

**WisdomTree
RESEARCH**

TAPPING CHINA'S EMERGING POTENTIAL

Authored by Jeremy Schwartz (CFA®, Director of Research)

Bradley Krom (Associate Director of Research)

Matt Wagner (Research Analyst)

Alejandro Saltiel (CFA®, Quantitative Research Analyst)



Most market participants are likely familiar with the growth of tech and consumer discretionary names in weight and importance in U.S. equities, but some may be overlooking a similarly dramatic change that has materialized in emerging markets. Over the past 10 years, due in large part to the slow and steady liberalizing of capital markets coupled with the exceptional growth of some of the country's biggest companies, China's star has risen not only as an economic power, but as an investing destination as well.

The country's largest companies, primarily in the information technology and consumer discretionary sectors, are joining the ranks of U.S. multinationals atop the charts of the largest, fastest-growing and most recognizable companies in the world. Since the start of 2017, the two largest companies in China have grown their combined market capitalization¹ by more than \$500 billion and have ascended to within the top five by size of global information technology companies. Such fast-growing companies are emblematic of the "new China," which is fundamentally different from the "old China." Even more interesting, the rise of China's national champions has largely been homegrown. As we show in the table below, nearly all of Tencent's and Alibaba's revenue was earned in China. This compares to a much more U.S.-centric model for most other large tech firms. This is an important distinction, particularly given heightened regulatory scrutiny in the U.S.

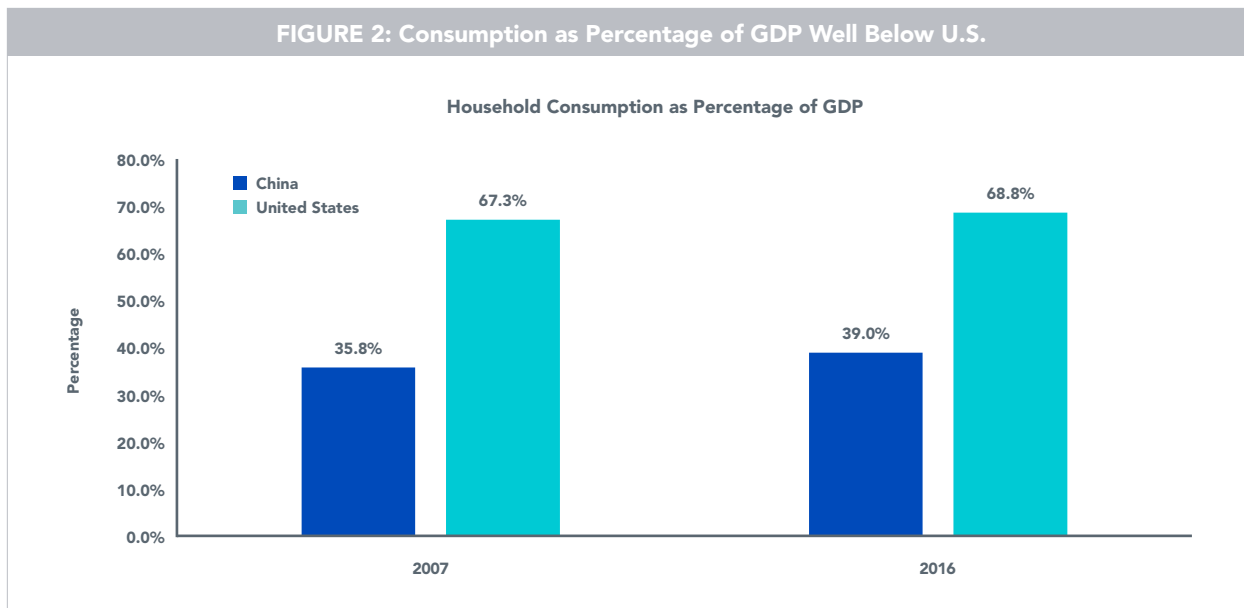
FIGURE 1: Alibaba and Tencent: Hallmarks of a Sectoral Shift

MSCI ACWI Index: Top 10 Firms by Market Capitalization in Information Technology Sector			Country Revenues	
Company Name	Market Capitalization (USD Billions)	Country of Domicile	U.S.	China
Apple, Inc.	\$851.3	United States	36.83%	7.34%
Microsoft Corp.	\$702.8	United States	50.30%	9.54%
Alphabet, Inc.	\$670.5	United States	47.35%	2.84%
Tencent Holdings Ltd.	\$496.0	China	2.46%	95.02%
Alibaba Group Holding Ltd.	\$471.6	China	0.00%	100.00%
Facebook, Inc.	\$382.8	United States	45.37%	3.22%
Samsung Electronics Co., Ltd.	\$296.4	Korea	12.91%	15.50%
Intel Corp.	\$243.7	United States	20.03%	22.92%
Taiwan Semiconductor Manufacturing Co., Ltd.	\$218.8	Taiwan	63.58%	9.00%
Visa, Inc.	\$215.6	United States	47.45%	9.91%

Sources: WisdomTree, MSCI, 3/31/18.

In our view, the investment case around China 10 years ago, like other export-dependent economies, was critically tied to the value of the yuan and the prospects for global trade. As illustrated with the trend toward increasing revenue earned in China, a principal factor that will continue driving this theme for the years ahead is the transition to a consumption-driven economy. The miraculous growth of the first decade of the 21st century was driven on the back of investment-led and export-led growth. Chinese policy makers have sought to strike a pragmatist's balance between maintaining economic growth and overseeing a transition. In every year since 2010, consumption has accounted for greater than half the growth of GDP², and household consumption as a percentage of total GDP has been steadily increasing toward 40%.³ However, this proportion is still well below developed markets like the United States, where consumption accounts for almost 70% of GDP.

¹ Market capitalization: Market cap = share price x number of shares outstanding. Firms with the highest values receive the highest weights.
² Gross domestic product (GDP): The sum total of all goods and services produced across an economy.
³ Sources: Bloomberg, National Bureau of Statistics, World Bank.



Source: World Bank, latest available data as of 3/31/18.

Today, the focus for investors is on the changing habits of the population’s increasing and pervasive use of technology and the decades-long trend of a growing middle class that will propel domestic consumption to supplant exports as the engine of growth. Based on 2017 data, of the nearly 753 million Chinese who access the Internet via mobile, more than 65% used their phones to purchase something online. Despite a comparatively low (by American standards) 55.8% Internet penetration rate, China is the most connected country in the world. As such, 40 million people gained access for the first time last year.⁴ Based on these trends, we believe the rise of Chinese technology and the consumer class will undoubtedly have a profound impact on global markets and investment opportunities going forward.

