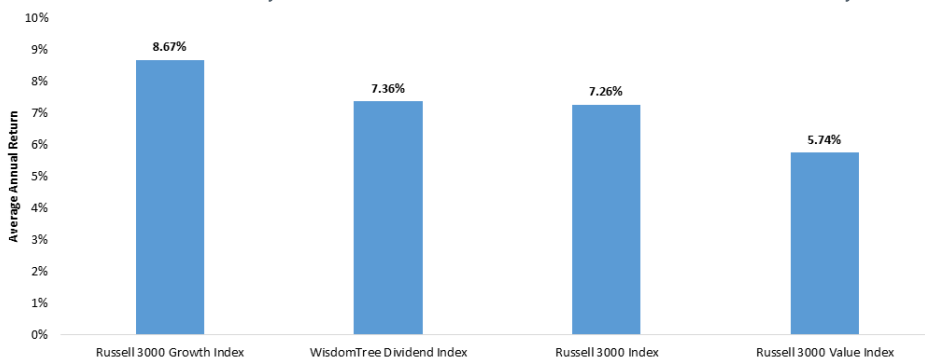


WHAT IS THE INCOME FACTOR IN U.S. EQUITIES?

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The factor discussion is gaining popularity in the world of [smart beta](#) indexing. Size, [value](#), [momentum](#), minimum [volatility](#), [quality](#)—these are all factors in the current discussion, and for the initiated they are becoming part of the common index lexicon. But are investors really looking for these specific factors by name? We explore how these factors relate to real-world investment goals. **Translating Factors into Investment Goals** Some commonly referenced investment goals are: • Keeping principal stable for unexpected expenses and emergencies • Generating a certain average annual return to meet future goals in retirement • Drawing income in order to meet planned expenses We focus on income, as WisdomTree was the first to create a suite of U.S. equity Indexes weighted by cash [dividends](#). **Defining the Income Factor** First, we need an Index that is governed by a set of rules that are focused on dividends but are also simple enough so as not to focus on additional things. The [WisdomTree Dividend Index](#), we believe, may be best suited because all it seeks to do is: • Include every dividend-paying company in the U.S.-listed equity markets that meets WisdomTree’s [liquidity](#) and [market capitalization](#) requirements. There are no selection criteria other than to find companies that have committed to paying regular dividends. • Weight those dividend payers by the cash dividends they indicate they will pay in accordance with their stated dividend policies. This is distinctly different than weighting by [dividend yield](#) or by [dividends per share](#) or even selecting dividend payers but weighting them by market capitalization, and it therefore does not introduce biases attributable to anything other than company dividend policies and practices. **Performance of the WisdomTree Dividend Index, with Its “Income Factor,” Has Been Strong**



Sources: WisdomTree, Bloomberg, with data from 6/1/2006 to 3/31/2016. 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.

• In a market where the [growth](#) style was in favor, the WisdomTree Dividend Index outperformed the [Russell 3000 Index](#) as well as the [Russell 3000 Value Index](#). It should be noted that, due to the dividend focus, many initially think of the WisdomTree Dividend Index, with its focus on the U.S. income factor, as being “value in drag.” Clearly, there was something other than just value at play over this period. • The Russell 3000 Index represents an

important benchmark that is meant to be very broadly inclusive (i.e., not selective) within the U.S. equity market. The differences between this index and the WisdomTree Dividend Index can be viewed as tilts coming as a consequence of the income factor. **The Income Factor Mix: Market, Size, Value, Operating Profitability**



Sources: WisdomTree, Kenneth French Data Library, Bloomberg, with data from 6/1/2006 to 3/31/2016. You cannot invest directly in an index.

We can see that the income factor leads to the following tilts: **1. Lower Market Sensitivity:** The interpretation here is that, in both upward- and downward-trending markets, the WisdomTree Dividend Index, with its focus on the income factor, would not be expected to capture the full movement in either direction. In some ways, one can think of this as a tilt toward “lower [volatility](#),” at least compared to the market, where we see the Russell 3000 Index at 1.01. **2. Sensitivity to Large Stocks:** What we see here is that there is no introduction of an important bias that many would attribute to smart beta strategies—a tilt toward small caps. The thinking is that, since it is known that small caps have greater risk but also greater return over time, this is one way to potentially outperform. However, the -0.173 shows that there is a significant tilt toward larger-capitalization stocks in the WisdomTree Dividend Index, as it focuses on the income factor. **3. Sensitivity to Value Style:** We do see a tilt toward the value style, although not too much more than the Russell 3000 Value Index. It is true that most mid-cap and small-cap growth companies in the United States do not pay regular dividends, and therefore they would not find themselves included in the WisdomTree Dividend Index. This would be one of the more prominent tilts observed through a focus on the income factor in the United States. **4. Sensitivity to Profitable Companies:** On the face of it, this makes sense: companies that are not profitable may not be able to make good on their regular cash dividend policies for long. Committing to regular dividends is one way to think about potential quality, in that U.S. companies will rarely initiate a regular dividend only to then discontinue it soon after—especially when they also have such options as [special dividends](#) or [buybacks](#) at their disposal. It is interesting to see this tilt, as well as remembering that in our prior blog post it was pointed out that [operating profitability, especially in large caps, has performed well over the past 10 years](#). This could be one element of the discussion lending clarity to the statement that the income factor is more than simply value style by a different name.

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DEFINITIONS

Smart Beta: A term for rules-based investment strategies that don't use conventional market-cap weightings.

Value: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Momentum Factor: Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Volatility: A measure of the dispersion of actual returns around a particular average level.

Quality: Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

Dividend: A portion of corporate profits paid out to shareholders.

Liquidity: The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

Market Capitalization: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Dividend yield: A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Dividends per Share: The sum of declared dividends for every ordinary share issued. Dividend per share (DPS) is the total dividends paid out over an entire year (including interim dividends but not including special dividends) divided by the number of outstanding ordinary shares issued.

Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Russell 3000 Index: Measures the performance of the 3,000 largest U.S. companies based on total market capitalization.

Russell 3000 Value Index: Measures the performance of the Russell 3000 Index constituents with value characteristics.

Special dividends: A non-recurring distribution of company assets, usually in the form of cash, to shareholders.

Buyback: When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.