WISDOMTREE'S NEW EQUITY INCOME EVOLUTION: COMPOSITE RISK SCORING

January 2020

One of WisdomTree's first strategies originally focused on higher dividend-yielding US stocks. It ranked a universe of dividend-paying equities by dividend yield and then selected the top 30%.

The original WisdomTree US High Dividend Index aligned with research conducted by Professor Siegel for his 2005 book, *The Future for Investors*.

Professor Siegel broke down the performance of the S&P 500 dividend-paying stocks into quintiles. Stocks with the highest dividend yields outperformed those with the lowest dividend yields—while also reducing risk.

INTRODUCING A NEW COMPOSITE RISK SCORING

One challenge with focusing on stocks in the top 30% of yields is that some securities could be considered "value traps," or "cheap for a good reason."

Sometimes the highest-yielding companies have seen their share prices precipitously drop due to risk factors and poor outlooks for future profitability, which could then lead to future dividend cuts.

In the past, we have relied on diversification to limit exposure to these names.

But new research we've conducted on a composite risk scoring methodology gives us a reason to add a new risk filter to our high-dividend screening and weighting process.

NEW RISK MANAGEMENT PROCESS

First, the top 30% of eligible dividend-paying companies are initially selected, as has been the process in the past.

However, under the new approach, these companies are then screened across three factors (value, quality and momentum), each meant to quantify a specific risk.

+ The value factor is designed to lower weight to companies deemed expensive by other traditional measures of valuation.
+ The quality factor is designed to lower weight to companies with poor profitability metrics or declining measures of profitability.
+ The momentum factor is designed to lower weight to companies that have a high yield but only because their stock prices have been in decline.

We use this composite score to help exclude companies that are signalling higher risk on other measures, so we refer to this as a composite risk score. The overlap of companies that pass the dividend yield screen AND score in the bottom 20% based on this composite risk scoring will be removed from the Index.

NEW RISK MANAGEMENT PROCESS

Companies scoring low on the composite risk score have underperformed the broader markets and did so with much higher risk and higher tracking error relative to the benchmark.

FIGURE 1: HOW DID THE HIGHER-RISK COMPANIES PERFORM?

	Annualised Return	Annualised Standard Deviation	Sharpe Ratio	Maximum Drawdown	Tracking Error	Information Ratio	Up Capture	Down Capture	Alpha	Beta
Universe Market Cap-Weighted	7.86%	14.51%	0.49	-49.46%	1.98%	-0.31	92.44%	95.25%	-019%	0.94
Bad Quintile Market Cap-Weighted	2.79%	20.36%	0.10	-67.94%	8.22%	-0.69	103.28%	125.35%	-6.34%	1.24
MSCI USA IMI	8.45%	15.30%	0.50	-50.78%	0.00%	0.00	100.00%	100.00%	0.00%	1.00

Sources: WisdomTree, MSCI, 30 June 2007–30 November 2019. Universe represents dividend-paying securities within the MSCI USA IMI that have a market cap above $200m and average daily traded value over $200,000 for the six months before screening. The Bad Quintile represents securities within that universe that score low on a composite risk score. Screening is done at the end of November each year, and securities are either market-cap-weighted or dividend-stream-weighted. ***You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.***

As of the most recent annual screening at the end of November 2019, there was also some noticeable difference in the fundamentals of these higher risk companies. There were 99 companies that were excluded as a result of the additional composite risk score. Looking at the chart below, you can see that while the excluded companies had substantially higher dividend yields, other metrics were much less favourable. The aggregate trailing P/E ratio for these excluded companies was 30x earnings, driven by the fact that more than one-quarter of the basket had negative trailing earnings. Looking at a standard quality metric like return on equity, we also saw substantially lower values. These companies also were net share issuers, diluting existing shareholders by issuing 3% of new shares outstanding.