MARKET VOLATILITY: MOVING BEYOND TRADE WARS AND REGULATORY COSTS

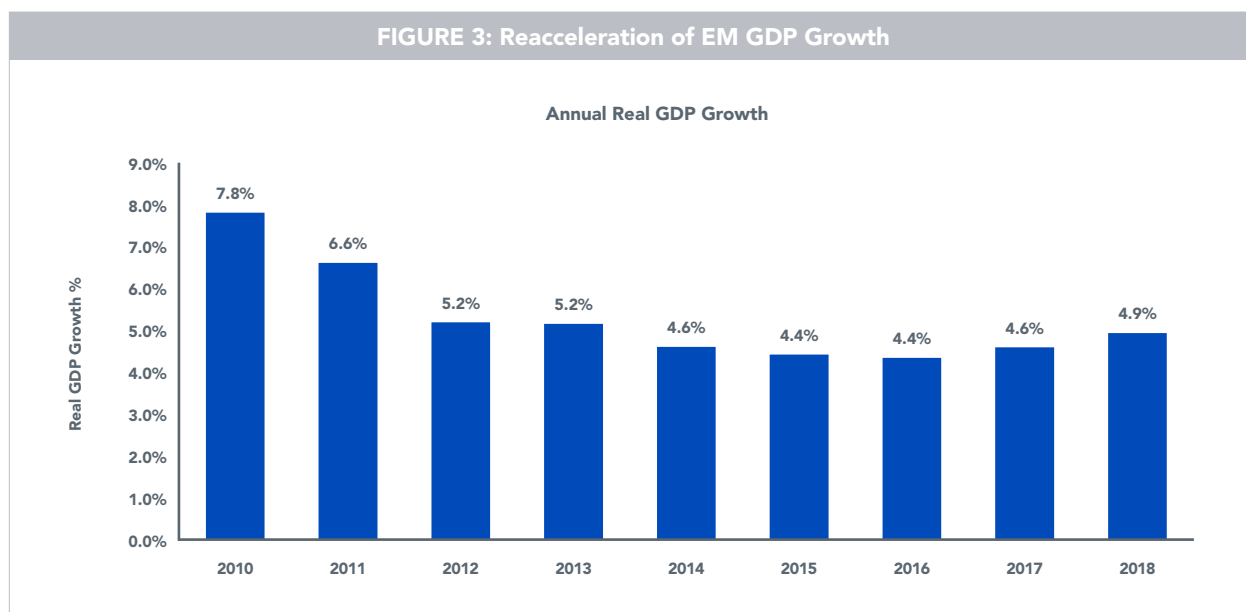
While risk and return often go hand in hand, volatility⁵ like we have seen so far in 2018 borders on the extreme. Unfortunately, a great deal of recent headline risk has been a result of political posturing as opposed to economic substance. U.S. technology companies have been at the epicenter of the latest market volatility as they face the threat of regulatory and compliance risks that will be associated with real costs and threats to growth, but their Chinese counterparts with nearly no U.S. presence face no such regulatory threat. Another factor in this year’s sell-off, trade tariffs, is similarly unrelated to the earnings growth prospects of these Chinese companies that have hardly any physical or trade presence outside of their domestic market.

⁴ Source: China Internet Network Information Center, 39th Survey Report, 1/17.

⁵ Volatility: A measure of the dispersion of actual returns around a particular average level. Also known as “standard deviation.”

In these instances, we are reminded of a quote from esteemed investor Benjamin Graham: "In the short run, the market is a voting machine but in the long run, it is a weighing machine." In our view, the long-term trajectory of high economic growth for China compared to developed markets should create investment windfalls. That being said, volatility can also cause investors to react to short-term noise instead of remaining focused on long-run goals. As we discuss below, our outlook for global and emerging market growth remains intact.

Despite potentially destabilizing headlines and political moves, the outlook for the global economy appears bright. For the first time since the global financial crisis, the International Monetary Fund (IMF) is projecting that all major economies will have positive real economic growth in 2018. Similarly, 2017 was the first year since 2009 that no advanced economy experienced deflation, and a continued uptrend in emerging market economic growth is projected for the remainder of 2018. This is precisely the market environment in which emerging markets may perform best.



Sources: WisdomTree, Bloomberg, 3/31/18. 2018 GDP growth represents projected.

CHINA'S IMPACT ON THE EVOLUTION OF EMERGING MARKETS

In 2001, Goldman Sachs' Jim O'Neill coined the term BRIC⁶ to help narrow and define the opportunity set in EM. At that time, those four countries—Brazil, Russia, India and China—represented approximately 25% of the MSCI Emerging Markets Index. Investors seeking exposure to emerging markets were forced to accept that their portfolios would likely be dominated by three sectors: financials, energy and materials. In fact, even during the previous peak of emerging markets in 2007, those three sectors accounted for more than 50% of the broad MSCI Emerging Markets Index.⁷ Today, this is no longer the case. In fact, as we show below, the types of businesses that are dominating in emerging markets are indicative of the rise of technology and the consumer. China plays a central role in this shift. In many ways, China appears to represent the future of emerging market investing. As such, we believe we may be on the verge of a tipping point that sees the role China plays in a portfolio begin an inevitable convergence with the role it plays in the global economy.

⁶ Source: "Building Better Economic BRICs," Goldman Sachs Global Economics Paper No. 66, 11/30/01.

⁷ Sources: WisdomTree, MSCI, 3/31/18.

FIGURE 4: The Rise of China: The Changing Face of Emerging Markets

	Emerging Markets		China	
	2007	2018	2007	2018
China Exposure	15.9%	29.6%		
Information Technology	10.1%	27.8%	1.7%	40.8%
Financials	20.2%	24.0%	22.3%	23.0%
Consumer Discretionary	4.8%	9.5%	2.7%	9.1%
Consumer Staples	4.0%	6.4%	2.9%	2.2%
Health Care	1.6%	2.8%	0.0%	2.7%
Industrials	9.5%	5.2%	13.1%	3.9%
Materials	15.5%	7.3%	6.8%	1.5%
Energy	17.6%	7.2%	20.8%	4.8%
Telecommunication Services	11.5%	4.6%	21.6%	4.3%
Utilities	3.5%	2.4%	2.4%	2.3%
Real Estate	1.6%	2.8%	5.7%	5.3%
	Emerging Markets		China	
Thematic Shifts	2007	2018	2007	2018
Technology/Consumer	15.0%	37.2%	4.4%	50.0%
Energy/Materials	33.1%	14.5%	27.6%	6.3%
	Emerging Markets		China	
Economic Shifts	2007	2018	2007	2018
New Economy	30.0%	51.7%	20.4%	58.8%
Old Economy	70.0%	48.3%	79.6%	41.2%

Sources: WisdomTree, MSCI, 3/31/18.

