gains we have recently witnessed in the U.S. equity markets is the underlying dividend growth. In our last Market Insight we detailed that the trailing average annual three-year growth in trailing 12-month dividends[1] for U.S. equities (on the S&P 500 Index) for the three years ending March 31, 2013, was at a record level going back all the way to 1957, the inception of the S&P 500 Index.[2] Capturing this strong dividend growth is a goal for many. There are a wide variety of dividend-focused indexes, and a number of them specifically target "dividend growers."

The dividend growth-oriented indexes we've reviewed rely on backward-looking criteria to identify consistent dividend growers—in other words, focusing on firms that deliver a pattern of past dividend growth behavior. We believe that a potential consequence of the methodology underlying these indexes is that they miss out on some of the dividend growth opportunities from firms that are newly establishing dividends—and which happen to be some of the strongest contributors to the S&P 500's record dividend growth indicated earlier.

We believe we have incorporated some "best practices" for maximizing dividend growth in our broad market Dividend Indexes through two parts of our Index methodologies:

1) **Selection: Being broadly inclusive of new and up-and-coming dividend payers. The recent growth trends described in our prior Market Insight epitomize why that may be important, given the current environment.**

2) **Weighting: By weighting by *Dividend Stream®* (dividend per share times number of shares outstanding) we felt we were naturally giving bigger weights to companies growing their dividends. This weighting methodology thus has a bias to giving more weight to those companies that can consistently raise their dividends, even if there is no selection requirement specifically calling for the demonstration of past dividend growth.**

Yet we see a specific segment of the dividend market that is in high demand for specific and tailored exposure: those companies with the best prospects for raising their dividends over time. We thus have tried to create an additional subset of our broad Dividend Index family that incorporates those selection factors we see as the most important indicators of a company's ability to grow their dividends—factors that aren't solely dependent on a history of dividend hikes.

[1] Trailing 12-month dividends: Dividends paid over the prior 12 months summed for the constituents within an index.
[2] Source: Professor Robert Shiller, Yale University, 2013.

We believe these new dividend growth Indexes are unique in the marketplace today as they are the only Indexes to screen for dividend growth prospects instead of just for companies that have historically raised their dividends over a given period prior to determining eligibility for a dividend growth index.

WISDOMTREE U.S. DIVIDEND GROWTH INDEX: SELECTION CRITERIA AND RATIONALE

The universe of eligible companies begins with the WisdomTree Dividend Index of 1,337 investable dividend payers as of March 31, 2013, the screening date for initial Index constituents. Then we add the following screening criteria:

+ **Minimum Market Capitalization of $2.0 Billion: To focus primarily on large-cap securities, as a separate Index focused on small-cap dividend growth was also created.**
+ **Must Have Dividend Coverage Ratio[3] Greater Than 1.0x: Companies that are paying out more dividends than they have earnings are less likely, we believe, to be dividend growth leaders.**
+ **The Index comprises the 300 companies with the best combined rank of Growth and Quality factors from this universe.**
    - **Growth Ranking 50%: Derived from long-term earnings growth expectations, which ultimately encompass the estimated growth in operating earnings per share over the company's next full business cycle, typically three to five years.**
    - **Quality Ranking 50%: Split evenly between three-year average return on assets (ROA)[4] and three-year average return on equity (ROE)[5].**

Weighting: The Index is *Dividend Stream*-weighted to reflect the proportionate share of the aggregate cash dividends. As described above, this gives bigger weight to companies growing their dividends, as well as having the potential to raise the trailing 12-month dividend yield[6] of the total portfolio.

Single Holding and Sector Caps: At the annual rebalance, the following caps apply: no single stock can represent more than 5%, and no sector can represent more than 20% of the Index. In between annual rebalances, single stocks and sectors may move above the 5% and 20% marks, respectively, due to market movement.

[3] Dividend coverage ratio: Earnings per share divided by dividend per share. Higher numbers indicate a firm has a greater amount of earnings per share relative to its dividend payments.
[4] 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.
[5] Return on equity (ROE): Firm profits (after accounting for all expenses) divided by the firm's equity. Higher numbers indicate greater profits relative to the level of equity.
[6] Trailing 12-month dividend yield: Dividends over the prior 12 months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

THOUGHTS ON THE SELECTION FACTORS

We believe the combined ranking of earnings growth and quality factors is a key element of our process of identifying stocks with the highest potential to increase dividends.

