Why We Believe High-Dividend Sectors Are Not "in a Bubble"

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Recently, a hotly debated question has been whether dividend-paying equities might be getting expensive or approaching so-called "bubble" territory. Anytime equities are viewed as being relatively cheap or expensive, it is important to note the characteristic being used to make that determination. The most widely cited view stipulating that dividend-paying stocks are expensive that we have seen is that the price-to-earnings (P/E) ratios[1] of the S&P 500 Utilities, Telecommunication Services, Health Care and Consumer Staples Sector Indexes ("high-dividend sectors"[2]) are high. Throughout this piece, unless otherwise specified:

- **The S&P 500 Utilities, Telecommunication Services, Health Care and Consumer Staples Indexes will be referred to as "Utilities," "Telecom," "Health Care" and "Consumer Staples," respectively.**

We believe that three of these four high-dividend sectors are in reality relatively cheaper than they have been on average over the past 20 or so years. Given that we are discussing relative prices of dividend-paying stocks, we believe the best metric to gauge whether they are cheap or expensive starts with the trailing 12-month dividend yield[3], which measures the relationship of a stock's price to the level of its dividends paid over the prior 12 months, as opposed to the P/E ratio.

We believe one should compare the trailing 12-month dividend yields of stocks or sectors to the dividend yield of the broader S&P 500 Index ("the market"). Over time, this difference in relative pricing (or "spread") will indicate the relative value of various stocks and sectors as determined by dividends.

- **A stock or sector with a trailing 12-month dividend yield higher than that of the broad market ("positive spread") would be considered selling at a relatively lower price.**
- **A stock or sector with a trailing 12-month dividend yield lower than that of the market ("negative spread") would be selling at a relatively higher price.**

For instance, the two sector indexes with the highest trailing 12-month dividend yield spreads in the U.S. equity markets today are Telecom and Utilities. As of August 31, 2012, Telecom had the highest spread of any sector index, valued at 2.70%, while Utilities had the second-highest spread, at 2.05%.

[1] Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.
[2] High-dividend sectors: These sectors are the ones we most often see in discussions of dividend stocks being expensive. They also are four of the highest-weighted sectors in the WisdomTree Equity Income Index, an Index selected to contain the highest-dividend-yielding stocks of all U.S. dividend payers, defined as the constituents of the WisdomTree Dividend Index.
[3] Trailing 12-month dividend yield: Dividends over the prior 12 months are added up and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

We believe slower growth potential would be a very good reason why trailing 12-month dividend yield spreads are currently higher for Utilities and Telecom. Sectors characterized by higher growth potential have tended to exhibit lower trailing 12-month dividend yield spreads.

However, a comparison of a sector's trailing 12-month dividend yield spread compared to its own history can help isolate valuation prospects for that sector and determine whether that sector is potentially "expensive" or "cheap."

Currently, of the aforementioned four high-dividend sectors, only one of them, Utilities, has a current trailing 12-month dividend yield spread that would make it "expensive" compared to its historical average over the 20-year period from 8/31/1992 through 8/31/2012 ("the period"). The other three sectors have trailing 12-month dividend yields that we consider to be relatively cheap compared to their historical averages over the period.

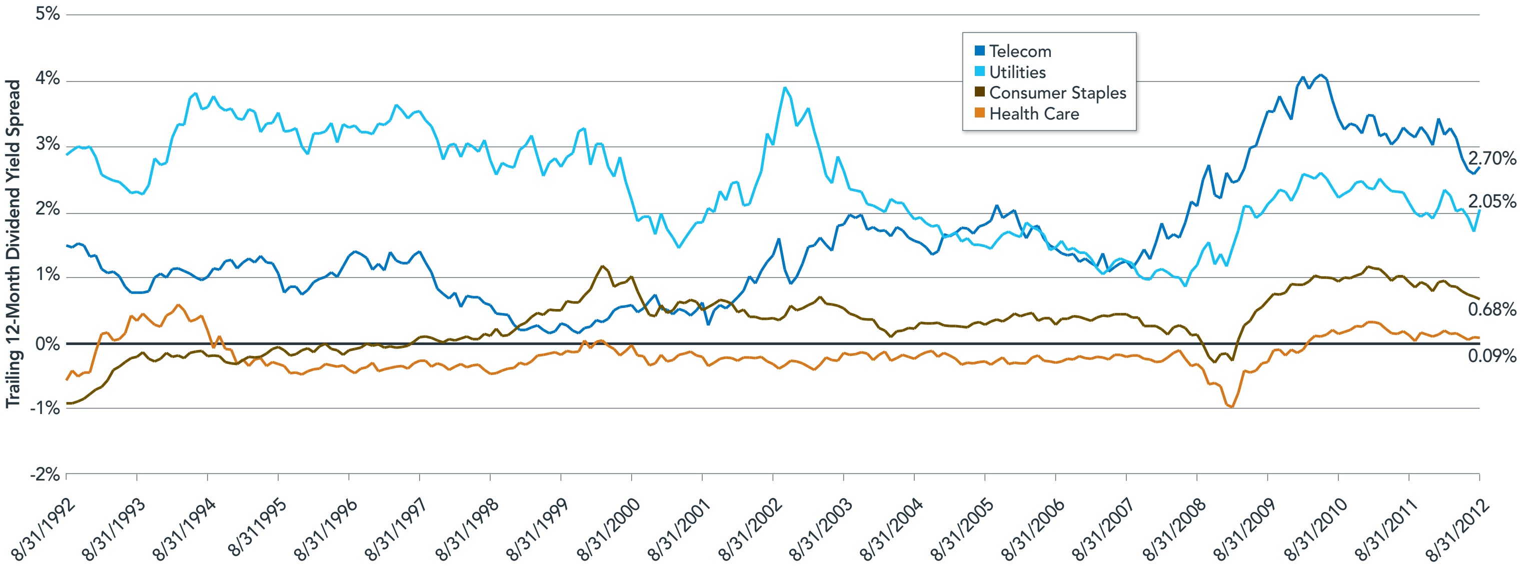
+ **Telecom: Over the period, the Telecom sector had an average trailing 12-month dividend yield spread of 1.54%, but as of August 31, 2012, this spread was 2.70%, the highest of any sector. One could thus argue that this is one of the more attractive spreads that these stocks have displayed over the past 20 years.**
+ **Consumer Staples: Over the period, Consumer Staples had an average trailing 12-month dividend yield that was only .32% higher than that of the S&P 500 Index. As of August 31, 2012, these stocks have a trailing 12-month dividend yield spread that is at .68%—again, signaling a relatively lower valuation than the sector's historical average.**
+ **Health Care: Over the period, Health Care stocks typically sold at premium prices with a negative spread, yet as of August 31, 2012, they exhibit a positive spread of .09%—another spread level that's higher than its historical average.**