FIGURE 2: FUNDAMENTALS COMPARISON: INITIAL DIVIDEND UNIVERSE

	Number of Securities	Dividend Yield	Net Buyback Yield	Shareholder Yield	Price-to-Earnings (P/E) Ratio	% Negative Earners	Estimated P/E Ratio	Return on Equity (ROE)	Return on Assets (ROA)
Initial Dividend Universe	1374	3.09%	1.93%	5.02%	18.2x	1.74%	16.2x	13.91%	2.83%
High Dividend Yield Subset	437	4.44%	0.81%	5.25%	16.9x	2.87%	15.0x	12.00%	2.81%
High Risk Companies Aggregate	99	6.24%	-3.29%	2.95%	30.1x	26.59%	21.0x	5.71%	1.47%

Sources: WisdomTree, FactSet, as of 30 November 2019. High Dividend Yield Subset is securities that pass the initial high dividend yield screen for the WisdomTree US High Dividend Index, usually around top 30% by dividend yield of the starting universe. All baskets above assume securities are weighted by their indicated cash dividends. ***Weights subject to change. Historical performance is not an indication of future performance and any investments may go down in value.***

HOW INDEX WEIGHTING PUSHES WEIGHT TOWARD POTENTIALLY LOWER RISK FIRMS

Since its inception in 2006, the WisdomTree US High Dividend Index has employed a process that weights companies on the basis of their indicated cash dividends. The new approach takes this as a baseline but incorporates the same composite risk scoring mechanism that we discussed earlier in this piece to adjust the initial dividend weighting. After the initial screening, companies selected that rank in the top one-third within the composite risk scoring framework would see their weights increase by 50%, whereas companies in the bottom one-third would see their weights decrease by 50%[1]. It is in this way that the existing constituents see their weights adjusted to better reflect differences in relative risk. On a fundamental basis, you still get a noticeably higher dividend yield through the selection and weighting, but it's slightly lower due to the exclusion of higher-risk companies. With this exclusion and weighting, though, you achieve a more favourable shareholder yield, return on equity and return on assets.

FIGURE 3: INDEX FUNDAMENTALS COMPARISON

	Dividend Yield	Net Buyback Yield	Shareholder Yield	Price-to-Earnings (P/E) Ratio	Estimated P/E Ratio	Return on Equity (ROE)	Return on Assets (ROA)
WisdomTree U.S. High Dividend	4.16%	1.48%	5.64%	15.43	14.03	14.31%	3.15%
S&P 500	1.82%	2.30%	4.12%	21.30	18.64	15.57%	3.62%
Russell 1000 Value	2.47%	2.02%	4.49%	18.03	15.62	11.11%	2.35%

Sources: WisdomTree, FactSet, as of 30 November 2019. You cannot invest directly in an index. WisdomTree US High Dividend Index uses constituent weighting based on most recent 30 November 2019 screening to reflect the latest index composition. ***Weights subject to change. Historical performance is not an indication of future performance and any investments may go down in value.***

FROM HIGH DIVIDEND YIELD TO MORE SUSTAINABLE HIGH DIVIDEND YIELD

Over the course of the more than 13 years that the WisdomTree US High Dividend Index has been in live calculation, the tools available for application within equity index construction have evolved. We believe that this new approach better reflects the tools of risk mitigation available to index providers currently, while at the same time delivering on the desire for a basket of US equities with higher levels of dividend yield.

[1] Companies ranking in the middle third by composite risk score will not have their dividend stream adjusted for weighting purposes.

IMPORTANT INFORMATION

Communications issued in the European Economic Area ("EEA"): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as "WisdomTree" (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. Past performance is not a reliable indicator of future performance. Any historical performance included in this document may be based on back testing. Back testing is the process of evaluating an investment strategy by applying it to historical data to simulate what the performance of such strategy would have been. Back tested performance is purely hypothetical and is provided in this document solely for informational purposes. Back tested data does not represent actual performance and should not be interpreted as an indication of actual or future performance. The value of any investment may be affected by exchange rate movements. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice. These products may not be available in your market or suitable for you. The content of this document does not constitute investment advice nor an offer for sale nor a solicitation of an offer to buy any product or make any investment.

An investment in exchange-traded products ("ETPs") is dependent on the performance of the underlying index, less costs, but it is not expected to match that performance precisely. ETPs involve numerous risks including among others, general market risks relating to the relevant underlying index, credit risks on the provider of index swaps utilised in the ETP, exchange rate risks, interest rate risks, inflationary risks, liquidity risks and legal and regulatory risks.

