

The Dividend Driver: Return on Equity

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A key driver of long-term compound returns is dividend growth. But what drives the driver? Corporate profitability.

Using over a half-century of data from Ken French's computations at Dartmouth, a strategy that identified the top 20% of stocks by profitability (return on equity, or ROE) posted annual returns of 11.73%, an outperformance of 451 basis points (bps) per year over the lowest ROE group. The high-ranking group also bested the market by 144 bps per year.

Part of the explanation: profitable companies grew dividends faster.

Figure 1: Equity Performance, Grouped by Profitability



Source: Kenneth French Data Library. Period based on availability of operating profitability returns sorted into quintiles, 6/30/1963–11/30/2022. Universe is U.S.-listed equities grouped by operating profitability. Past performance is not indicative of future results. You cannot invest directly in an index.

Triggering Robust Future Dividends: The Profile of a Profitable Grower

The DuPont Corporation's Donaldson Brown developed a concept a century ago that breaks ROE into an interaction between profit margins, asset turnover and the equity multiplier.

$$\text{Return on Equity} = \text{Profit Margin} \times \text{Asset Turnover} \times \text{Equity Multiplier}$$

Those can be expressed as follows:

$$\frac{\text{Net Income}}{\text{Total Equity}} = \frac{\text{Net Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Total Assets}} \times \frac{\text{Total Assets}}{\text{Total Equity}}$$

Notice that some denominators are also numerators. As they cancel each other, we are left with income over equity, or ROE. If a firm wants to be profitable, it must have excellent margins and be efficient with its assets.

Suppose a company earns \$1 per share and pays a 25-cent dividend, leaving 75 cents in retained earnings. The retention ratio is 75%.

Multiply the retention ratio by the ROE to get implied dividend growth.

Visually:

$$\text{Retention Ratio} \times \text{ROE} = \text{Implied Dividend Growth}$$

If the company's ROE is 10%, the implied annual dividend growth rate is $0.75 \times 10\%$, or 7.5%.

Figure 2 shows these concepts using current metrics for the [WisdomTree U.S. Quality Dividend Growth Fund \(DGRW\)](#) and the [WisdomTree U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#).

Figure 2: DuPont Inside DGRW & DGRS

Arithmetic	DuPont Model Component	DGRW	S&P 500	DGRS	Russell 2000
A	Net Income/Sales	13.1%	12.5%	6.3%	4.8%
B	Sales/Total Assets	33.5%	32.9%	68.6%	31.4%
C	Total Assets/Total Equity	5.84	4.49	4.25	4.85
Multiply: A x B x C	Return on Equity (ROE)	25.7%	18.4%	18.4%	7.3%
	Retention Ratio	60.7%	68.9%	63.9%	66.6%
ROE x Retention Ratio	Implied Dividend Growth Rate	15.6%	12.7%	11.7%	4.9%

Source: WisdomTree PATH software, as of 4/30/23.

Both **DGRW** and **DGRS** score well on profit margins (A) and asset turnover (B). The equity multiplier (C) for **DGRW** indicates that component companies have a little more leverage than S&P 500 members, while **DGRS** has less leverage than the Russell 2000.

DGRW's current dividend yield is 2.2%, which at face value is something of a yawn when compared to the 1.6% yield accorded the S&P 500. However, the former's more robust ROE opens the door for a faster dividend growth rate in the future (figure 3). The same goes for **DGRS** in small caps.

Figure 3: Quality Dividend Growth Fundamentals

Fundamentals	DGRW	S&P 500	DGRS	Russell 2000
Price/Earnings (Fwd)	18.0	18.9	11.6	23.0
Dividend Yield	2.2%	1.6%	3.1%	1.5%
Implied Dividend Growth Rate	15.6%	12.7%	11.7%	4.9%

Source: WisdomTree PATH software, as of 4/30/23. **The performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted.**

For the most recent month-end performance, please click the respective ticker: [DGRW](#), [DGRS](#).

For definitions of terms in the table above, please visit the [glossary](#).

Next, developed and emerging markets. Figure 4 runs the numbers for:

- The [WisdomTree International Quality Dividend Growth Fund \(IQDG\)](#), which has the same stocks as its currency-hedged "cousin," [IHDG \(the WisdomTree International Hedged Quality Dividend Growth Fund\)](#).

- The [WisdomTree Europe Quality Dividend Growth Fund \(EUDG\)](#)
- The [WisdomTree Global ex-U.S. Quality Dividend Growth Fund \(DNL\)](#)
- The [WisdomTree Emerging Markets Quality Dividend Growth Fund \(DGRE\)](#)

The international strategies all score highly on profit margins (A), have more efficient asset usage (B) and engage lower levels of leverage (C). This combination indicates implied dividend growth that exceeds their respective benchmarks, maybe with lower risk.

Figure 4: Implied Dividend Growth Rate, International Strategies

Arithmetic	DuPont Model Component	IQDG	MSCI EAFE	EUDG	MSCI Europe	DNL	MSCI ACWI ex-US	DGRE	MSCI Emerging Markets
A	Net Income/Sales	11.9%	9.7%	10.6%	10.3%	13.2%	9.6%	9.0%	9.1%
B	Sales/Total Assets	66.4%	17.6%	41.7%	18.2%	65.4%	18.4%	52.3%	20.4%
C	Total Assets/Total Equity	3.05	6.96	4.57	7.35	2.97	7.20	3.75	7.22
Multiply: A x B x C	Return on Equity (ROE)	24.2%	11.8%	20.2%	13.8%	25.7%	12.8%	17.6%	13.5%
	Retention Ratio	0.50	0.59	0.52	0.61	0.56	0.59	0.55	0.58
ROE x Retention Ratio	Implied Dividend Growth Rate	12.0%	7.0%	10.6%	8.4%	14.4%	7.5%	9.7%	7.8%

Source: WisdomTree PATH software, as of 4/30/23.

Figure 5 reproduces the fundamentals table for some of the international strategies.

Figure 5: Quality Dividend Growth Fundamentals

Fundamentals	IQDG	MSCI EAFE	EUDG	MSCI Europe	DNL	MSCI ACWI ex-US	DGRE	MSCI Emerging Markets
Price/Earnings (Fwd)	19.4	13.2	16.5	12.9	19.0	13.1	12.5	12.9
Dividend Yield	2.6%	3.1%	2.9%	3.1%	2.3%	3.1%	3.6%	3.3%
Implied Dividend Growth Rate	12.0%	7.0%	10.6%	8.4%	14.4%	7.5%	9.7%	7.8%

Source: WisdomTree PATH software, as of 4/30/23. **The performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted.**

For the most recent month-end and standardized performance, SEC Standardized Yield, and fund holdings, click here: [IQDG](#), [EUDG](#), [DNL](#), [DGRE](#).

Happy 10th Birthday, DGRW

The last 10 years have been good ones for the Fund, as have the timeframes since. On June 1, 2023, it ranked in the 14th percentile of 1,410 funds in the Large Blend Morningstar peer group for the last year; in the 11th percentile of the group's 1,273 funds for the last three years; in the 13th percentile of 1,172 funds

for the last five years; and in the sixth percentile of 870 funds for the last 10 years. Its 12.0% return from its May 22, 2013, inception to the end of May 2023 has also edged out the S&P 500's 11.9% run, with lower volatility.

Important Disclosures and Risks Related to this Article

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DGRW, DGRS, DNL, DGRE: There are risks associated with investing, including the possible loss of principal. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Please read each Fund's prospectus for specific details regarding the Fund's risk profile.

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