

Quality Stocks in Focus Amid Global Volatility

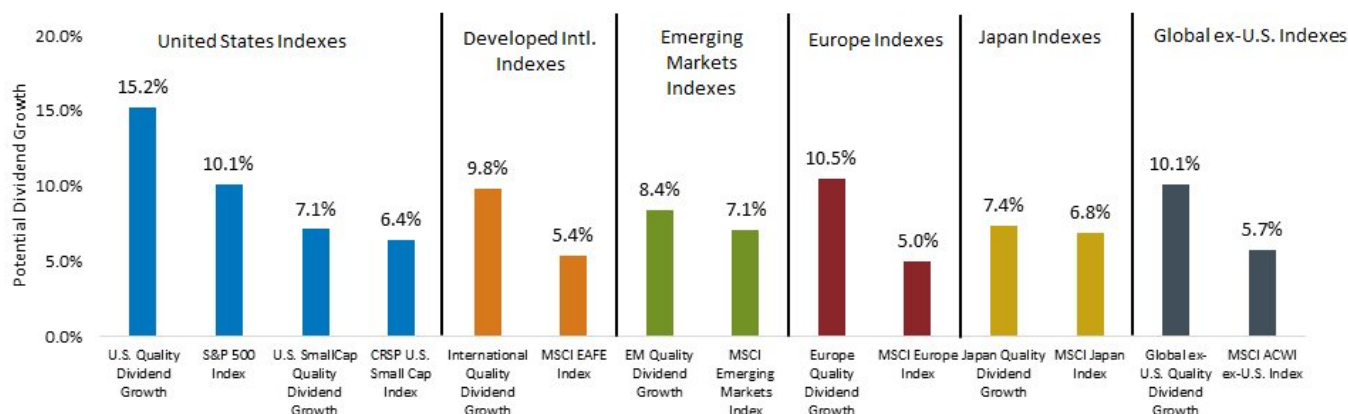
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As the market continues to synthesize aspects of China's role within the global economy, there is a premium focus on stocks that can achieve sustainable earnings and dividend growth over the medium to long run. Coupled with this short-term search for income growth opportunities while global growth is scarce is a broader and long-term thematic focus on quality investing and the "quality" factor in both the academic and investment worlds. WisdomTree has been leading this charge with a family of Indexes that cover the major regions and include selection factors designed to pick dividend-paying stocks with quality and growth characteristics. **Big-Picture Criteria** Each of these Indexes is: 1. **Broadly Focused:** Each of these Indexes had between 250 and 300 underlying constituents.¹ In capturing dividend growth around the world, it is important not to be narrowly focused and open to greater potential stock selection risk. 2. **Not Focused on Past Dividend Growth Behavior:** None of these Indexes utilizes any measure of past or backward-looking dividend growth behavior in order to indicate future dividend growth potential. This is especially important outside of the United States, where dividend behavior could exhibit greater variability. **Half of the Selection Screening—Earnings Growth** This criterion is pretty simple: We believe that firms expected to grow their earnings faster, all other things being equal, should have greater potential to increase their future dividends faster. We understand that these are only estimates, but we believe that while there may be a lot of noise around a single company's precise earnings growth, in aggregate the companies with higher growth expectations—we believe—grow faster than those with lower expectations. **Half of the Selection Screening—Quality** Our quality factor ranking is based on three-year historical averages for return on equity (ROE) and return on assets (ROA). We believe companies that generate greater profitability, controlling for any excessive use of leverage, should have a greater potential to increase their future dividends than firms demonstrating lower profitability metrics. **Back to Buffett** We mentioned in earlier blog posts that in his most recent annual shareholder letter, [Warren Buffett said that he looks for "businesses earning good returns on equity while employing little or no debt."](#)² Since high leverage implies the use of debt, our use of a quality ranking that incorporates both ROE and ROA enables us to mitigate the use of leverage as a sole driver of what may superficially appear to be a high ROE figure. **How Is Our Approach Tied to Dividend Growth Potential?** The answer lies in the dividend discount model (DDM). The model states that the potential dividend growth of a company is tied to its ability to generate profits and how well those profits are retained for future productive use. One way to look at profit capability is through return on equity, and retention of those profits for future use is the earnings retention ratio. Therefore: **ROE x Earnings Retention Ratio = Dividend Growth Potential** We emphasize that this is simply a measure of potential—it does not mean that all stocks will always reach their full sustainable

dividend growth potential. It is, however, a very interesting metric by which to compare WisdomTree's Quality Dividend Growth family to common market capitalization-weighted benchmarks.



Source: Bloomberg, with data as of 9/25/15. Subject to change. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, visit our [glossary](#). • **U.S. Large Caps Strongest Overall:** The S&P 500 Index has the strongest return on equity of any market capitalization-weighted Index that we show by a significant margin. It is therefore impressive that U.S. Quality Dividend Growth gets approximately 50% higher. • **Europe Had Highest Relative Difference:** The application of WisdomTree's Quality Dividend Growth methodology had the largest relative impact in Europe, where the potential dividend growth was double that of the MSCI Europe Index. • **International Differentials:** While Europe has the widest differentials, both the developed international and global ex-U.S. saw differentials of similar magnitude, as the market cap-weighted benchmarks saw potential dividend growth in the 5% to 6% range, and the WisdomTree International Quality Dividend Growth and Global ex-U.S. Quality Dividend Growth had a range of 9.8% to 10.1%, also notable differentials.

Conclusion While the future is of course uncertain, we believe that our dividend growth methodology applies a framework to selecting dividend payers with growth characteristics. We have focused on variables that we believe are key drivers of dividend growth, and this is a theme that could apply to all equities worldwide. With the global market uncertainty, we think quality stocks should receive greater attention from investors.

1Source: Standard & Poor's, as of 9/25/2015.

2Source: Warren E. Buffett, Berkshire Hathaway annual letter to shareholders, 2/28/15.

Important Risks Related to this Article

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.