On Earnings Growth Expectations: We believe the companies that can grow their earnings have the greatest potential to raise their dividends, which is why long-term earnings growth expectations as a factor make up 50% of our selection criteria. Just to note other index providers that also look at earnings growth expectations as part of their classification of growth companies: The Russell family of indexes includes a similar earnings expectations variable in its model to determine whether constituent stocks qualify as part of the Russell growth indexes or Russell value indexes. We certainly recognize that these are only estimates and that, with an increasing time horizon, it becomes more and more difficult for estimates such as these to be accurate. However, while the specific growth estimates may be hard to pin down, in general the relative direction and trends tend to be more accurate. We also believe that earnings growth is a necessary consideration for future dividend increases.

On Quality Factor Rankings: Analysis of "quality" factors can take different forms. In our case, we have identified higher quality companies as those that have displayed above-average historical returns on equity and on assets. We have used these criteria as part of our selection methodology, because we believe companies with better profitability metrics are better able to fund growing dividends.

We are certainly not the first to suggest there is a link between dividend growth and ROE[8] or to use ROE as part of a stock selection criterion. Warren Buffett often says in his annual letters that he looks for "businesses earning good returns on equity while employing little or no debt." Since high leverage[9] implies the use of debt, our use of a quality ranking that incorporates both return on equity and return on assets enables us to mitigate the use of leverage as a sole driver of what may superficially appear to be a high ROE figure. Companies that achieve a high return on assets are often able to grow without needing large capital expenditures. This frees more of their profits to be returned to shareholders in the form of dividends.

Two of our favorite quotes from Warren Buffett and his business partner on the "quality" factor:

+ **Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down. – Warren Buffett, Berkshire Hathaway Inc., Annual Report, 2008**

+ **We've really made the money out of high quality businesses . . . If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result. – Charlie Munger at USC Business School in 1994**

[7] "Russell U.S. Equity Indexes Construction and Methodology," Russell Indexes, March 2013.
[8] ROE is tied to dividend growth in the dividend discount model described below.
[9] Leverage: Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Moreover, in finance literature, return on equity is critically linked to dividend growth and intrinsic value[10] of companies through the dividend discount model (DDM).[11] The DDM for stock valuation states: The Value of a stock = DPS (1) / (R-G)

Where:

+ **DPS (1) = Dividends per share expected to be received in one year**
+ **R = The required rate of return for the investment**
+ **G = Growth rate in dividends = ROE x earnings retention (or 1 minus dividend payout ratio)[12]**

The growth rate equals the return on equity times the reinvestment rate; simply stated, the growth of dividends is determined by what fraction of earnings is put back into the firm and how profitable those earnings are in their subsequent use. A sustainable dividend growth rate is thus critically linked in finance theory to ROE.

KEY CHARACTERISTICS OF WISDOMTREE'S "DIVIDEND GROWTH" COMPANIES

Now that we have laid out the most crucial elements of our Index construction process, it is important to consider how qualifying constituents look in terms of those metrics compared to both non-qualifiers and the broader markets. We also include a comparison to the NASDAQ US Dividend Achievers Select Index, which is the market capitalization-weighted[13] benchmark for dividend growth-focused exposure in the United States (as well as for the WisdomTree U.S. Dividend Growth Index).

+ **Higher Growth Expectations: The average long-term earnings growth estimates were over 5 percentage points higher for qualifiers to this index than for non-qualifiers. They were also higher than the S&P 500 Index and the WisdomTree Dividend Index, two indexes included to represent broad measures of U.S. equities that do not target potential dividend growth as part of their construction processes.**
+ **NASDAQ US Dividend Achievers Select Index: ROE for this index was very similar to the qualifying constituents of the WisdomTree U.S. Dividend Growth Index, as were both ROA and leverage. Earnings growth estimates were a bit lower, but this is not surprising, given the fact that they are not a focus of the underlying index methodology for the NASDAQ US Dividend Achievers Select Index.**
+ **Higher-Quality Factors: ROE for qualifiers was twice that of non-qualifiers, with the difference for ROA being even greater.**
+ **Lower Leverage: The qualifiers to the WisdomTree U.S. Dividend Growth Index employ less leverage to operate their businesses than both the non-qualifiers and the broader equity market measures.**

[10] Intrinsic value: Value of a firm based on its operations, business practices and profitability, which may or may not be closely related to the value of that same firm based on its equity share price.
[11] William L. Silber & Jessica Wachter, "Equity Valuation Formulas," New York University, 2013.
[12] Earnings retention (or 1 minus dividend payout ratio): The dividend payout ratio is the dividend per share divided by the earnings per share. Since the earnings retention plus the dividend payout ratio must be added together to equal 100% of the earnings, 1 minus dividend payout ratio = earnings retention, the percentage of earnings not paid out as dividends.
[13] 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.

