

How Rising Rates Impact Dividend Paying Equities

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Since the beginning of the year, longer-term interest rates in the U.S. have risen considerably—mostly driven by the expectation that the Federal Reserve (Fed) would begin tapering its quantitative easing (QE) program. At its December meeting, the Fed did indeed announce it would begin scaling back purchases of both mortgage-backed securities and U.S. Treasury bonds by \$5 billion a month and now would be on track to end its asset purchase program by the end of 2014—assuming no drop-off in economic performance in the coming months. Although more companies have begun paying dividends, the percentage of equities with a higher dividend yield than the 10-Year U.S. Treasury yield has declined. The recent rise in Treasury yields has impacted various income-oriented investment strategies, but not all strategies are the same. In the chart below, I look at how the relationship between the 10-Year Treasury and dividend-paying equities has changed over the past year, up until the most recent Fed announcement. **Relationship between Equity and Bond Yields**

Index	Date	10-Yr Treasury Yield	Dividend Yield Greater Than Treasury Yield Weight
S&P 500	12/31/2012	1.76%	67%
	12/18/2013	2.89%	24%
WisdomTree LargeCap Dividend	12/31/2012	1.76%	91%
	12/18/2013	2.89%	39%
WisdomTree Equity Income	12/31/2012	1.76%	100%
	12/18/2013	2.89%	74%
WisdomTree SmallCap Dividend	12/31/2012	1.76%	82%
	12/18/2013	2.89%	51%

Sources: Bloomberg, WisdomTree. Weight is the index percentage weight of stocks with an indicated dividend yield higher than the 10-Year Treasury yield. WisdomTree Index weights are based on the expected rebalanced weights. Past performance is not indicative of future results.

• **Rates Have Risen Rapidly** – Through December 18, 2013, the 10-Year Treasury yield has increased from 1.76% to 2.89%—a change of 113 basis points. To put this in context, rates still remain well below their monthly average of around 6.0% over the last 30 years. But as interest rates increase, they provide more competition for dividend-paying equities, especially higher-yielding equities.

• **Dividend Yield Edge of Equities over Bonds Has Decreased** – Within the [S&P 500 Index](#), the weight of dividend-paying equities with an indicated dividend yield above that of the 10-Year Treasury has decreased dramatically, from 67% to 24%. WisdomTree Indexes have also seen a decline in weight, but the percentage with higher dividend yields is still higher due to the Index methodology that focuses on dividends. In particular, the annual rebalance back to the Dividend Stream® puts an emphasis on stocks with higher dividend yields, as weights are adjusted such that more weight is allocated to firms that grow their dividends faster relative to their prices.

• **Small Caps for Income** – When investors think of dividends, they tend to think of mature large-cap companies as the primary source. As a result, I feel that many investors mistakenly overlook small-cap equities as attractive income options. I find it impressive that the WisdomTree SmallCap Dividend Index has more than twice the weight of the S&P 500 in stocks with a dividend yield higher than the 10-Year Treasury. WTSDI has over 50% of its weight in equities with a higher dividend yield than the 10-Year Treasury.

Conclusion I believe one of the supporting points for equities during the last few years was the income advantage they provided compared to the traditionally low yields available in fixed income securities. There is still a healthy part of the broader market that can offer higher yields than U.S. Treasuries, but it is no longer the majority of stocks in the market. If one wants to focus on equities for their income potential, the dividend growth prospects are becoming a more important component of the returns—as equities not only offer the current dividend but also the future growth potential. As I discussed in an earlier [blog post](#), this year was the fourth consecutive year of double-digit dividend growth, and I believe we will continue to see elevated dividend growth due to dividend payout ratios still being near historical lows. Now would be a good time to evaluate various dividend strategies, and I'd point out that compared to large caps, small caps had a greater percentage of stocks with higher yields than the 10-Year Treasury.

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