CHINA AS THE PROXY FOR EM

In many investors' minds, as China goes, so goes emerging markets. While this idea was primarily driven by the size of China's economy relative to other EM countries, it's finally becoming true for portfolios. While accounting for only approximately 16% in 2007, China has nearly doubled in size to become the largest country exposure in emerging market benchmarks. This has primarily been a function of the rise of the Chinese tech and consumer discretionary sectors.

Thematically, the same shift in geographic exposure of the Index can largely be explained by contrasting the weights of technology and consumer versus energy and materials. Put simply, sectors that experienced large growth in China also experienced strong growth in the overall Index. As energy and materials fell in prominence in China, they slipped by more than 50% in the broader emerging market Index. For EM investors, this shift in the opportunity set means that while many have long associated emerging markets with value⁸ investing, its overall profile appears to have shifted to a much more growth⁹-oriented index. We believe this has important implications for understanding current valuations compared to history. We believe that China's role in investor portfolios is poised to accelerate toward the role that China plays in the global economy.

⁸ 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.

⁹ 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.

CATALYST: KEY CAPITAL MARKET REFORMS

Joining the World Trade Organization in 2001 was a signal that China had arrived as a full member of the global economy. China then embarked on a series of steps designed to promote the internationalization of the yuan and relax restrictions of the flow of capital into and out of mainland China. In the following years, policy makers have taken additional steps to open up capital markets to foreign investors. Central to these achievements was outgoing People's Bank of China (PBoC) Chairman Zhou Xiaochuan. By all indications, we believe that the new PBoC chairman, Yi Gang, may be poised to accelerate the path of reform as China seeks further influence in Asia and around the world.

FIGURE 5: Milestones to Global Economic Inclusion

Year	Select Milestones
2001	China becomes a member of the World Trade Organization
2005	China surpassed Britain, France and Italy to become the 4th largest economy in the world
	China relaxes its currency peg to the U.S. dollar, eventually settling on a 0.50% band
2007	Dim sum bond market created in Hong Kong; allows foreign companies to raise yuan-denominated funds offshore
2009	China surpasses Germany to become the 3rd largest economy in the world
2010	Accord between the PBoC & HKMA allows for unrestricted trading of Chinese yuan offshore in Hong Kong (CNH)
2011	China surpasses Japan to become the 2nd largest economy in the world
2012	China relaxes its currency band to 1% fostering in an era of two-way volatility
2014	China relaxes its currency band to 2%
2015	China relaxes its currency band to 3%
	Panda bond market created in mainland China to allow foreign companies to raise yuan-denominated funds onshore
2016	Chinese yuan added to the IMF Special Drawing Rights basket, attaining global reserve currency status
2017	MSCI announces gradual phase in of Chinese A-shares into indexes to begin June 2018
2018	Chinese debt added to the Bloomberg Barclays Global Aggregate Index
2018+?	JPMorgan or Citi may decide to include Chinese fixed income in global bond benchmarks for the 1st time

Source: WisdomTree, as of 3/31/18.

MARKET ACCESS, EQUITY BENCHMARKS & A-SHARES

While China has made significant progress along the path of liberalizing its economy and financial markets, at least two large impediments remain: capital restrictions and state ownership. Since China does not fully allow the free flow of capital into (or out of) mainland China, Chinese companies have been forced to navigate a variety of trade-offs in determining where they should legally incorporate and where they should publicly list their equity. As a result, Chinese companies currently trade in five currencies on seven exchanges that represent seven share classes (as shown in figure 6). Additionally, since the Chinese government may be a significant shareholder of certain businesses, a large portion of a company's stock may not be eligible for trading. Due to these complexities, Chinese equities account for only approximately 3% of global equity benchmarks, despite their companies comprising 15% of global equity market capitalization.¹⁰ That will not always be the case.

¹⁰ Sources: MSCI, World Federation of Exchanges, as of 3/31/18.

FIGURE 6: Share Classes, Currencies and Exchanges

Exchange Location	Share Class	Description	Trading FX	Largest Sector	Companies
Mainland China	A-Shares	China securities incorporated in Mainland China, listed on the Shanghai or Shenzhen Stock Exchange and traded in yuan (CNY)	CNY	Financials	Kweichow Moutai, Ping An Insurance, China Merchants Bank
	B-Shares	China securities incorporated in Mainland China, listed on the Shanghai Stock Exchange (USD) and Shenzhen Stock Exchange (HKD)	USD / HKD	Industrials	Shanghai Lujiazui Fin & Trade Dev, Inner Mongolia Yitai Coal, Chongqing Changan Automobile
International	H-Shares	China securities incorporated in Mainland China, listed on the Hong Kong Stock Exchange (HKD)	HKD	Financials	China Construction Bank, ICBC, Ping An Insurance
	Red Chips	China securities of state-owned companies incorporated outside Mainland China, listed on the Hong Kong Stock Exchange (HKD)	HKD	Telecom. Services	China Mobile, CNOOC, BOC Hong Kong
	P Chips	China securities of non-government owned companies incorporated outside Mainland China, listed on the Hong Kong Stock Exchange (HKD)	HKD	Consumer Discretionary	Tencent, Geely Automobile, China Evergrande
	N-Shares	China securities (including ADRs) incorporated outside Greater China (mainland China, Hong Kong, Macao and Taiwan), listed on the NYSE Euronext-New York, NASDAQ, NYSE AMEX (N-Shares) traded on USD, and Singapore (S-Shares) Exchanges traded on Singapore Dollars (SGD)	USD	Information Technology	Alibaba, Baidu, JD.com
	S-Shares		SGD	Industrials	Yangzijiang Shipbuilding Holdings, Yanlord Land Group, SIIC Environmental

Source: WisdomTree, as of 3/31/18.

