DIVERSIFYING INCOME STREAMS

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Treasury yields setting new all-time lows is starting to feel like an everyday occurrence. With markets signaling that a jolt of stimulus was expected from the Federal Reserve (Fed), the Fed delivered with an emergency 50 basis point (bps) cut this week.

Taking a step back from recent coronavirus induced volatility, rates have been trending lower since the late 2018 market correction. This has led many investors to seek income from higher-yielding equities. The 30-Year yield now sits comfortably below the post-sell-off 2% dividend yield on the S&P 500 Index.[1]

A reach for yield in equities is clear from the run-up in Utilities valuations. The bond-proxy sector has been trading at a price-to-earnings (P/E) premium to the S&P 500 Index since mid-2019.

Utilities Valuations and Interest Rates

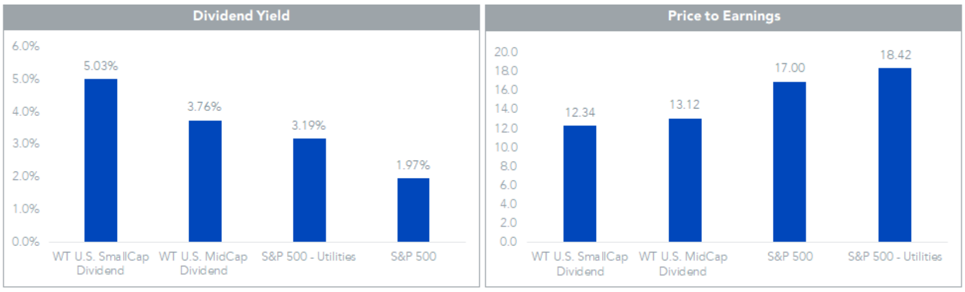
Sources: WisdomTree, FactSet; data from 10/31/1995 to 2/28/2020. Trailing P/E excluding negative earners. You cannot invest directly in an index. Past performance is not indicative of future returns.

At WisdomTree, we have long argued for investors to build equity portfolios with diversified income streams. The S&P 500 Index has a higher dividend yield than U.S. Treasuries, but its valuations are near 20-year highs—albeit discounted from levels of two weeks ago—with Utilities valuations even higher.

WisdomTree's dividend-weighted mid- and small-cap Indexes offer diversification from richly valued large caps, and more growth potential than Utilities. Because smaller companies are typically priced at discounts to their larger peers to compensate for additional risk, investors can obtain higher yields by allocating down the size spectrum for yield.

WisdomTree's Indexes have lower earnings multiples and higher yields than both the broad large-cap index and the Utilities sector.

Yield and Valuation

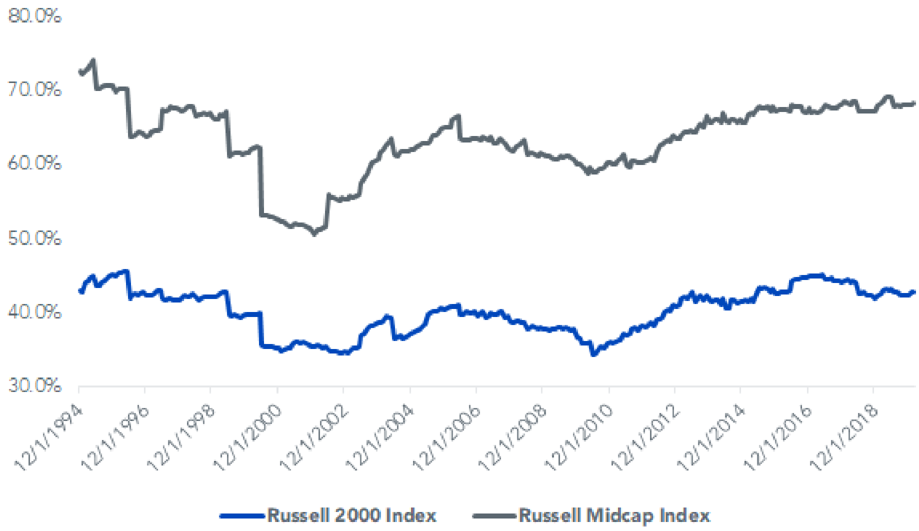


Sources: WisdomTree, FactSet. Data as of 2/28/2020. Forward P/E excluding negative earners. You cannot invest directly in an index. Past performance is not indicative of future returns.

