# WHY WE BELIEVE DIVIDEND STOCKS ARE NOT IN A BUBBLE

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U.S. equity markets have been roaring in 2013, with new market highs being set. In the face of such strong performance, whispers abound about the potential for a pullback. The 2013 rally has been led by higher-dividend, defensive sectors, and we have seen some analysts question whether there is a "dividend bubble." To the contrary, we think dividend stocks in aggregate are attractively priced; below we discuss differences among segments of the dividend market and higher-dividend sectors. **Current Sector Valuations** Looking at the [S&P 500 Index](#) ("U.S. equities"), the four sectors that have led the rally from the beginning of 2013 to the end of April have been Utilities (+19.74%), Health Care (+19.22%), Consumer Staples (+18.11%) and Telecommunication Services (+17.07%) (i.e., the "defensive sectors"). Typically, firms in these sectors have relatively higher dividend yields.

**Index Valuation Characteristics**

| Index Exposure | "Defensive Sectors" | | | |
|---|---|---|---|---|
| Index Name | S&P 500 Utilities Sector Index | S&P 500 Consumer Staples Sector Index | S&P 500 Telecommunication Services Sector Index | S&P 500 Health Care Sector Index |
| Price to Earnings Ratio[4] | 15.9x | 17.0x | 20.5x | 15.8x |
| Long-Term Earnings Growth Expectations[5] | 4.7% | 9.3% | 6.9% | 10.0% |
| Dividend Yield[6] | 3.9% | 2.8% | 4.2% | 1.9% |
| Earnings / Price or Earnings Yield[7] | 6.3% | 5.9% | 4.5% | 6.3% |
| Dividends / Earnings | 61.5% | 47.9% | 92.9% | 29.7% |
| Index Exposure | "U.S. Equities" | "High-Yielding Dividend-Payers[1]" | "Large Cap Dividend-Payers[2]" | "Potential Dividend Growers[3]" |
| Index Name | S&P 500 Index | WisdomTree Equity Income Index | WisdomTree LargeCap Dividend Index | WisdomTree U.S. Dividend Growth Index |
| Price to Earnings Ratio[4] | 14.1x | 14.7x | 13.8x | 14.6x |
| Long-Term Earnings Growth Expectations[5] | 10.8% | 6.7% | 8.8% | 11.6% |
| Dividend Yield[6] | 2.1% | 3.9% | 2.9% | 2.3% |
| Earnings Yield[7] | 7.1% | 6.8% | 7.3% | 6.9% |
| Dividend Yield / Earnings Yield | 29.0% | 56.6% | 39.8% | 33.2% |

Sources: WisdomTree, Bloomberg. Data as of 4/30/2013.
Past performance is not indicative of future results. You cannot invest directly in an index.

*For definitions of terms and indexes, visit our [Glossary](#).* • **Defensive Sector [Price/Earnings (P/E) Ratios](#):** U.S. equities, defined by the S&P 500—an index weighted by market capitalization that does not focus on dividends in any way—had a P/E ratio of slightly over 14x as of April 30, 2013. The four defensive, typically higher-dividend, sectors all had higher P/E ratios than that of broader U.S. equities, ranging from 15.8x to 20.5x. These numbers are why some analysts consider high-dividend stocks to be expensive. • **Long-Term Earnings Growth Expectations:** Additionally, each of the defensive sectors has lower long-term earnings growth expectations, ranging from a low of 4.7% for Utilities to a high of 10.0% for Health Care. • **[Dividend Yields](#)**: The dividend yields on these defensive sectors range from 1.9% for Health Care to 4.2% for Telecommunication Services. • **Dividend Yield / [Earnings Yield](#):** We find it interesting to compare the dividend yields of these indexes to their earnings yields in order to illustrate the impact of dividend policy. What we see is that the Telecommunication Services sector is paying out the vast majority of its earnings as dividends by this metric— that's how it generates such a high yield. The Health Care sector is on the opposite end of the spectrum, paying out only about 30% of its earnings as dividends. I would argue that analysts are drawing a misguided conclusion about dividend stock valuations by just looking at these particular higher-dividend sectors. When one looks at diversified baskets of dividend stocks across all market sectors, shown through the WisdomTree Indexes above, the valuation picture changes. It is also important to remember that not all dividend strategies offer exposure to the same types of dividend-paying stocks. Some dividend indexes are designed to represent a broad basket of dividend payers, while others select stocks based on high dividend yields or dividend stocks with growth characteristics. Below, we review WisdomTree Indexes for each category along with their current valuation picture. **Similar P/E Ratios:** Whether one looks at high-yielding dividend payers, large-cap dividend payers or potential dividend growers, we find the P/E ratios to be in a very narrow band and all below 15 times earnings. We find these to be very reasonable valuations, especially given where U.S. equities are by the same metric. **Primary Difference Is Dividend Payout Ratio:** Because the price-to-earnings ratios and, conversely, the earnings yields (earnings-to-price ratios) are broadly similar for these indexes above dividend strategies, one of the key elements leading to the differences in dividend yields would be the payout ratio. The potential dividend growers had the lowest dividend payout ratio (dividend yield / earnings yield)—33%—and thus a lower dividend yield than the high-yielding dividend payers, which had a dividend payout ratio of 56.6%. But that is not to say that one set of stocks is dramatically more expensive than the other—the P/E ratios are similar. The story being told by the numbers is that the high-yielding dividend payers are returning more of their earnings to shareholders, whereas the potential dividend growers—similarly priced on a P/E ratio basis—are reinvesting a greater share of their earnings or returning cash to shareholders through the use of stock buybacks. **Long-Term Earnings Growth Expectations:** Given the lower dividend payout ratios (and higher reinvestment in the company or use of cash to fund stock buybacks), it should not come as a surprise that high-yielding dividend payers had lower growth expectations than the potential dividend growers. Given similar price-to-earnings ratios, many might view the potential dividend growers as being more attractively priced, given their higher growth expectations. **Exposure to Expensive-Defensives** For those who believe that the defensive sectors are relatively expensive, we discuss how various dividend-focused indexes are exposed to these sectors. We believe that many investors would think all dividend indexes were always heavily exposed and that they'd be surprised to learn that the exposure actually ranged from below 30% to nearly 70% as of April 30, 2013.