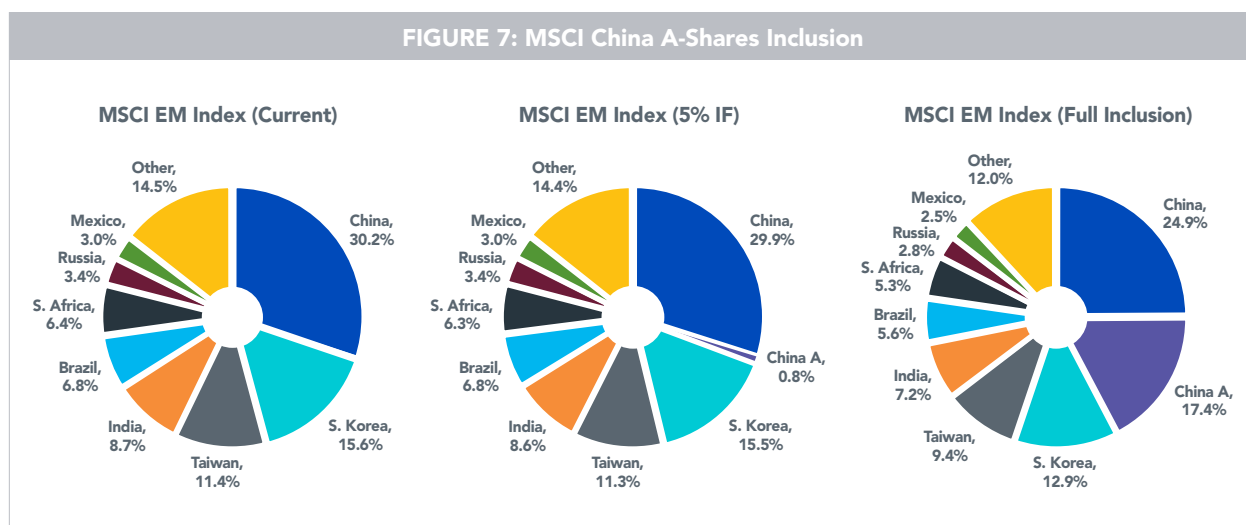
MSCI's 2017 decision to include China A-shares beginning in June 2018 represents an important step in internationalizing Chinese assets, but several steps that are anticipated near term will increase the flow of both foreign and domestic institutional flows:

- + **Bond Market Liberalization:** Current speculation is whether JPMorgan will finally include Chinese government bonds as part of its emerging market fixed income indexes in 2018. This would follow a decision made in March 2018 to include China in the Bloomberg Barclays Global Aggregate Bond Index.
- + **Relaxing of Foreign Ownership Limits:** Plans are being made to relax foreign ownership limits for Chinese financial services companies, a change that will entice foreign institutional players into the market.¹¹
- + **Pension Reform:** China is pushing for long-term steady growth of pension fund coverage that will increase domestic fund buyers.

¹¹ Source: Chris Flood, "China's fund industry predicted to grow fivefold by 2025," FT.com, 4/8/18.

CATALYST: THE MARKET IMPACT OF A-SHARES

While some companies chose to list multiple share classes in different jurisdictions, companies listed in Shanghai and Shenzhen (A-shares) faced extremely limited access for international investors. After a series of capital market pilot programs and reforms, MSCI announced in June 2017 that it would include 234 Chinese-listed companies in the MSCI Emerging Markets Index. After a two-step process in June and September is completed, approximately 0.8% of the MSCI EM Index will be Chinese A-shares. To limit market impact in the short run, MSCI sought to limit the number of holdings that were eligible and also cap their weights via a 5% inclusion factor (IF). However, as we show below, should those 234 securities one day be eligible for full inclusion, Chinese A-shares would comprise more than 17% of MSCI EM. While the timing of full MSCI inclusion remains uncertain, we believe it could occur over the next five years. In fact, we do not believe it is a coincidence that Chinese policy makers announced a 4x increase¹² in the daily mainland stock quotas to take effect May 1 in order to facilitate these changes to EM benchmarks.



Source: MSCI, as of 3/31/18. Weights subject to change.

Given our view that inclusion is likely to occur at a much more rapid pace than markets expect, we continue to advocate that investors should be over-weight China generally via strategies that also provide meaningful exposure to A-shares. Thematically, we're constructive on two ways to approach Chinese equities:

- 1) China All Access:** WisdomTree believes that with China likely accelerating market reforms, the concept of how beta¹³ is defined will likely undergo a dramatic shift. In our view, investors should seek exposure via the broadest and most inclusive indexes for Chinese securities. For this reason, we chose to collaborate with Standard & Poor's (S&P) to provide exposure to the S&P 500 of China. Based on MSCI's current methodology, A-shares could potentially grow to 41% of MSCI China based on full inclusion. Today, the S&P China 500 Index has nearly 52% in A-shares-listed Chinese companies.¹⁴ With more than 400 mainland-listed companies, we believe the Index strikes a great balance between breadth and tradability.

¹² Rmb52/42bn for northbound/southbound.

¹³ Beta: Measure of the volatility of an index or investment relative to a benchmark. A reading of 1.00 indicates that the investment has moved in lockstep with the benchmark; a reading of -1.00 indicates that the investment has moved in the exact opposite direction of the benchmark.

¹⁴ Source: S&P, as of 3/31/18.

FIGURE 8: Chinese Indexes by Share Classes

Share Class	MSCI China 2018		WT China ex-SOE		S&P China 500	
	Weight	Count	Weight	Count	Weight	Count
A-shares	2.6%	234	25.9%	50	51.9%	423
B-shares	0.1%	1			0.1%	4
H-Shares	31.4%	68	8.9%	11	15.7%	63
Red chips	12.3%	30			5.5%	25
P chips	28.8%	39	34.9%	53	14.4%	35
N-Shares	24.7%	15	30.2%	20	12.3%	12
S-Shares					0.1%	1
TOTAL	100.0%	387	100.0%	134	100.0%	563

Source: WisdomTree, as of 3/31/18.

