

Why Dividends and Buybacks Matter to Investors

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With U.S. equity markets climbing back to even for the year, after correcting 10%, the debate about the prospects for forward-looking returns intensifies.¹ One argument states that the U.S. markets were unnaturally buoyed by the unprecedented balance sheet expansion and monetary easing of the U.S. Federal Reserve (Fed). This argument received partial validation once the market sold off more than 10% after the Fed's first interest rate hike in almost a decade, but what about the subsequent rally?² We believe the starting point of the rate hike cycle is less important than where rates end once the hiking cycle is complete, but here too there is wide debate. Anytime equities are viewed as relatively cheap or expensive, it is important to note the characteristic being used to make that determination. The most widely cited characteristic that is used to stipulate that stocks are expensive is the [price-to-earnings \(P/E\) ratio](#). As a stronger dollar and lower oil prices weighed on corporate earnings in 2015, price-to-earnings multiples remain fairly elevated. While the P/E ratio is an important valuation metric, we do not think it should be the only metric used. Instead, we suggest that an intuitive framework for answering this question could be looking to dividends and share buybacks, whose components often are referred to as shareholder yield and are, we believe, important components of total returns. **Trends in Dividends and Buybacks** Companies historically have paid out a large majority of their earnings as dividends. From 1871 to 2015, the average dividend yield was approximately 4.4%, and the average payout ratio was more than 60%. This is strikingly different from the average dividend yield of 2.01% and payout ratio of 36% over the most recent five years. Whether these higher retained earnings (lower dividend payouts) are wasted on unprofitable projects or lead to higher earnings and dividend growth is key to the debate about future returns on the market.³ Looking at the history of the [S&P 500 Index](#) over the last 15 years, increasingly firms have been using share buybacks as a method for returning cash to shareholders. As of December 31, 1999, dividends and share buybacks were roughly equal, at around \$140 billion each. But as of September 30, 2015, firms distributed to shareholders \$559 billion of share buybacks and \$376 billion of dividends over the previous 12 months. We find it impressive that total buybacks were about 50% more than dividends.⁴ The current dividend yield of 2.22% could imply that the market is "expensive" because it is below the average 4.4% dividend yield of the markets since 1871.⁵ This might be the case if firms were not altering the way they return money to shareholders (i.e., through increased buybacks). So looking at the combined dividend yield and net buyback ratio, or shareholder yield, being north of the long-term historical average might tell a different story about valuations. Also, assuming a constant level of cash flows in the future, this recent buyback surge could potentially lead to higher per-share earnings and dividend growth. In the table below, we examine the dividend yield and net buyback ratio of a cross-section of WisdomTree's U.S. Indexes to get

a sense of the opportunities to achieve the highest shareholder yield. **WisdomTree U.S. Index Buybacks and Dividends**

Ticker	Index Name	Net Buyback Ratio	Trailing 12M Dividend Yield	Shareholder Yield (Net Buyback + Dividend Yield)
WTDXF	WisdomTree Dividend ex-Financials Index	2.26%	3.95%	6.21%
WTDGI	WisdomTree U.S. Quality Dividend Growth Index	3.56%	2.46%	6.02%
WTDL	WisdomTree Dynamic Long U.S. Equity Index	3.39%	2.45%	5.85%
WTEPS	WisdomTree Earnings 500 Index	3.25%	2.22%	5.47%
WTLVI	WisdomTree LargeCap Value Index	3.60%	1.63%	5.23%
WTEI	WisdomTree Earnings Index	3.05%	2.16%	5.21%
WTLDI	WisdomTree LargeCap Dividend Index	2.07%	3.11%	5.18%
WTSDG	WisdomTree U.S. SmallCap Quality Dividend Growth Index	2.33%	2.65%	4.98%
WTDI	WisdomTree Dividend Index	1.66%	3.19%	4.85%
WTUSWD	WisdomTree Weak Dollar U.S. Equity Index	2.93%	1.73%	4.66%
WTDS	WisdomTree Dynamic Short U.S. Equity Index	2.50%	2.07%	4.56%
WTHYE	WisdomTree High Dividend Index	0.35%	4.07%	4.42%
WTMEI	WisdomTree MidCap Earnings Index	1.94%	1.71%	3.65%
WTUSSD	WisdomTree Strong Dollar U.S. Equity Index	1.43%	2.16%	3.59%
WTMDI	WisdomTree MidCap Dividend Index	0.41%	3.17%	3.58%
WTSEI	WisdomTree SmallCap Earnings Index	1.15%	1.60%	2.74%
WTSDI	WisdomTree SmallCap Dividend Index	-1.28%	3.94%	2.66%

Source: WisdomTree, FactSet, 3/17/16. 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](#). • **WisdomTree Dividends ex-Financials Index (WTDXF) Displayed Highest Shareholder Yield**—primarily driven by its high dividend yield. WTDXF has one of the highest dividend yields of the Indexes displayed above because constituents are weighted by their indicated dividend yield, which has a modified equal weighting effect. Typically, you would expect higher-yielding securities to buy back less stock because they are paying out a significant part of their earnings as dividend income. This point can be visualized by looking at the [WisdomTree High Dividend Index's \(WTHYE\)](#) net buyback ratio of 0.35%. WTHYE selects constituents based on dividend yield and then weights them by their *Dividend Stream*®. We believe that WTDXF's lower constituent level (fewer than 100) compared to WTHYE's more than 440 constituents and their weighting difference both led to the dramatic difference in the net buyback ratio.⁶ • **Quality Dividend Growth Indexes Displayed High Net Buyback Ratios**—Both the [WisdomTree U.S. Quality Dividend Growth \(WTDGI\)](#) and the [WisdomTree U.S. SmallCap Quality Dividend Growth \(WTSDG\)](#) Indexes screen based on growth and quality factors, which we believe tilted the portfolios to constituents that exhibited higher buybacks. It is impressive that WTSDG's net buyback ratio is more than 2.3%, while the broader [WisdomTree SmallCap Dividend Index \(WTSDI\)](#), which doesn't screen based on growth and quality, had a negative buyback ratio (signaling stocks within the Index were net share issuers). It is also interesting to note that the [WisdomTree SmallCap Earnings Index \(WTSEI\)](#), a broad small-cap index that screens for profitable companies (i.e., an indirect measure of quality), had a buyback ratio more than 2% higher than WTSDI. • **Multifactor Approach Resulted in High**

Levels for Net Buybacks and Dividends—The [WisdomTree Dynamic Long U.S. Equity Index \(WTDL\)](#) screens constituents based on a variety of growth, quality and value indicators, and then tilts its weight to stocks that exhibit low-volatility characteristics. As expected, this multifactor approach typically leads to attractive readings across various fundamental measures, and in this case both a relatively high buyback ratio and dividend yield. It is important to note that this Index is rebalanced on a quarterly basis, while the other Indexes above are all rebalanced annually. 1Source: WisdomTree, Bloomberg, 12/31/15–3/17/16. 2Source: WisdomTree, Bloomberg, 12/16/15–2/11/16. 3Source for all data in paragraph: Robert Shiller, as of 12/31/15. 4Source: S&P Dow Jones, as of 9/30/15, most recent data available for buyback information. 5Source: WisdomTree, Bloomberg, as of 3/17/16. 6Source: WisdomTree, as of 3/17/16.

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.