

# WHAT DIVIDEND TRENDS SAY ABOUT THE MARKET'S GAINS

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Recently, a hotly debated question has been whether U.S. equities are expensive or approaching so-called “bubble” territory. 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](#). While the P/E ratio is an important [valuation](#) metric, we do not think it should be the only metric used. We suggest that an intuitive framework for answering this question could be comparing price performance (upward or downward movement of stock prices that does not account for [dividend](#) payments) to [dividend growth](#). WisdomTree conducts the annual rebalance of its U.S. dividend Index family in December, with the [annual screening date](#) occurring on the last trading day of November. The annual screening process provides a plethora of data about how dividends for the U.S. equity markets have changed over time and gives us important information about the underlying market [fundamentals](#). In figure 1, we look at the [Dividend Stream®](#) for the [WisdomTree Dividend Index \(WTDI\)](#), WisdomTree’s broadest and most inclusive dividend Index, and compare it with the price changes for WTDI and the [Russell 3000 Index](#). **Figure 1: Annual *Dividend Stream* (\$ Billions): WisdomTree**



Sources: WisdomTree, Bloomberg, 11/30/07–11/30/14

WTDI and Russell 3000 price levels have been rebased to starting *Dividend Stream* for comparison purposes.

## Dividend Index

**Record *Dividend Stream* Supports Prices:** In 2007, the WisdomTree Dividend Index recorded what remained until November 30, 2012, its peak level of \$288.5 billion. At the 2014 rebalance screening, seven years later, a new peak of \$410.3 billion was recorded. This indicates approximately 42.2% cumulative growth in the indicated *Dividend Stream* over the period. • **Price Change Matches Dividend Growth:** We find it interesting that the Russell 3000 Index price change over the same period was 43.3%. This is one way to

signal that market prices have moved in tandem with dividends over the last seven years; prices did not increase relative to dividends.<sup>1</sup> Can Dividend Growth Continue? Firms that are not paying out all of their cash as dividends are increasingly buying back their own stock, which can lead to share reduction if their [buybacks](#) are greater than issuance. This is important to consider because those who assume that future dividend growth is going to "[mean revert](#)" and trend back to historical levels—thus supporting a claim that the market is expensive, given its below-average [dividend yields](#)—are not accounting for the net buybacks, which could be locking in future dividend growth. Figure 2: Net [Buyback Yield](#) Greater than 2% for Four Years in a Row, Supporting

	Gross Buyback Ratio	Net Buyback Ratio = Effective Ratio * Gross Buyback Ratio	Trailing 12M Dividend Yield	Net Buyback + Dividend Yield	Total Buybacks (\$ B)	Effective Ratio (Column A / Column B)	Buyback Weighted Reduction in Shares Outstanding (Column A)	% Buybacks Resulting in Reduction Shares Outstanding	Buyback Weighted Reduction in Shares Outstanding (Column B)	% Buybacks Resulting in Increase Shares Outstanding	Buyback Weighted Reduction in Shares Outstanding
12/31/2014	2.61%	2.28%	2.86%	5.14%	\$557.32	87.37%	4.40%	96.67%	5.04%	3.33%	-14.09%
12/31/2013	2.67%	2.24%	2.87%	5.10%	\$459.74	83.74%	3.78%	92.63%	4.52%	7.37%	-5.45%
12/31/2012	2.67%	2.06%	3.33%	5.39%	\$370.02	77.24%	3.86%	85.78%	5.00%	14.22%	-3.00%
12/31/2011	3.07%	2.49%	3.22%	5.70%	\$389.49	81.13%	4.45%	92.17%	5.49%	7.83%	-7.74%

Sources: WisdomTree, Bloomberg, 12/31/11–12/31/14.

**Dividend Growth** Information in figure 2 references the WisdomTree Dividend Index. A negative share reduction equates to a share increase. For WTDI, the net [buyback ratio](#) was approximately 2.3% in 2014, and the combined dividend yield and *net* buyback ratio was over 5.1% for each of the last four years. If you consider the combined dividend yield plus net buybacks ratio, it is actually higher than the average dividend yield since 1871.<sup>2</sup> This, we think, is very supportive of current valuations. Companies whose buybacks reduced [shares outstanding](#) had a weighted average reduction in shares outstanding of between 4.5% and 5% in each of the last four years, and only 3%–14% of all buybacks conducted in these years resulted in share counts creeping higher. When comparing the gross buybacks (total amount) to the net amount that resulted in share counts declining, we find that share buybacks have been very effective in the last four years. Share buybacks that reduce share count lock in *per-share* dividend growth. Firms can distribute the same dollar value of aggregate dividends in the future, but, since it is spread out over fewer shares, they mathematically increase their *per-share* dividends. If recent buyback trends continue—and we expect they will—this suggests that dividend growth is apt to be higher than its long-term historical norms. <sup>1</sup>The price change for WTDI was only 29.3%. We used the Russell 3000, which had a larger increase, to illustrate price changes as a better way to capture companies that initiated a dividend and added to the U.S. equity market *Dividend Stream* but not necessarily to the price of WTDI. <sup>2</sup>Source: Robert Shiller, as of 12/31/14.

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## DEFINITIONS

**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.

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

**Dividend growth**: The growth in trailing 12-month dividends for the specified universe.

**Annual screening date**: The screening date refers to the date upon which characteristics of eligible constituent firms are measured, whereas the rebalance refers to when the results from the screening date are implemented by way of Index weights and constituents.

**Fundamentals**: Attributes related to a company's actual operations and production as opposed to changes in share price.

**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.

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

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

**Mean reversion**: The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

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

**Buyback yield**: amount of a company's buybacks divided by its market capitalization.

**Buyback ratio**: The ratio of the amount of a company's buybacks to its market capitalization.

**Shares outstanding**: all the shares of a corporation or financial asset that have been authorized, issued and purchased by investors.