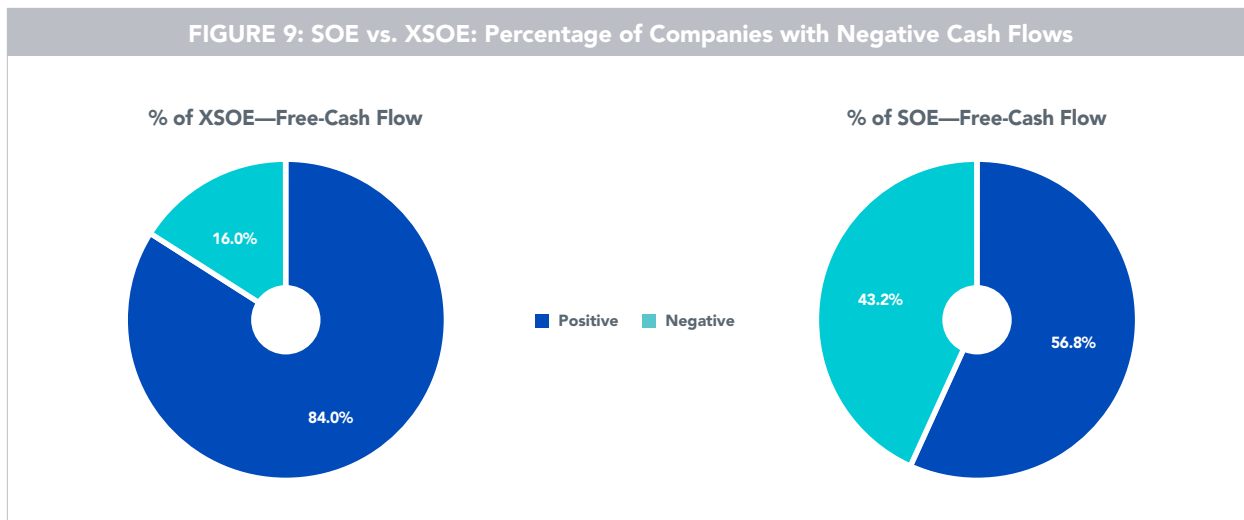
2) Ex-State Owned: The WisdomTree China ex-State-Owned Enterprises Index provides exposure to companies with less than 20% government ownership. As we outline below, a large body of research shows that government-owned firms are not always run for the benefit of shareholders, which negatively impacts returns. This also creates a fairly dramatic shift in sectors away from "old China" toward "new China," such as consumer and technology. This also results in less sector, share class and single-stock concentration than the MSCI China Index. MSCI China has 64% of its weight in information technology and financials, with more than 30% of its weight coming from just two companies alone, and it is a concentrated bet from a share class perspective as well within primarily Hong Kong-listed shares. The WisdomTree China ex-State-Owned Enterprises Index conducted a special rebalance in August 2017 to include up to 25% exposure to A-shares.

STATE-OWNED CHINA = OLD CHINA

Investing in China has long been complicated by concerns over the country's elements of so-called "state capitalism." In its broadest definition, state capitalism refers to combining the elements of a powerful state with a capitalist system to promote strong and steady economic growth. Judged by the criterion of strong and steady economic growth, many would argue that China's Politburo deserves high marks. From a long-term investor's perspective, the report card is a bit murkier.

The government's entrenchment in the private sector through state-owned enterprises¹⁵ has forced investors to accept that investing in China must therefore mean investing alongside the Chinese government. In many instances, shareholder return may not necessarily be the top priority. The result: an overindebted system and lackluster returns compared to private market peers. As we show below, that has resulted in a material impact on these businesses' ability to generate free cash flow.

¹⁵ State-owned enterprises: Companies in which a government controls at least a 20% stake.



Sources: WisdomTree, FactSet. XSOE: ex-state-owned enterprises in MSCI China Index. SOE: state-owned enterprises in MSCI China. Data as of 3/31/18.

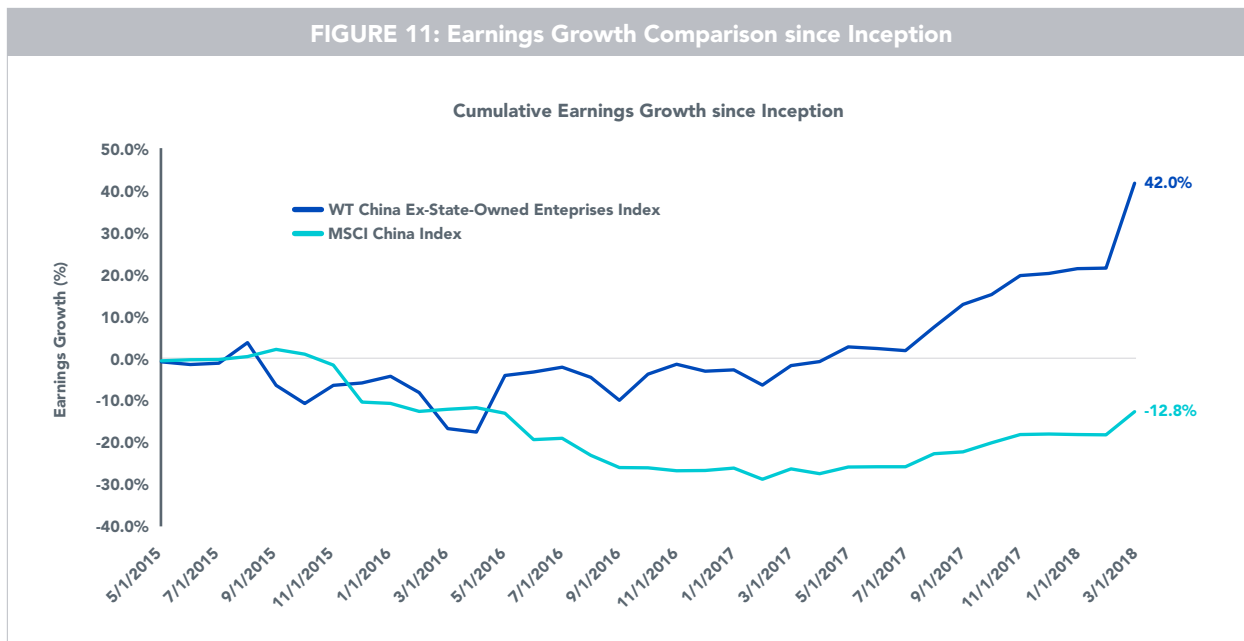
Similarly, the returns of the state-owned segment over the last decade have dramatically underperformed the ex-stated-owned segment. Despite making up only one-fourth of the index weight over the last decade, on average, the ex-state-owned segment generated more than 80% of the contribution to returns to the Index; that is because non-state-owned companies outperformed state-owned companies by more than 1,000 basis points for the last decade.

FIGURE 10: MSCI China Returns: Ex-State Owned Outperforms State Owned

03/31/2008—03/31/2018	Avg. Weight	Annualized Segment Return	Contribution to Total Return
MSCI China Index Non-State-Owned Segment	27.84%	13.51%	4.85%
MSCI China Index State-Owned Segment	72.16%	2.25%	1.20%
MSCI China Index Total	100.00%		6.05%

Sources: WisdomTree, MSCI, as of 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Not only has the sole focus been on performance, there also has been a clear and dramatic differential in the primary driver of those returns: earnings growth versus multiple expansion. Cumulative earnings growth for the MSCI China Index, which historically has been more than 70% state-owned companies, has been negative over the last three to four years, while the WisdomTree China ex-State-Owned Enterprises Index was quite positive and has accelerated up in recent quarters. This earnings differential is not surprising when considering that the Chinese government does not invest in companies for a return on its investment the same way the private investors do. In fact, the Chinese government often invests in unprofitable companies exactly because they are unprofitable and the government takes a stake to stabilize an otherwise failing enterprise. On the macro level, this aligns with the government’s policy of allowing for a “slow landing” and moderating the economic cycle, but from an investor’s standpoint, investing alongside the government has not been historically profitable.