Small-/Mid-Cap Dividend Universe

While the universe of mid- and small-cap dividend payers is smaller than it is for large caps, a broad universe of 68% of the [Russell Midcap Index] and 43% of the [Russell 2000 Index] constituents do pay [dividends]. This percentage has steadily increased over the past decade.

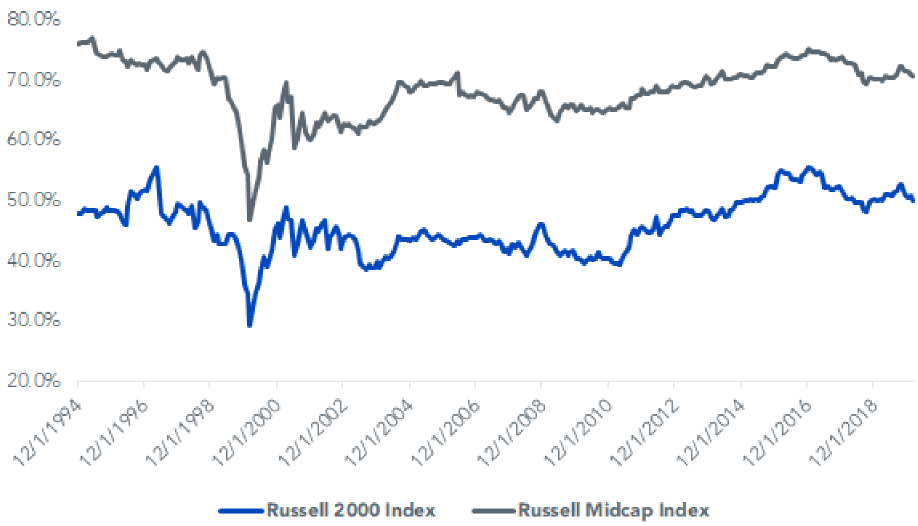
Percent Index Constituents Dividend Payers



Sources: WisdomTree, FactSet, 12/31/1994–2/28/2020. Past performance is not indicative of future results.
You cannot invest directly in an index.

As a percentage weight of each index, dividend payers comprise 71% of the weight of the Russell Midcap Index and 50% of the Russell 2000 Index.

Percent Index Weight Dividend Payers

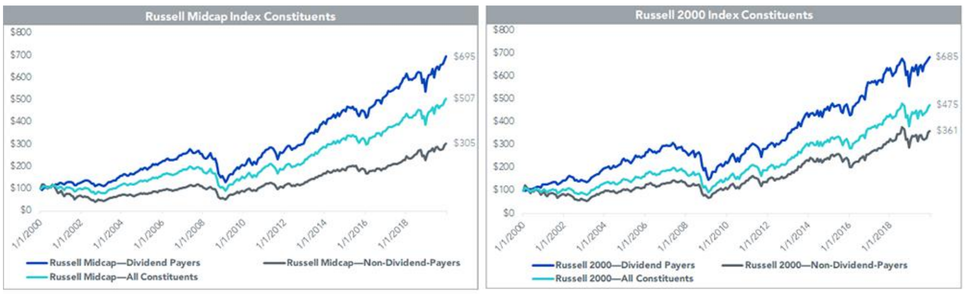


Sources: WisdomTree, FactSet, 12/31/1994–2/28/2020. You cannot invest directly in an index. Past performance is not indicative of future returns.

Over the past 20 years, using market cap weighting, non-dividend payers within the Russell Midcap have underperformed dividend payers by 4.46% annualized. Within the Russell 2000, the non-dividend payers have underperformed by 3.48% annualized.