The information contained in this document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares in the United States or any province or territory thereof, where none of the issuers or their products are authorised or registered for distribution and where no prospectus of any of the issuers has been filed with any securities commission or regulatory authority. No document or information in this document should be taken, transmitted or distributed (directly or indirectly) into the United States. None of the issuers, nor any securities issued by them, have been or will be registered under the United States Securities Act of 1933 or the Investment Company Act of 1940 or qualified under any applicable state securities statutes.

This document may contain independent market commentary prepared by WisdomTree based on publicly available information. Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Any third party data providers used to source the information in this document make no warranties or representation of any kind relating to such data. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.

This document may contain forward looking statements including statements regarding our belief or current expectations with regards to the performance of certain assets classes and/or sectors. Forward looking statements are subject to certain risks, uncertainties and assumptions. There can be no assurance that such statements will be accurate and actual results could differ materially from those anticipated in such statements. WisdomTree strongly recommends that you do not place undue reliance on these forward-looking statements.

The products discussed in this document are issued by WisdomTree Issuer PLC ("WT Issuer"). WT Issuer is an umbrella investment company with variable capital having segregated liability between its funds organised under the laws of Ireland as a public limited company and authorised by the Central Bank of Ireland ("CBI"). WT Issuer is organised as an Undertaking for Collective Investment in Transferable Securities ("UCITS") under the laws of Ireland and shall issue a separate class of shares ("Shares") representing each fund. Investors should read the prospectus of WT Issuer ("WT Prospectus") before investing and should refer to the section of the WT Prospectus entitled 'Risk Factors' for further details of risks associated with an investment in the Shares.

Notice to Investors in Switzerland – Qualified Investors: Some of the sub-funds referred to in this document may not have not been registered with the Swiss Financial Market Supervisory Authority ("FINMA"). In Switzerland, such sub-funds that have not been registered with FINMA shall be distributed exclusively to qualified investors, as defined in the Swiss Federal Act on Collective Investment Schemes or its implementing ordinance (each, as amended from time to time). The representative and paying agent of the sub-funds in Switzerland is Société Générale Paris, Zurich Branch, Talacker 50, PO Box 5070, 8021 Zurich, Switzerland. The prospectus, the key investor information documents (KIID), the articles of association and the annual and semi-annual reports of the sub-funds are available free of charge from the representative and paying agent. As regards distribution in Switzerland, the place of jurisdiction and performance is at the registered seat of the representative and paying agent.

For Investors in France: The information in this document is intended exclusively for professional investors (as defined under the MiFID) investing for their own account and this material may not in any way be distributed to the public. The distribution of the Prospectus and the offering, sale and delivery of Shares in other jurisdictions may be restricted by law. WT Issuer is a UCITS governed by Irish legislation, and approved by the Financial Regulatory as UCITS compliant with European regulations although may not have to comply with the same rules as those applicable to a similar product approved in France. The Fund has been registered for marketing in France by the Financial Markets Authority (Autorité des Marchés Financiers) and may be distributed to investors in France. Copies of all documents (i.e. the Prospectus, the Key Investor Information Document, any supplements or addenda thereto, the latest annual reports and the memorandum of incorporation and articles of association) are available in France, free of charge at the French centralizing agent, Societe Generale at 29, Boulevard Haussmann, 75009, Paris, France. Any subscription for Shares of the Fund will be made on the basis of the terms of the prospectus and any supplements or addenda thereto.

For Investors in Malta: This document does not constitute or form part of any offer or invitation to the public to subscribe for or purchase shares in the Fund and shall not be construed as such and no person other than the person to whom this document has been addressed or delivered shall be eligible to subscribe for or purchase shares in the Fund. Shares in the Fund will not in any event be marketed to the public in Malta without the prior authorisation of the Maltese Financial Services Authority.

This communication is only intended for duly registered banks and/or licensed portfolio management companies in Monaco. This communication must not be sent to the public in Monaco.