

Equity Prices Are More Volatile Than Their Fundamentals

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WisdomTree recently introduced the Emerging Markets Dividend Growth Index (WTEMDG) at a time when emerging market equities have been disappointing—performers lagging many of the other global equity markets regions¹. In this blog, I provide some analysis on how much of the volatility in [emerging market equity](#) prices is tied to changes in the emerging market fundamentals, and I take a look at history to illustrate the relationship between volatility in the dividends and prices of emerging market equities. **Noisy Equity Prices** One reason WisdomTree believes a rules-based rebalancing program adds value is that equity prices contain an element of noise—equity prices often fluctuate more than the fundamental fair values. To illustrate how equity volatility is higher than fundamentals, we compare the average annual volatility of equity prices to the average annual volatility of dividends. Whether one looks at the MSCI Emerging Markets Index (EM Equities) or the [S&P 500 Index](#) (U.S. Equities), the average annual volatility indicates that prices exhibit greater movements (both positive and negative) around their average level than do dividends. This is one indication that equity markets tend to overreact to changes in dividend levels, and we believe this creates the opportunity to rebalance a portfolio back to these fundamental metrics. **EM Equities vs. U.S. Equities—Price vs. Dividend Behavior (6/30/1993–6/30/2013)**

		Average Annual Growth			Average Annual Standard Deviation	
Period	Equity Region	Price	Dividends ¹	Price-to-Dividend Multiple ²	Price	Dividends ¹
20-Year	EM Equities	5.0%	7.5%	-2.3%	22.6%	16.7%
	U.S. Equities	6.7%	5.0%	1.6%	16.4%	8.3%
10-Year	EM Equities	10.9%	13.4%	-2.2%	23.8%	19.3%
	U.S. Equities	5.2%	7.5%	-2.2%	16.9%	11.1%

Yet Emerging Market Dividends Are Volatile Yet emerging market dividends behave differently than dividends from those in the United States. The dividend volatility over 20 years was twice as high for EM Equities as it was for U.S. Equities². There is a different mentality in the United States than in the emerging markets when it comes to dividend policies. U.S. companies do not like to raise and lower their dividends; they often manage cash to maintain a certain dividend per share every quarter. By contrast, emerging market dividend growth often mirrors the behavior of earnings. We think the volatility of these dividends in EM Equities helps motivate our new dividend growth Index to focus on stocks that rank highly on our proprietary quality and growth selection factors. We believe that our stock selection factors can potentially help manage the volatility that we see in emerging market *Dividend Streams*®.

The Link between Dividend Growth and Return: Valuation While their dividend growth has disappointed recently, the emerging markets still possess some of the best prospects for economic growth over the long term. When investors get overly enthused about growth prospects, there is a tendency to overpay for this potential growth. From this perspective, it is interesting to contrast how the price-to-dividend multiple has changed with respect to U.S. Equities and EM Equities over the last 10 and 20 years³. Over the last 20 years U.S. Equities have seen trailing 12-month dividend growth of 5.0% and price appreciation of 6.7% per year⁴. This increase in price level was fueled by an expansion of 1.6% per year in the price-to-dividend ratio—or a valuation multiple of the market that measures the relationship between the index price level and the index's trailing 12-month dividends. In the emerging markets, the price-to-dividend ratios have contracted over the last 20 years, as price growth lagged dividend growth by more than 2.2% per year over the period. These contracting valuation multiples (dividends becoming less expensive relative to prices) for the emerging markets are one reason why I believe that these stocks are attractive from their current valuation perspective.

Combining a Focus on Dividend Growth Stocks with Relative Value Rebalancing WisdomTree believes that a focus on growth-oriented companies must be married with a disciplined focus on valuations, and when we consider dividend growth potential as a component of index methodology, we marry it with a sensitivity to valuation. Specifically, WisdomTree uses a rules-based rebalancing program that involves tying Index constituent weights back to the *Dividend Stream* to focus on valuations—as it does in all its dividend-based Indexes. While many dividend-focused indexes in emerging markets focus on yield and valuation, there is a dearth of options that focus on dividend growth. We believe that the WTEMDG approach with its flexibility to respond to growth represents the future of dividend growth indexing.

Unless otherwise stated, data source is WisdomTree. ¹Refers to the MSCI Emerging Markets Index performance over the period 6/30/2010 to 6/30/2013, which has lagged that of the MSCI EAFE Index and the S&P 500 Index. ²Source: Bloomberg, MSCI, 6/30/1993-6/30/2013 ³Source: Bloomberg, MSCI, 6/30/1993-6/30/2013 ⁴Source: Bloomberg, MSCI, 6/30/1993-6/30/2013

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