SHIFTING TRENDS: FROM LOW VOLATILITY TO QUALITY DIVIDEND GROWTH

Over the period of about the last three years, the annualized returns of the S&P 500 Index have been nearly 12%. That is a strong number, and it shouldn't be surprising that U.S. stocks are more expensive now than they were then.

Let's discuss what has been driving these returns and analyze various factor strategies to shed light on their potential to continue this trend in returns going forward.

Multiple Expansion, Earnings Growth or Dividend Yield: what's most Important?

By itself, an index's trailing total return may not say much about its future return potential. Fortunately, we can model different drivers behind performance by deconstructing the three separate components of total return:

Average Dividend Yield

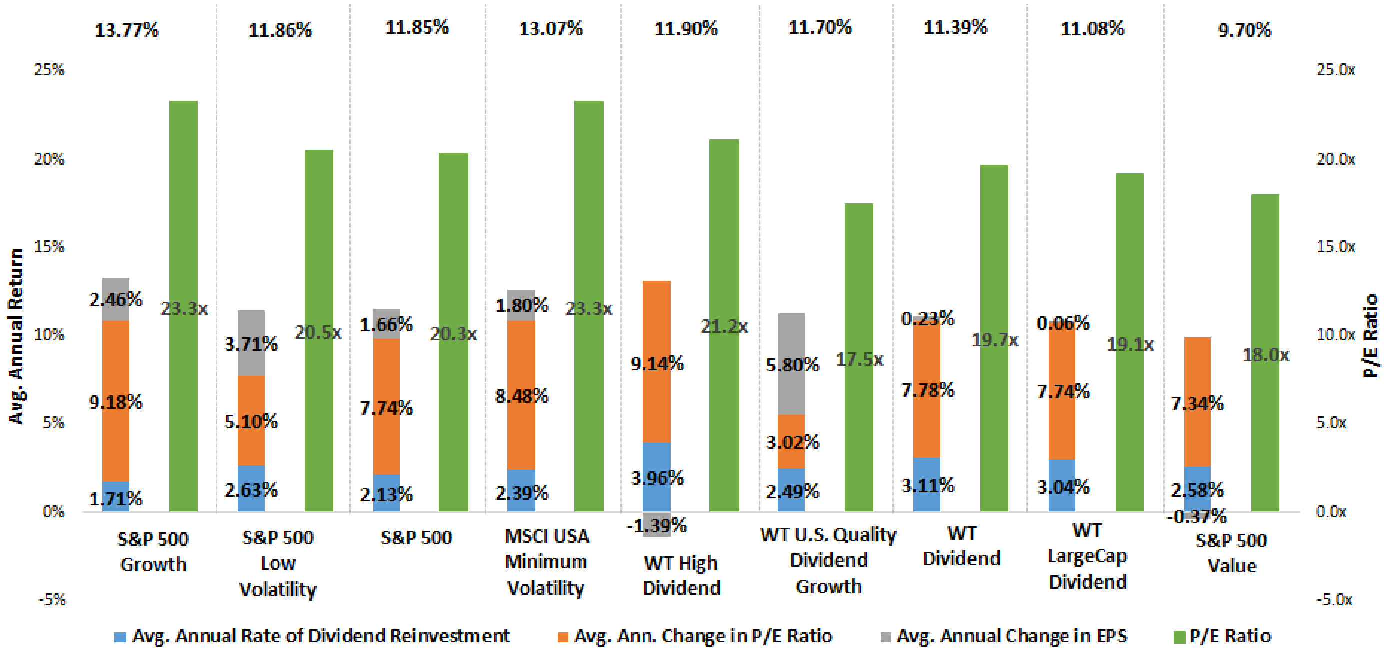
We also refer to this as the average annual rate of dividend reinvestment, and it measures the contribution of the reinvestment of dividends to total returns. This can be a "lower volatility" driver of returns in that, at its very worst, it would drop to zero, meaning no companies were paying dividends. Additionally, a higher average dividend yield may serve as a potential buffer against earnings growth headwinds or declining price-to-earnings (P/E) ratios, and make that index less dependent on rising prices for future returns.