Sources: WisdomTree, FactSet. Data as of 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

State-owned companies can tap cheap financing from state-owned banks, creating a system of risk concentration among state-owned enterprises that imposes a degree of fragility on the Chinese economy at large. Reforms over the past several years have resulted in significant strides by these companies, largely state-owned enterprises, to reduce this leverage.¹⁶ Such reform is creating great opportunity for investors in China broadly by reducing systematic risk. While we have optimism in the long-term reform of the state-owned enterprises, the reality of the present system is threefold:

- + Sectoral Shifts:** State-owned enterprises are concentrated in the energy, financials and telecommunications sectors, as opposed to the fastest growing and most innovative technology and consumer discretionary companies, such as Tencent, Alibaba and JD.com.
- + Profitability and Valuations:** State-owned enterprises have not rewarded shareholders to the same degree as non-state-owned enterprises over the past 10 years as measured by profitability metrics such as return on equity. Despite their growth and profitability, ex-state-owned enterprises are at similar valuations to their more mature and less profitable state-owned peers.
- + Negative Free Cash Flows¹⁷:** Reform and deleveraging is underway, but the risks of negative free cash flows and a misalignment of shareholder and government interests persists as another risk that may or may not provide investors with a commensurate return premium.

¹⁶ Source: Edward White, "China SOE leverage to decline further in 2018: Moody's," FT.com, 1/7/18.

¹⁷ Free cash flow: A measure of how much cash is left in a company after taking into account all the necessary expenses, including net capital expenditures.

FIGURE 12: Return on Equity and Sector Weights for SOEs and XSOEs

Sector	Weights			Return on Equity		
	SOE	XSOE	O/U Wgt	SOE	XSOE	Difference
Consumer Discretionary	0.8%	8.3%	-7.5%	14.6%	9.7%	4.8%
Consumer Staples	1.1%	1.1%	0.0%	7.9%	16.9%	-9.0%
Energy	4.8%	N/A	4.8%	5.5%	N/A	N/A
Financials	19.2%	3.8%	15.4%	12.6%	17.1%	-4.5%
Health Care	0.7%	2.0%	-1.4%	10.8%	14.5%	-3.7%
Industrials	3.2%	0.8%	2.4%	9.7%	12.8%	-3.1%
Information Technology	0.6%	40.2%	-39.6%	3.6%	19.7%	-16.1%
Materials	1.3%	0.2%	1.0%	9.5%	21.0%	-11.5%
Real Estate	2.1%	3.2%	-1.0%	14.9%	18.0%	-3.1%
Telecommunication Services	4.3%	N/A	4.3%	8.0%	N/A	N/A
Utilities	1.8%	0.4%	1.4%	10.2%	20.1%	-10.0%
Weight	40.0%	60.0%	-20.1%	10.7%	16.9%	-6.2%

Source: WisdomTree, as of 3/31/18. You cannot invest directly in an index. Weights subject to change.

CATALYST: EXPANSION OF THE CHINESE INVESTOR CLASS

So far, we have focused primarily on what Chinese markets can do for international investors. An underappreciated story that we believe could also have a profound impact on equity prices going forward is the impact that Chinese investors could have on markets. Similar to other countries in Asia, China has historically been a country of savers. Based on PBoC figures, Chinese household financial savings are more than \$12 trillion in capital. That equates to more than 90% GDP and 150% of A-shares market cap.¹⁸ Over the last several years, Chinese policy makers have stated explicitly that they intend to enact meaningful reforms aimed at cooling investment in the property market and restraining the growth of wealth management products. In our view, Chinese equities could be a logical destination for these incremental flows. With scars of the previous downdraft in 2015 beginning to fade, Chinese investors could be poised to return to domestic equity markets in a big way. One enticement that policy makers are actively pursuing is expanding access not only for global investors, but for local investors as well. In 2018, some of the largest, most recognizable Chinese firms listed on international exchanges will cross-list Chinese depository receipts¹⁹ (CDRs) on the mainland. Chinese officials are able to maintain control of capital flows, and local investors are able to finally invest in the national champions that China has historically sought to promote abroad. With firms like Alibaba, JD.com, Baidu and Tencent representing the first wave, we believe this could have a powerful impact in terms of re-engaging investors on domestic exchanges. From there, we believe a larger percentage of savings could continue to be directed into mainland- and internationally listed equities over time. This could mark a clear positive both for market prices and for a reduction in volatility.

For international investors, we believe these catalysts represent a compelling case for over-weighting Chinese equities in portfolios. However, investing is seldom zero sum. Below, we highlight the fundamental case for Chinese equities relative to other emerging markets and the U.S. as competition for global capital intensifies.

¹⁸ Source: PBoC, as of 3/31/18.

¹⁹ Chinese depository receipt: A type of depository receipt that is traded on Chinese stock exchanges. A CDR is a certificate issued by a Chinese bank that represents a pool of foreign equity that is traded on local Chinese exchanges.

CHINA VS. THE REST: DOUBLE THE GROWTH EXPECTATIONS AT COMPARABLE VALUATIONS

There is a tendency of higher earnings growth to coincide with valuation premiums, and Chinese equities are no exception. By nature of the country's fast-paced economic growth and the growing market capitalization of the information technology sector, China is among the highest growth markets in the world. This broad-based, high-growth trend is evident in the more than 20% long-term earnings growth estimates of Chinese indexes, as well as in P/E²⁰ premiums relative to broad emerging markets and developed international indexes. Below, we contrast WisdomTree's favored methods for accessing China against MSCI's approach to China, emerging and developed markets. In our view, global competition among businesses will also increasingly imply a global competition for capital.

Looking at headline fundamentals, China is not necessarily cheap compared to other slower-growing economies. China tends to trade at a premium to emerging markets, which tend to trade at a discount to developed markets (ex-U.S.) given the fundamentally different risk profile. Today, the S&P China 500 Index is the cheapest way to gain broad-based exposure with a P/E ratio of 15.7x, a sizeable discount to the MSCI USA Index's 22.8x. The WisdomTree China ex-State-Owned Enterprises Index, on the other hand, is at comparable valuations to the U.S. at a P/E of 21.9x. The key to understanding current valuations is rooted in growth rates and profitability: growth expectations of 28.2% for the ex-State-Owned Enterprises Index are more than double the 13.2% for the U.S., and return on equity offers an improvement of more than 140 basis points. Over the last several years, Chinese firms have grown at remarkable rates. In response, investors are comfortable paying a market premium to gain access to that growth. In our view, this trend is primarily reflected in the PEG ratio²¹ of China-centric strategies. As a rule of thumb, many investors focus on investing in strategies with PEG ratios below 1. While P/Es may appear stretched, as long as Chinese firms continue to meet lofty expectations quarter over quarter, the market rally in asset prices could continue.