FIGURE 1: WISDOMTREE U.S. DIVIDEND GROWTH INDEX KEY CHARACTERISTICS [3/31/2013]

	Long-Term Earnings Growth Expectations	ROE	ROA	Leverage	Earnings Retention	ROE x Earnings Retention
Qualifiers (WT U.S. Dividend Growth Index)	13.0%	23.2%	9.3%	2.50x	68.9%	16.0%
Non-Qualifiers	7.4%	11.7%	3.5%	3.32x	60.1%	7.0%
S&P 500 Index	10.6%	13.5%	3.0%	4.56x	67.5%	9.1%
WisdomTree Dividend Index	9.0%	13.7%	2.9%	4.74x	53.4%	7.3%
NASDAQ US Dividend Achievers Select Index	10.5%	22.5%	8.7%	2.59x	59.5%	13.4%

Sources: WisdomTree, Bloomberg.
Past performance is not indicative of future results. You cannot invest directly in an index. Data is as of 3/31/2013, the screening date for initial constituents.

MISSING OUT?

The NASDAQ US Dividend Achievers Select Index has as its primary criterion for constituent selection 10 consecutive years of dividend growth. A primary motivation for the creation of the methodology underlying the WisdomTree U.S. Dividend Growth Index was an attempt to provide an alternative approach focusing on dividend growth—an approach that didn't necessarily rely solely on a backward-looking screen. Below, we illustrate how this difference in index methodology impacted the selection of the top 20 WisdomTree U.S. Dividend Growth Index constituents.

FIGURE 2: TOP 20 CONSTITUENTS FOR THE WISDOMTREE U.S. DIVIDEND GROWTH INDEX "WTDGI" [3/31/2013]

Rank	Ticker	Company Name	Sector	Index Weight	Long-Term Earnings Growth Expectations	Return on Equity (ROE)	Trailing 12-Month Dividend Yield	Year of Potential Eligibility[1] NASDAQ US Dividend Achievers Select Index "DVG"
1	AAPL	APPLE INC	Information Technology	4.87%	17.34%	39.93%	1.76%	2023
2	MSFT	MICROSOFT CORP	Information Technology	3.77%	9.00%	38.70%	3.03%	2014
3	WMT	WAL-MART STORES INC	Consumer Staples	3.76%	9.87%	23.02%	2.22%	Current Member
4	PG	PROCTER & GAMBLE CO/THE	Consumer Staples	3.73%	8.85%	18.41%	2.92%	Current Member
5	KO	COCA-COLA CO/THE	Consumer Staples	3.03%	8.23%	32.38%	2.60%	Current Member
6	MCD	MCDONALD'S CORP	Consumer Discretionary	2.97%	9.44%	36.42%	2.97%	Current Member
7	HD	HOME DEPOT INC	Consumer Discretionary	2.24%	15.20%	21.32%	1.81%	2019
8	INTC	INTEL CORP	Information Technology	2.18%	11.33%	24.99%	4.05%	2013
9	MO	ALTRIA GROUP INC	Consumer Staples	2.15%	7.34%	93.95%	5.03%	2019
10	PEP	PEPSICO INC	Consumer Staples	2.02%	7.95%	31.04%	2.75%	Current Member
11	UTX	UNITED TECHNOLOGIES CORP	Industrials	1.89%	12.15%	21.86%	2.25%	Current Member
12	IBM	INTL BUSINESS MACHINES CORP	Information Technology	1.85%	9.25%	74.51%	1.61%	Current Member
13	UPS	UNITED PARCEL SERVICE-CL B	Industrials	1.73%	10.62%	35.75%	2.73%	2019
14	MMM	3M CO	Industrials	1.69%	9.67%	27.75%	2.28%	Current Member
15	CMCSA	COMCAST CORP-CLASS A	Consumer Discretionary	1.59%	18.84%	10.09%	1.56%	2018
16	CSCO	CISCO SYSTEMS INC	Information Technology	1.46%	9.88%	16.42%	2.11%	2021
17	BA	BOEING CO/THE	Industrials	1.41%	11.48%	115.41%	2.09%	2021
18	USB	US BANCORP	Financials	1.40%	13.08%	15.13%	2.31%	2020
19	AMGN	AMGEN INC	Health Care	1.35%	8.35%	19.94%	1.55%	2021
20	CAT	CATERPILLAR INC	Industrials	1.31%	9.75%	35.51%	2.32%	Current Member
		Sum/Average of WTDGI Top 20		**46.42%**	**10.88%**	**36.63%**	**2.50%**	
		Sum/Average of DVG Current Members		**22.25%**	**9.46%**	**33.43%**	**2.44%**	
		Sum/Average of DVG Exclusions		**24.17%**	**12.04%**	**39.24%**	**2.55%**	