Average Annual Change in P/E Ratio

Over the last three years, the critical driver of returns has been "multiple expansion," meaning rising P/E ratios. At its core, this means that investors are willing to pay more for each dollar of earnings per share being generated. This component has the potential to be heavily affected by changes in investor sentiment, which would mean a change in what investors in aggregate are willing to pay per dollar of earnings.

Decomposition of Index Total Returns, 6/30/13–10/3/16

Index Total Returns



Sources: WisdomTree, Bloomberg, with data as of 10/3/16. Returns measured from 6/30/13 to 10/3/16, with start date commensurate with availability of P/E ratio data for the S&P 500 Low Volatility Index. You cannot invest directly in an index. Past performance is not indicative of future returns.

Average Annual Change in Earnings per Share (EPS)

This is an important driver of equity returns—some would say the most important driver—because that is really what equity ownership means: access to the growth of earnings per share over time.

What "Won" over the Past Three Years?

At first glance, the returns are clustered together quite closely. The S&P 500 Growth Index led, with 13.77% per year. The S&P 500 Value Index was at the opposite end of the spectrum, but it was still up 9.70% per year.

The components of the total return decomposition were much more interesting than the headline numbers.

Average Annual Rate of Dividend Reinvestment as a "Shock Absorber"

Of the indexes shown, the WisdomTree High Dividend Index was the standout, at 3.96%. Both the WisdomTree Dividend Index and the WisdomTree Large Cap Dividend Index were also above the 3.00% level. The S&P 500 Growth Index was the lowest, at 1.71%. This is significantly below the market (S&P 500 Index), which was at 2.13%.

Average Annual Change in P/E Ratio

This component of the decomposition tells us that investors were willing to pay greater than 9.00% per year more for the earnings per share of the S&P 500 Growth Index over this period. Other indexes with similar P/E ratio expansion were the MSCI USA Minimum Volatility Index, which expanded at 8.48% per year, and the WisdomTree High Dividend Index, which expanded at 9.14% per year. The bottom line: these indexes have grown more expensive, and this has been a major driver of returns. Can they continue to get more expensive at a similar rate, relative to their earnings? That's possible, yes, but each year of valuation expansion makes subsequent years of similar expansion more and more difficult.

Average Annual Change in EPS

For most of the indexes shown, this was fairly low. The S&P 500 Index itself only saw the average annual change in EPS at 1.66% per year—the lowest of its three drivers. The real standout for this particular period was the WisdomTree U.S. Quality Dividend Growth Index, with EPS growth of 5.80% per year. This contributes to the fact that this Index also had the lowest P/E ratio of the indexes shown as of October 3, 2016, when measured on a trailing 12-month earnings basis.

What Could Be the Best Future Opportunity?

Over long periods of time, the real return of equities has been fairly commensurate with their earnings yield. A higher earnings yield necessarily means a lower P/E ratio. Of the indexes shown, the WisdomTree U.S. Quality Dividend Growth Index had the lowest P/E ratio for this period.

While the WisdomTree Indexes certainly saw P/E multiple expansion, albeit to varying degrees, it's important to note that each has an annual rebalance that builds in a sensitivity relative valuation. Over time, the avenue to gaining greater weight in these indexes is through the growth of dividends—an important distinction to be made against indexes that may be weighted by market capitalization.

Neither the MSCI USA Minimum Volatility Index nor the S&P 500 Low Volatility Index has a rebalancing mechanism that builds in a sensitivity to relative valuation. While these indexes may not always become more and more expensive, any shift to lower valuation will not come from the rebalancing process.

If the U.S. Federal Reserve embarks on a cycle of raising interest rates—even a slow cycle—then dividend-paying stocks such as those in the Utilities or Telecommunication Services sectors may face competition as sources of income. It's worth noting that, as of this writing, the WisdomTree U.S. Quality Dividend Growth Index did not have exposure to these sectors, something that we think would surprise a lot of people about any dividend-focused index centered on U.S. equities.

Unless otherwise noted, data source is Bloomberg, as of 10/3/16.