FIGURE 13: Global Fundamentals Comparison

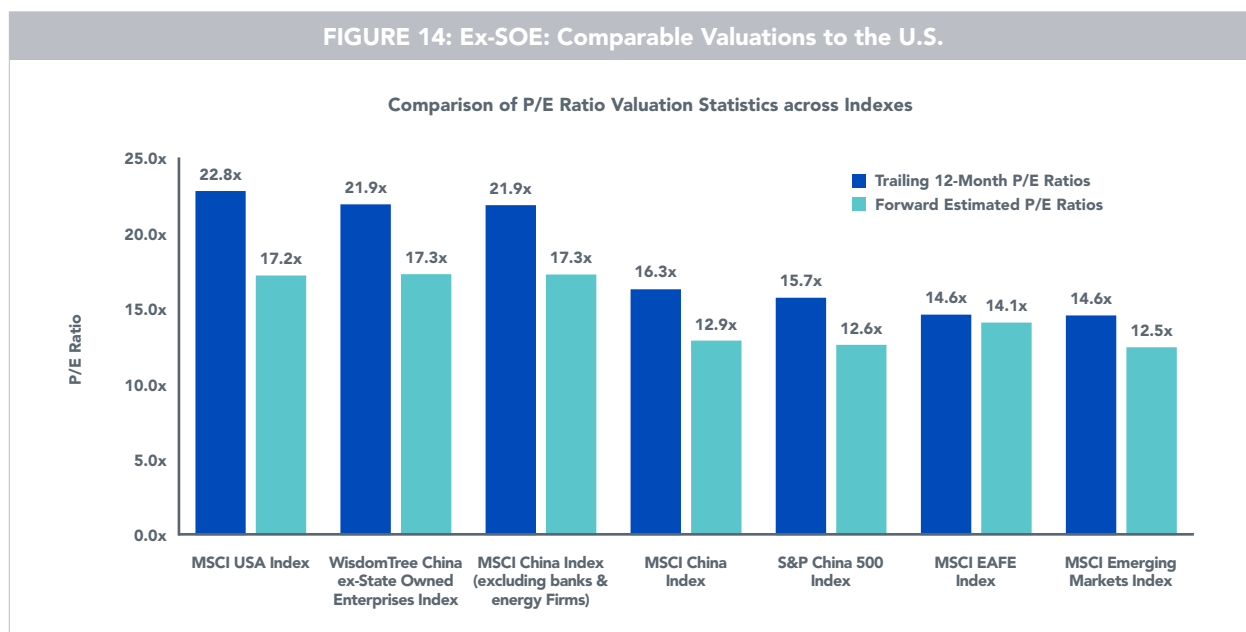
Fundamentals	WisdomTree China ex-State Owned Enterprises Index	MSCI China Index	S&P China 500 Index	MSCI Emerging Markets Index	MSCI EAFE Index	MSCI USA Index
P/E Ratio	21.9x	16.3x	15.7x	14.6x	14.6x	22.8x
Forward P/E Ratio	17.3x	12.9x	12.6x	12.5x	14.1x	17.2x
Long-Term Earnings Growth Estimates	28.2%	26.1%	23.0%	18.6%	12.1%	13.2%
PE-to-Growth (PEG) Ratio	0.78	0.63	0.68	0.78	1.21	1.72
Return on Assets	1.8%	1.4%	1.4%	1.9%	1.6%	3.0%
Return on Equity	15.2%	11.4%	12.1%	11.8%	11.4%	13.8%
Leverage	8.4x	8.2x	8.9x	6.1x	7.1x	4.5x
Earnings Retention	78.5%	71.9%	71.7%	67.7%	55.2%	58.2%
ROE x Earnings Retention	11.9%	8.2%	8.6%	8.0%	6.3%	8.0%
Dividend Yield	1.0%	1.7%	1.8%	2.2%	3.1%	1.8%

Sources: WisdomTree, MSCI, 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

²⁰ Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

²¹ PEG ratio: A stock's price-to-earnings ratio divided by the growth rate of its earnings.

Looking deeper, varying sector tilts, alongside growth estimates, justify the valuation differentials across China indexes, in our view. The MSCI China Index and the S&P China 500 Index are broad indexes with nearly 30% weight in financials and energy companies, an over-weight of more than 10% to the ex-State-Owned Enterprises Index. The ex-SOE Index tilts away from these value sectors in favor of the growth-oriented information technology and consumer discretionary sectors. Figure 14 illustrates the impact of certain sector weights on P/E ratios. By removing banks and energy stocks from the MSCI China Index, two lower-growth industries with a high degree of state ownership, the value-tilted MSCI China benchmark is at similar valuations as the ex-SOE Index.



Sources: WisdomTree, FactSet, as of 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

A review of sector exposures helps inform the valuation differentials as well as clearly identify large sector bets. One of the biggest takeaways from the chart of sector weights below is that the MSCI China Index has an almost 65% combined weight between financials and information technology. In our view, for a broad-based China index, these are extreme sector weights. The S&P China 500 Index provides a much more diversified approach across sectors with no sector comprising more than a 25% weight. The sector allocations that emerge from the ex-State-Owned Enterprises Index also have some interesting insights to consider. Three sectors stand out as under-weights:

- + Telecommunication Services:** Large firms like China Mobile dominate this sector, but these larger players are removed when the focus is on companies with less than 20% government ownership.
- + Financials:** When people think of Chinese financials, the so-called “big four” come to mind—China Construction Bank, Bank of China, Industrial and Commercial Bank of China and Agricultural Bank of China. All of these firms are more than 20% owned by the government and are widely viewed as instruments of state policy.
- + Energy:** In this strategic sector, a preponderance of large firms are owned by China’s government, as it is focused on securing China’s energy future.

FIGURE 15: Sector Weights

Sector	MSCI China	WT China ex-State-Owned Enterprises	S&P China 500
Consumer Discretionary	9.1%	22.7%	11.3%
Consumer Staples	2.2%	4.1%	5.5%
Energy	4.8%	0.0%	2.9%
Financials	23.0%	15.8%	24.7%
Health Care	2.7%	6.9%	5.4%
Industrials	3.9%	5.5%	11.4%
Information Technology	40.8%	33.5%	20.9%
Materials	1.5%	2.3%	7.7%
Real Estate	5.3%	8.3%	5.9%
Telecommunication Services	4.3%	0.2%	1.6%
Utilities	2.3%	0.8%	2.6%
Total Weight	100.0%	100.0%	100.0%

Sources: WisdomTree, FactSet, 3/31/18. You cannot invest directly in an index. Weights subject to change.