[1]Year of potential eligibility: Constituents of DVG must demonstrate 10 consecutive years of dividend increases to be eligible for inclusion. Year indicates when an excluded stock could meet that criterion. "Current Member" indicates stocks that are currently included in DVG.
Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index. Holdings subject to change. Data is as of 3/31/2013, the screening date for initial constituents.

+ **Of the top 20 constituents of the WisdomTree U.S. Dividend Growth Index, nine are current constituents of the NASDAQ US Dividend Achievers Select Index (DVG).**
+ **Many of the 11 excluded firms would not be eligible for DVG until around 2020, even if they continue to increase their dividends each year. These excluded firms tended to have higher average long-term earnings growth expectations, higher average ROE and even higher average trailing 12-month dividend yields.**

INFORMATION TECHNOLOGY

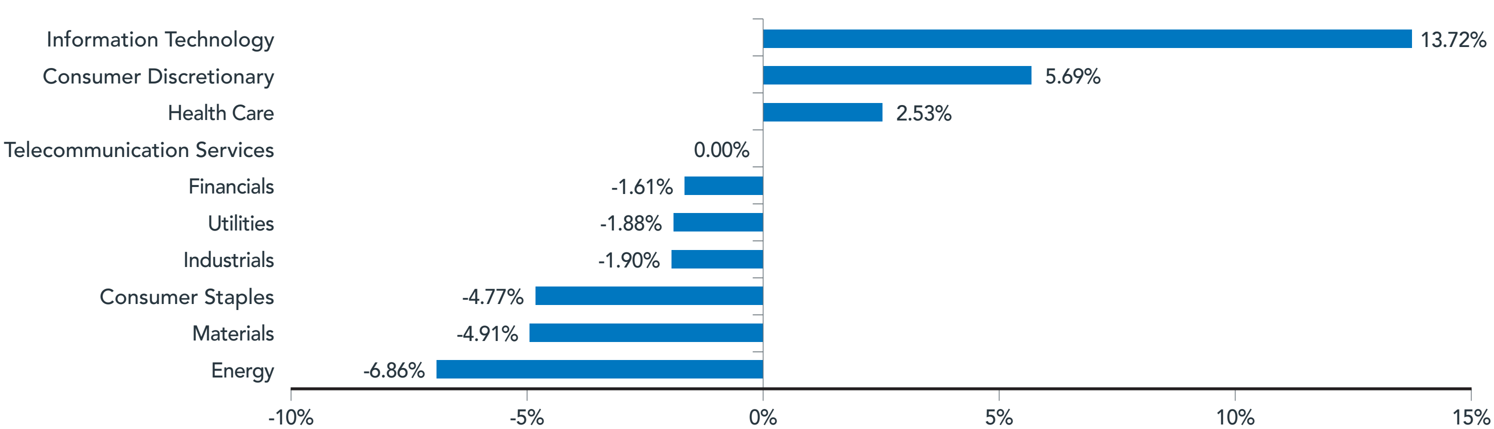
Of the top 20 constituents of the WisdomTree U.S. Dividend Growth Index, the one information technology firm that is also a current member of the NASDAQ US Dividend Achievers Select Index is IBM. The others—Apple, Microsoft, Intel and Cisco—are all excluded. In prior commentaries, we emphasized the current nature of information technology companies in the U.S.—namely that they tend to generate lots of cash and that many have begun to utilize dividends as a means to return some of that cash to shareholders.

FIGURE 3: SHOULD AN INDEX FOCUSED ON DIVIDEND GROWTH BE UNDER-WEIGHT IN INFORMATION TECHNOLOGY?