During certain periods where growth significantly outperforms value, non-dividend payers—highly correlated to small-growth—tend to outperform. Over the long run, these small-growth companies have lagged their dividend-paying peers and have done so with higher risk (standard deviation).

Performance Impact of Excluding Non-Dividend Payers



Sources: WisdomTree, FactSet; data from 1/31/2000 to 12/31/2019. Portfolios are market cap weighted and rebalanced annually at the end of December. Actual index returns will differ from hypothetical portfolio returns. Past performance is not indicative of future results. You cannot invest directly in an index.

Most of the excess returns of dividend payers for this period came from the early 2000s, immediately following the tech bubble. The portfolio of mid-cap dividend payers slightly outperformed non-dividend payers over the growth-led rally of the 2010s. But the small-cap dividend payers lagged by about 60 bps annualized. Because of the significant risk reduction, the small-cap dividend payers had a higher Sharpe ratio.

Summary Return Statistics

Russell Midcap Index Constituents			
	Dividend Payers	Non-Dividend Payers	All Constituents
	Full Period		
Return	**10.22%**	5.76%	8.49%
Risk	**14.85%**	21.28%	16.00%
Sharpe	**0.58**	0.19	0.43
	2000–2009		
Return	**7.70%**	-0.79%	4.41%
Risk	**16.52%**	25.96%	18.20%
Sharpe	**0.30**	-0.14	0.09
	2010–2019		
Return	**12.78%**	12.67%	12.70%
Risk	**13.02%**	15.26%	13.48%
Sharpe	**0.94**	0.79	0.90

Russell 2000 Index Constituents			
	Dividend Payers	Non-Dividend Payers	All Constituents
	Full Period		
Return	**10.14%**	6.66%	8.13%
Risk	**15.72%**	21.67%	18.31%
Sharpe	**0.54**	0.23	0.35
	2000–2009		
Return	**8.58%**	1.24%	4.36%
Risk	**16.63%**	24.89%	20.25%
Sharpe	**0.35**	-0.06	0.08
	2010–2019		
Return	**11.72%**	12.32%	12.01%
Risk	**14.81%**	17.93%	16.19%
Sharpe	**0.75**	0.66	0.71

Sources: WisdomTree, FactSet. Data from 1/31/2000 to 12/31/2019. Green indicates higher returns/Sharpe ratios or lower risk. Red indicates lower returns/Sharpe ratios or higher risk. Portfolios are market cap weighted and rebalanced annually at the end of December. Actual index returns will differ from hypothetical portfolio returns.

Balancing Risks and Yield

Should the coronavirus tilt the U.S. economy into recession—a scenario that is too early to predict—small caps will certainly be punished more than large caps, and some dividend payers will be forced to cut their payouts. A diversified basket of companies helps mitigate that threat.

Elevated valuations of large-cap equities and historically low yields in fixed income create unprecedented challenges for asset allocators. As illustrated, mid- and small-cap dividend payers may be one way to help lower overall portfolio valuations and increase income—thus helping to solve for valuation risks and shortfall risks.

Investing in smaller companies involves incremental risk as measured by the volatility of returns. But focusing on dividend payers can help lower that risk, as well as adding diversification to portfolios—an important consideration, given the tech-heavy concentration of many U.S. large-cap portfolios today.

[1] Sources: WisdomTree, FactSet, as of 2/28/20.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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You cannot invest directly in an index.

DEFINITIONS

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Basis point : 1/100th of 1 percent.

Correction : A drop of 10% or greater in an Index or stock from a recent high.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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.

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.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Diversification : A risk management strategy that mixes a wide variety of investments within a portfolio.

Dividend weighted : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

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.

Core Earnings : Income generated by the company's daily operations rather than one-time events or market fluctuations.

Russell Midcap Index : The Russell Midcap Index measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

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

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Tech Bubble : Market collapse between 1999-2001 that was led by technology stock.

Sharpe ratio : Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.