CHINA'S TECH- AND CONSUMER-DRIVEN CONVERSION

In addition to differences in sector composition, we believe investors should focus on the monumental shift that is occurring in China's markets. As China transitions its economy from an export-centric model to one of domestic consumption, it's important to examine the rapid growth occurring in the technology and consumer discretionary sectors. To establish a baseline, we highlight the 10 largest technology and consumer companies in the S&P 500. Over the last five years, these businesses have boosted sales by a cumulative 57%. Comprising nearly 19% of the Index, this has led to total returns for each sector of 155.6% and 107.1%, respectively. Among these firms are the most-well-known technological innovators and brands in the world.

FIGURE 16A: Top 10 Weights: S&P 500 Index

S&P 500 Index: Top 10 Firms Information Technology & Consumer Discretionary Sector		
Company Name	Index Weight	Cumulative Sales Growth (5 Years)
Full Index		50.3%
Apple, Inc.	3.8%	45.3%
Microsoft Corp.	3.1%	35.2%
Amazon.com, Inc.	2.6%	191.1%
Facebook, Inc.	1.7%	698.8%
Alphabet, Inc.	2.8%	117.8%
Intel Corp.	1.1%	17.7%
Visa, Inc.	1.0%	75.0%
The Home Depot, Inc.	0.9%	35.0%
Cisco Systems, Inc.	0.9%	1.8%
Mastercard, Inc.	0.7%	68.9%
Top 10 Total/Median Sales Growth	18.6%	57.1%

Sources: WisdomTree, FactSet, as of 3/31/18. You cannot invest directly in an index. Weights subject to change.

Next, we contrast these sales growth figures with the largest tech and consumer companies in China. While many names may appear familiar, many of them may not. This is despite the fact that median sales for these companies have grown in excess of 435% over the last five years. Among the less obvious names is TAL Education Group (TAL). While Alibaba has topped sales growth, TAL has experienced the second highest revenue growth in China over this period. TAL stands poised to benefit on the back of the digitization of the Chinese consumer. It is currently the largest provider of online tutoring services for children in the world. As China grows richer and the middle class continues to expand, parents will increasingly focus on ways to invest in their children’s education. Companies like this are an example of the power of technological trends driving household consumption patterns that will power earnings going forward.

FIGURE 16B: Top 10 Weights: WisdomTree China ex-State-Owned Enterprises Index

WT China ex-SOE Index: Top 10 Firms Information Technology & Consumer Discretionary Sector		
Company Name	Index Weight	Cumulative Sales Growth (5 Years)
Full Index		325.1%
Tencent Holdings Ltd.	9.8%	403.7%
Alibaba Group Holding Ltd.	9.0%	586.2%
Baidu, Inc.	4.8%	255.2%
JD.com, Inc.	3.7%	720.2%
Ctrip.com International Ltd.	2.4%	466.7%
Midea Group Co. Ltd.	2.3%	233.9%
Geely Automobile Holdings Ltd.	1.7%	250.5%
NetEase, Inc.	1.6%	515.2%
New Oriental Education & Technology Group, Inc.	1.4%	133.1%
TAL Education Group	1.3%	591.7%
Top 10 Total/Median Sales Growth	38.0%	435.2%

Sources: WisdomTree, FactSet, as of 3/31/18. You cannot invest directly in an index. Weights subject to change.

SUMMARY

The Chinese equity markets are changing rapidly. The country is home to some of the fastest-growing and best-in-class businesses in the world and will be the beneficiary of increased institutional investor positioning in the market as capital market integration continues down its present path. The following is a rundown of these changes, followed by two approaches to China that we believe merit investor attention:

- + Consumption-Led Growth:** Consumption-led growth will underpin the continuation of the “Chinese miracle.” The rise of the middle class is emerging as a more important driver of growth than industrial investment. In recent years, household consumption has regularly contributed greater than 50% to GDP growth. Combining this consumption trend with concerted government efforts to reduce excessive leverage sets the stage for more stable and sustainable domestic growth.
- + Less Reliant on Global Trade:** As growth from consumption continues to increase as a percentage of the GDP pie, more revenue is coming from China domestically and less is reliant on exports. For this reason, any trade tariff concerns are likely less of an issue in 2018 than they would have been just a decade ago.

- + Capital Market Integration:** While the inclusion of A-shares in MSCI Indexes occurring over the spring and summer of 2018 will be largely symbolic, it is a continuation of a decades-long trend of increased capital market integration that will have immense tailwinds on Chinese assets.
- + Earnings Growth:** No single market in the world can rival the earnings opportunity at present in China. Valuations compared to the size of the growth opportunity do not seem stretched in our view. The changing sector landscape of China, particularly when focusing on the ex-state-owned segment of the market, makes higher valuations justified as the top companies in the consumer discretionary and information technology sectors continue to out-pace their developed market peers.

In our view, investors should seriously consider boosting exposure to Chinese equities over the medium term. The S&P China 500 Index is the broadest China allocation exposure available that incorporates all share classes and provides a more balanced sector exposure than other broad alternatives. By contrast, the WisdomTree China ex-State-Owned Enterprises Index is more selective via excluding exposure to state-owned enterprises. The result of the Index has been a heavy tilt toward profit growth, along with giving investors unique exposure to mitigate the risk that can arise with investing alongside SOEs. In our view, both strategies provide investors with powerful tools as China continues to liberalize its markets and further integrate Chinese companies into the global economy.

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MSCI Emerging Markets Index: A free-float weighted equity index that captures large- and mid-cap representation across emerging markets (EM) countries. WisdomTree China ex-State-Owned Enterprises Index: Measures the performance of Chinese stocks that are not state-owned enterprises. State-owned enterprises are defined as government ownership of more than 20% of outstanding shares of companies. Bloomberg Barclays Global Aggregate Bond Index: A flagship measure of global investment-grade debt from 24 local currency markets. This multicurrency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. S&P China 500 Index: Comprises 500 of the largest, most liquid Chinese companies while approximating the sector composition of the broader Chinese equity market. All Chinese share classes including A-shares and offshore listings are eligible for inclusion. MSCI China Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the Chinese equity market. S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard & Poor's Index Committee, designed to represent the performance of the leading industries in the United States economy. MSCI ACWI Index: A free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. MSCI USA Index: Designed to measure the performance of large- and mid-cap segments of the U.S. market. MSCI EAFE Index: A market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

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