	S&P 500 Index	NASDAQ US Dividend Achievers Select Index	WisdomTree U.S. Dividend Growth Index
Information Technology	18.02%	6.28%	20.00%
Consumer Discretionary	11.62%	14.04%	19.73%
Health Care	12.54%	5.51%	8.04%
Telecommunication Services	2.97%	0.08%	0.08%
Financials	15.93%	7.21%	5.60%
Utilities	3.51%	1.88%	0.00%
Industrials	10.11%	21.29%	19.40%
Consumer Staples	10.97%	24.77%	20.00%
Materials	3.43%	9.04%	4.14%
Energy	10.92%	9.89%	3.03%

Sources: WisdomTree, Bloomberg; data as of 3/31/2013, the screening date for initial constituents. Allocations subject to change. You cannot invest directly in an index.

FIGURE 4: SECTOR EXPOSURES OF WISDOMTREE U.S. DIVIDEND GROWTH INDEX MINUS NASDAQ US DIVIDEND ACHIEVERS SELECT INDEX [3/31/2013]



Sources: WisdomTree, Bloomberg. Allocations subject to change. You cannot invest directly in an index.

There is no way to know where future dividend growth will come from, but we believe the fact that information technology firms in the U.S.[14] not only continued to grow their dividends through the 2008–09 financial crisis but keep generating cash today makes them deserving of special consideration. Setting a baseline, the S&P 500 Index—a market capitalization-weighted index that does not focus on dividends or dividend growth in any way—has over 17% of its weight in this sector. Since that index is so heavily followed, it sets somewhat of a benchmark from which we can judge whether other indexes seem to have higher or lower exposure.

+ **The NASDAQ US Dividend Achievers Select Index has approximately 6% of its weight in information technology firms. This is not surprising, since many firms in this sector have not yet been paying and increasing their regular dividends for 10 consecutive years.**
+ **The WisdomTree U.S. Dividend Growth Index has 20% of its weight in this sector. This results in a nearly 14.0% over-weight compared to the NASDAQ US Dividend Achievers Select Index**

While we cannot say whether information technology firms will continue their pace of dividend increases, we do believe that this large difference in weight (stemming from two completely different methodologies of focusing on the idea of dividend growth) warrants consideration.

[14] Refers to the universe of the WisdomTree Dividend Index and the Information Technology sector constituents contained therein.

CONCLUSION

There is no question that investors are drawn to the idea of dividend growth—potentially more so today than in the past due to the ongoing stimulative monetary policies[15] of the Federal Reserve (and other central banks around the globe). Historically, dividend-paying stocks have been able to provide a measure of inflation protection. However, there can be little doubt that what investors really want is future dividend growth, i.e., dividend growth that occurs after they've made their investment. While there is no way to know with certainty what will happen in the future, we believe that our dividend growth methodology applies a logical framework of analysis to essentially increase the probability of placing greater weight in companies that have the best chance of raising their future dividends. This is not to say that any of these firms will or won't raise their dividends in periods to come, but we do believe it is a more rigorous approach than simply implying that past dividend growth will lead to future dividend growth, as other indexes tend to do.

[15] Monetary policies: Actions taken by a central bank with the intention of impacting the economic growth potential of a particular market.

Unless otherwise stated, data source is WisdomTree.

Dividends are not guaranteed, and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time.

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, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

WisdomTree Dividend Index: Measures the performance of dividend-paying companies incorporated in the United States that pay regular cash dividends and meet WisdomTree's eligibility requirements. Weighted by indicated cash dividends. S&P 500 Index: A market capitalization-weighted index 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. Dow Jones U.S. Select Dividend Index: Measures the performance of 100 dividend-paying U.S. companies. NASDAQ US Dividend Achievers Select Index: Designed to track the performance of dividend-paying companies in the U.S. that have increased their annual dividend payments for the last 10 or more consecutive years. WisdomTree U.S. Dividend Growth Index: Designed to track the performance of dividend-paying companies in the U.S. that WisdomTree believes have the potential to increase their dividends due to certain factors, which include estimated earnings growth, return on equity and return on assets. Weighting is by indicated cash dividends.

WisdomTree Funds are distributed by ALPS Distributors, Inc.

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

© 2013 WisdomTree Investments, Inc. "WisdomTree" is a registered mark of WisdomTree Investments, Inc.

WIS005322 5/2014