
ADDITION BY SUBTRACTION: SCORING DIVIDEND RISKINESS

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Markets discount future [cash flows](#).

But the future is uncertain, so there are countless quantitative models and heuristics that investors use to cope with uncertainty in valuing securities.

WisdomTree's original [dividend](#) Indexes assumed a dividend paid was a sign of corporate health—after all, a company must have profits to pay a dividend—and we assigned the weight of each company to its cash dividends paid, aiming for [diversification](#) to mitigate unforeseen tail risks.

But we recognize that some future dividends are in fact more uncertain (riskier) than others. It's compelled us to remove exposure to the riskiest dividend payers in our Indexes and adjust dividend weights for our core dividends and high-dividend Indexes to account for the likelihood of dividends being maintained or grown.

Current Dividends as Guide

In the U.S., companies tend to size dividend payouts so they can be maintained in good times and bad to avoid the negative signaling associated with a dividend cut.

The implication is that *today's dividend* can be viewed as a reflection of management's confidence in *future earnings and dividends*.

And with no one having more information about the prospects of the business than its management, there is a fair amount of justification for tethering estimates of fundamental value to a company's current dividend.

[Dividend Stream®](#) weighting

This rationale—using today's dividend as an objective measure of value—helped shape WisdomTree's approach to Dividend Stream weighting broad investable universes. For the [WisdomTree U.S. Dividend Index](#), for example, the roughly 1,400 largest dividend-paying U.S. companies were included in last year's reconstitution. Constituents were weighted in proportion to their annual cash dividends.

Relative to [market cap weighting](#), this approach naturally tilts toward companies and sectors in more mature businesses—those with higher payouts and lower reinvestment rates. It also means more of a tilt to “[value](#)” than “[growth](#).”

While we still believe in the merits of this dividend-weighting approach, there are instances where we believe the trends in profitability ([quality](#)) and recent price performance ([momentum](#)) of a company can signal the riskiness of a company's dividend.

To account for the inherent uncertainty in future cash flows, we believe we should discount the value we would otherwise assign to riskier companies that have a lower probability of maintaining/growing dividends and increase the value we would assign to the less risky companies with a higher probability of maintaining/growing dividends.

Composite Risk Scores

We've previously discussed the method that [WisdomTree has come up with to evaluate the riskiness of a dividend](#). In short, we designed a [composite risk score](#) of 50% quality and 50% momentum to evaluate the safety of companies and their dividend.

In 2020, a year that's seen a 6% reduction in the *Dividend Stream* for the WisdomTree U.S. Dividend Index, companies in the 1st decile on the composite risk score (least risky) have actually grown their dividends by more than 3%. On the other end, companies in the 10th decile (most risky) have reduced their aggregate dividends by nearly 60%.

Dividend Changes Across Risk Deciles

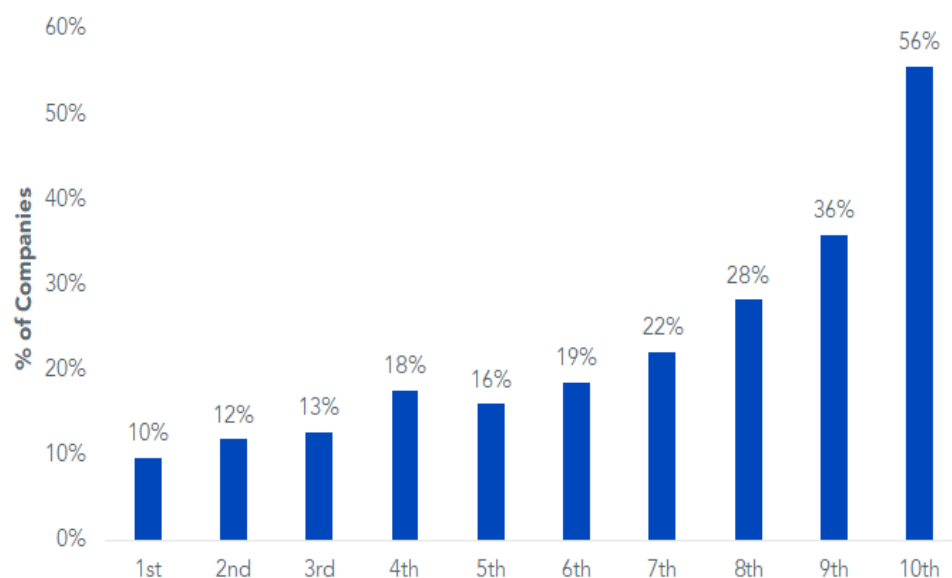
% Dividend Stream Changes Summary										
Div Policy	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th
Suspended	-1.1%	-1.7%	-2.3%	-4.1%	-3.3%	-4.9%	-8.9%	-17.3%	-24.7%	-40.7%
Cutter	-1.2%	-0.3%	-0.7%	-3.5%	-1.7%	-1.2%	-14.1%	-2.1%	-7.4%	-20.6%
Grower	5.6%	4.8%	4.4%	3.4%	3.7%	3.1%	3.2%	5.5%	2.4%	1.9%
Total	3.3%	2.8%	1.4%	-4.1%	-1.3%	-2.9%	-19.8%	-14.0%	-29.8%	-59.4%

Sources: WisdomTree, FactSet, Bloomberg. Composite risk scores as of 11/30/19, the screening date for the WisdomTree U.S. Dividend Index.

Dividend data as of 10/22/20 and represents changes relative to 11/30/19.

Another way to look at the dividend reductions across risk deciles is to show what percentage of dividend payers in each decile either cut or suspended their dividend this year. The 1st decile had just 10% of companies reduce payouts, whereas the 10th decile had more than half of companies reduce payouts.

Dividend Cuts/Suspensions Across Risk Deciles



Sources: WisdomTree, FactSet, Bloomberg. Composite risk scores as of 11/30/19, the screening date for the WisdomTree U.S. Dividend Index. Dividend data as of 10/22/20 and represents changes relative to 11/30/19.

We believe this composite risk scoring approach will help tilt away from companies with lower profitability, and thus less capacity to grow their dividends in normal times and more likely to reduce their dividends when the economy slows down—just the time when investors often expect outperformance, not underperformance, from dividend strategies.

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.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

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You cannot invest directly in an index.

DEFINITIONS

Cash flows: a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.

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

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

Dividend Stream: Refers to the regular dividends per share multiplied by the number of shares outstanding.

Market capitalization-weighting: 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.

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.

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.

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.

Momentum: 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.

Composite risk score: A term that refers to combining multiple factors—for example quality and momentum—to quantify the potential riskiness of a security relative to comparable companies.