Quality Dividend Funds' Day in the Sun

A fundamentally weighted equity index fund includes components chosen based on metrics such as revenue, dividend rates, earnings or book value. One school of thought is that these strategies have the potential to substantially outperform the broader markets in inflationary, rising-rate economic environments and bear markets like we have today. To this end, Jeff Weniger, Head of Equity Strategy at WisdomTree Asset Management explains why the WisdomTree U.S. Quality Dividend Growth Fund (DGRW) could be a compelling proposition for investors.

WisdomTree is a leader in dividend investment strategies. The company launched its first 20 dividend weighted strategies in June 2006, its first earnings weighted strategies in February 2007 and its quality dividend growth strategies in 2013. In the last 16 years, WisdomTree has built a solid reputation and has grown to become an $80 billion global asset manager.

DGRW, an exchange traded fund (ETF) that seeks to track the WisdomTree U.S. Quality Dividend Growth Index, now has about $6.1 billion in AUM.

Individual components of market capitalization weighted index ETFs are included in amounts that correspond to their total market capitalization, and the fund components with a higher market capitalization receive a higher weighting in the fund. Proportionally, the performance of companies with a small market capitalization will have less of an impact on the performance of the overall fund.

In contrast, a dividend weighted ETF like DGRW reflects the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share. When the fund is rebalanced, companies that have increased their dividends are given a higher weighting.

"DGRW will naturally start to shun problem stocks and tip the fund toward quality companies," he says. "You get natural exposure to balance sheet strength because the type of company that's paying a dividend tends to be a more established company."

Since DGRW screens out companies that do not pay dividends, it excludes notable growth stocks in the technology sector, including Tesla (TSLA), Meta Platforms (META – formerly Facebook), Amazon (AMZN) and Alphabet (GOOGL). **Nvidia (NVDA) pays a small dividend, so it is underweighted in the fund. Admittedly, that hurt the strategy in the most recent bull market, but now that the economy has shifted, DGRW is seeing its day in the sun.

"Those winners and popularity contest stocks seem to have now fallen by the wayside hard," says Weniger. "The market appears to be buying up tried and true, more conservative business models, and you're picking up a lot of potential performance."

To be eligible for inclusion in DGRW, companies must be listed on a U.S. stock exchange and be incorporated and headquartered in the U.S. They must pay regular cash dividends on shares of their common stock in the 12 months preceding the annual reconstitution, which takes place in December. Companies need a market capitalization of at least $100 million by the screening date. Further, the shares must have had an average daily dollar volume of at least $100,000 for three months preceding the screening date.

Importantly, DGRW does not only include high dividend stocks because a company could be paying a high dividend for a reason: Chapter 11 bankruptcy could be right around the corner, for example. All WisdomTree's dividend mandates have a composite risk score based on 16 years of data generated across various economic cycles and significant market events. The fund seeks to screen out Risky companies by using metrics such as return on equity, return on assets and even momentum. Payout ratios are also a factor: to be included in DGRW, companies must prove that their earnings are greater than the dividend.

Almost all the fund's components are large-cap firms. Its largest holdings** are Johnson & Johnson (JNJ), Apple (AAPL), Microsoft (MSFT), Philip Morris (PM), Merck (MRK), Coca-Cola (COKE), Proctor & Gamble (PG), Altria (MO), PepsiCo (PEP) and UnitedHealth Group (UNH). However, it includes some mid-cap and small-cap stocks, too.

"In DGRW, dividends tend to run parallel to value mandates," says Weniger. "You've got these growth flavors inside the fund, and then you have these value flavors. When you smash those two together, you end up with a blended investment style"

The fund contains companies from all sectors, but the allocation is different from ETFs that track large-cap index funds such as the S&P 500. For instance, as of May 31, consumer staples companies comprise 6.8% of the S&P 500, whereas companies in this sector make up 20.6% of DGRW. The fund is overweight on consumer staples because those stocks typically play a key role in defensive strategies. DGRW is underweight in the technology sector, although the quality screen picks up profitable, established companies such as Cisco and Intel. It is about market weight or slightly underweight the consumer discretionary sector and underweight the communications services sector, which is vulnerable to cuts in advertising budgets in inflationary environments.

"Market cap weighting worked great when the S&P 500 was melting up from March 2009 until late 2021, but now the environment has changed," Weniger concludes. "DGRW employs a transparent weighting formula to magnify the effect that dividends play in the total return of the indexes. It's a great way to get broad exposure without blindly buying everything."