**Defensive Sector Exposures within Various Dividend-Focused Indexes**

As of 4/30/2013

| Dividend-Focused Index | Defensives* | Consumer Staples | Health Care | Telecommunication Services | Utilities |
|---|---|---|---|---|---|
| WT U.S. Dividend Growth Index | 27.9% | 20.0% | 7.8% | 0.0% | 0.1% |
| NASDAQ U.S. Dividend Achievers Select Index | 32.6% | 25.1% | 5.5% | 0.1% | 1.9% |
| S&P High Yield Dividend Aristocrats Index | 40.3% | 17.4% | 8.9% | 3.3% | 10.7% |
| WT LargeCap Dividend Index | 40.6% | 16.0% | 11.8% | 6.5% | 6.3% |
| Dow Jones U.S. Select Dividend Index | 52.4% | 13.3% | 4.0% | 2.6% | 32.6% |
| WT Equity Income Index | 55.9% | 15.0% | 15.2% | 12.1% | 13.7% |
| Morningstar Dividend Yield Focus Index | 68.1% | 13.5% | 23.3% | 17.3% | 13.9% |

*Defensives: Refers to the sum of sector weights within Consumer Staples, Health Care, Telecommunication Services and Utilities.
Sources: WisdomTree, Bloomberg
Past performance is not indicative of future results. You cannot invest directly in an index. Allocations subject to change.

*For definitions of terms and indexes, visit our Glossary.* • The WisdomTree U.S. Dividend Growth and NASDAQ US Dividend Achievers Select indexes focus on dividend growth, albeit in different ways. Their exposure to the defensive sectors was on the low end of the range. • The Dow Jones U.S. Select Dividend, WisdomTree Equity Income and Morningstar Dividend Yield Focus indexes each incorporate dividend yield into their selection methodologies, leading them to having the highest exposure to defensive sectors of all the dividend-focused indexes shown. • The WisdomTree LargeCap Dividend Index does not focus on yield or growth as part of its selection methodology and ends up in the middle position on this chart. The S&P High Yield Dividend Aristocrats Index does in fact weight its constituents by dividend yield, but the fact that it requires 20 consecutive years of dividend growth for its constituents lowers its exposure to the defensive sectors compared to the other yield- focused approaches. **Conclusion** While one can argue that the Consumer Staples, Health Care, Telecommunication Services and Utilities sectors are becoming expensive, since they've led the recent rally, we believe it is a mistake to make the generalization that all dividend payers are becoming expensive based on that fact alone. Additionally, there are dividend-focused indexes that do not have majority exposure to these sectors, so avenues exist through which one can apply a dividend focus without having to seek exposure to defensive sectors. *View Jeremy Schwartz discuss dividends* (Video) *Read our Dividend Growth series here.*

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**S&P 500 Index** : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.