

POTENTIAL FOR DIVIDEND GROWTH OUTSIDE THE UNITED STATES

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The concept of dividend growth is particularly attractive in today’s low-interest-rate environment across developed markets. Time and time again the view is espoused that all the monetary easing being undertaken by developed market central banks will lead to inflation. Rather than investments with fixed payments, dividends are thought to have the potential to grow and even outpace the rate of inflation, should it arise in the future. While a plethora of options stand out for those focused on U.S. equities, after auditing dividend-focused indexes of international equities outside the U.S., we found the following three options:

- The [Dow Jones EPAC Select Dividend Index](#) requires dividend payments for the last three years, in addition to dividend payout ratio and other criteria.
- The [NASDAQ International Dividend Achievers Index](#) requires five consecutive years of positive dividend growth. It’s also worth noting that a significant portion of its international exposure is through [American Depository Receipts \(ADRs\)](#) and [Global Depository Receipts \(GDRs\)](#).
- The [S&P International Dividend Opportunities Index](#) requires stable or increasing three-year dividend growth in addition to other criteria focused on earnings. The two major common threads we see across these options: 1. Their weighting schemes focus on [dividend yield](#). 2. Prior to index inclusion, each constituent must demonstrate some history of dividend growth or, at the very least, stable dividend payments. While these attributes aren’t inherently good or bad in and of themselves, we believe they may not provide the best positioning to generate future dividend growth.

What Determines Future Growth Potential? Moreover, in the finance literature, [return on equity \(ROE\)](#) is critically linked to dividend growth and [intrinsic value](#) of companies through the dividend discount model (DDM).¹ The DDM for stock valuation states: **Value of a stock = $DPS(1) / (R-G)$** where:

- $DPS(1)$ = Dividends per share expected to be received in one year
- R = The required rate of return for the investment
- G = Growth rate in dividends, which equals $ROE \times \text{earnings retention (or } 1 \text{ minus dividend payout ratio)}$

The growth rate equals the return on equity times the reinvestment rate; simply stated, the growth of dividends is determined by what fraction of earnings is put back into the firm and how profitable those earnings are in their subsequent use. A sustainable dividend growth rate is thus critically linked in finance theory to ROE. In short, if the focus is on dividend growth, according to this particular model of equity valuation, it could be beneficial to reinvest a larger proportion of earnings AND have those earnings be strongly profitable, in the form of a high ROE.

Index Characteristics as of May 31, 2013 Index Screening

	Long-Term Earnings Growth Expectations	ROE	ROA	Leverage	Earnings Retention	ROE x Earnings Retention
WisdomTree Global ex-U.S. Growth Index	14.7%	35.0%	14.0%	2.5x	71.5%	25.0%
NASDAQ International Dividend Achievers Index	6.6%	18.6%	6.8%	2.7x	50.8%	9.4%
Dow Jones EPAC Select Dividend Index	4.7%	17.8%	5.4%	3.3x	16.9%	3.0%
S&P International Dividend Opportunities Index	6.1%	19.2%	6.4%	3.0x	-7.0%	N/A

Sources: WisdomTree, Standard & Poor’s
Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of

terms and indexes, visit our [Glossary](#). • **Earnings Retention:** The earnings retention rate of firms within the [WisdomTree Global ex-U.S. Growth Index](#) is significantly higher than that of the other indexes listed. All of these indexes focus solely on dividend payers, but we believe this result is a direct focus of weighting schemes focused on yield. One way to generate yield is to pay out a higher proportion of current earnings, but the fact is, this higher current payout (and lower earnings retention) may hurt future growth potential. • **ROE:** ROE for firms within the WisdomTree Global ex-U.S. Growth Index is nearly two times that of the other indexes listed. Notably, all of these figures are quite strong, but the direct focus applied in WisdomTree's methodology certainly emphasizes this attribute. **Conclusion** There is no one way to determine future equity valuation, but the dividend discount model has been around for a significant length of time. We also believe that it makes logical sense that potential dividend growth could be constrained by earnings reinvestment and profitability of those earnings –as it would be these two factors driving the potential generation of cash that could be used to pay higher future dividends. Dividend-focused indexes that employ a variety of yield-focused weighting methodologies may not be the strongest options for those looking for future growth potential. *Read our full research [here](#).* ¹ William L. Silber & Jessica Wachter, "Equity Valuation Formulas," New York University, 2013.

Important Risks Related to this Article

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DEFINITIONS

Dow Jones EPAC Select Dividend Index: Designed to measure the performance of relatively higher-yielding companies in developed market countries outside the United States that meet certain dividend criteria defined by Dow Jones. Weighting is by dividend yield.

NASDAQ International Dividend Achievers Index: Designed to measure the performance of companies in developed international markets that have increased their dividends for the past five consecutive years. Weighting is by dividend yield.

ADRs: American Depository Receipts, shares of a firm incorporated outside the U.S. but issued by a global bank and traded in the U.S., denominated in U.S. dollars.

Global Depository Receipts (GDRs): Ways for corporations to list their stock on different exchanges outside their home country.

S&P International Dividend Opportunities Index: Designed to measure the performance of companies in developed international markets with relatively higher dividend yields that meet other criteria defined by Standard & Poor's. Weighting is by dividend yield.

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

Return on Equity (ROE): Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Intrinsic value: Value of a firm based on its operations, business practices and profitability, which may or may not be closely related to the value of that same firm based on its equity share price.

Earnings Retention: Proportion of a firm's earnings that are not paid out to shareholders in the form of a dividend but rather reinvested back into the business. Higher numbers indicate a greater percentage of earnings are being reinvested.