FIGURE 1A: JUDGING DIVIDEND YIELD LEVELS OVER TIME [8/31/1992–8/31/2012]

	S&P 500 Sector Indexes			
	Consumer Staples	Utilities	Health Care	Telecom
Trailing 12-Month Dividend Yield as of 8/31/2012	2.78%	4.15%	2.19%	4.79%
Avg. Spread to S&P 500 Index (8/31/1992-8/31/2012)	0.32%	2.41%	-0.17%	1.54%
Spread to S&P 500 Index as of 8/31/2012	0.68%	2.05%	0.09%	2.70%
Spread as of 8/31/2012 minus Avg. Spread	0.37%	-0.36%	0.26%	1.16%

Source: Bloomberg
Past performance is not indicative of future results.

FIGURE 1B: TRAILING 12-MONTH DIVIDEND YIELD SPREADS OVER TIME [8/31/1992–8/31/2012]



Source: Bloomberg
Past performance is not indicative of future results.
You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

ALTERNATIVE CONSIDERATIONS FOR U.S. UTILITIES BEING SLIGHTLY EXPENSIVE

While the U.S. Utilities sector is currently slightly expensive compared to its history, it is interesting to note that using the same analysis technique[4], foreign Utilities[5] are actually showing prices that are relatively cheap from a historical point of view.

+ **Based on the MSCI AC World ex-US Utilities Index, the average trailing 12-month dividend yield of foreign Utilities between July 31, 2002, and August 31, 2012[6] is 4.33%, while the broader MSCI AC World ex-US Index has an average trailing 12-month dividend yield of 2.90% over the same period.**
+ **Based on these numbers, it's clear that the average trailing 12-month dividend yield spread of the MSCI AC World ex-US Utilities Index has been 1.43% over that period, meaning that the current spread of 1.79% as of August 31, 2012, is higher than this average.**

[4] Identical comparison technique of average trailing 12-month dividend yield spread for the MSCI AC World ex-US Utilities Index and the MSCI AC World ex-US Index is used, but with a different period (7/31/2002–8/31/2012), due to data availability.
[5] Foreign Utilities: Defined by the MSCI AC World ex-US Utilities Index.
[6] Period different due to limited data availability.

CONCLUSION

Figure 1B showed that Telecom, Consumer Staples and Health Care exhibit signs of being relatively cheap – not expensive or near bubble territory as some have claimed. On the other hand, Utilities, to be fair, are slightly more expensive than typical, but not by a large degree. One option for those concerned about the valuation risk apparent from this analysis of U.S. Utilities may be foreign Utilities[7], which appear to be trading at discounts vis-à-vis both U.S. Utilities[8] and their own history. We therefore feel confident to conclude that there are still potential valuation opportunities within high-dividend sectors—even after strong recent performance.

[7] As represented by the MSCI AC World ex-US Utilities Sector Index.
[8] Refers to the fact that the trailing 12-month dividend yield spread between the MSCI AC World ex-US Utilities Index and the MSCI AC World ex-US Index is larger than that between the S&P 500 Utilities Index and the S&P 500 Index.

Unless otherwise stated, data source is WisdomTree.

S&P 500 Sector Sub-Indexes: Composed of companies within the broad S&P 500 Index classified into an index encompassing each of the following 10 GICS industry sectors: Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services and Utilities. 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. WisdomTree Equity Income Index: Measures the performance of the 30% highest-yielding dividend-paying equities within the WisdomTree Dividend Index, weighted by indicated cash dividends. WisdomTree Dividend Index: Measures the performance of dividend-paying companies incorporated in the United States that pay regular cash dividends and meet WisdomTree's eligibility requirements. Weighted by indicated cash dividends. MSCI AC World ex-US Index: Measures the performance of companies incorporated in both emerging market and developed markets, excluding the United States. Index weighting is by market cap. MSCI AC World ex-US Sector Sub-Indexes: Composed of companies within the broad MSCI AC World ex-US Index classified into an index encompassing each of the following 10 GICS industry sectors: Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services and Utilities.