VALUE HUNTERS: LOOK TO CHINA

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Chinese stocks—measured by the Shanghai Composite—have been off to the races in recent months. Investors are starting to expect more stimulus measures from the central bank and government, and there has been an opening of China's capital markets, encouraging investment sentiment. While prices for many Chinese stocks are moving higher, there remains a segment of the Chinese stocks with very depressed valuations: the largest Chinese banks. Four of the largest banks have price-to-earnings (P/E) ratios below 5.5x. These banks all just recently released their year-end earnings reports for 2014. What might be surprising to some is that the reports came out better than many analysts had expected. These banks reported an average increase in net profits of more than 6.7% in 2014 compared to the prior year. While growth in profits was encouraging, Chinese banks kept dividend payments relatively stable in order to help meet stricter capital adequacy ratios (CAR). China's banking regulators require that the largest banks must have met a Tier 1 capital ratio of 7.9% by the end of 2014 and 9.5% by the end of 2018 to make progress toward complying with Basel III requirements. In order to do so, the Chinese banks have been conservative in growing their dividends and are shoring up capital by issuing preferred shares that can serve as additional Tier 1 capital. Below we detail some highlights from each bank's earnings: • **China Construction Bank (CCB):** CCB reported 2014 net profit after taxes of RMB 228 billion, higher 6% year-over-year (YOY). Dividend per share (DPS) was left flat at RMB 0.301. • **Industrial and Commercial Bank of China (ICBC):** Net profit for the year reached RMB 276.3 billion, up 5.1% from the previous year. The bank proposed a dividend payment amounting to RMB 91.02 billion from RMB 91.96 billion last year. • **Bank of China (BOC):** The bank achieved an after-tax profit of RMB 177 billion for the year, a YOY increase of 8%. It announced plans to pay RMB 0.19 DPS, down from RMB 0.196 last year, in part due to higher capital adequacy ratios. • **Agricultural Bank of China (ABC):** Net profit after tax increased 8% to RMB 179 billion between 2013 and 2014. The board indicated that cash dividends to common shareholders would be higher by 2.83%, for a total of RMB 59 billion. While these earnings reports came in largely without major conflict, Chinese financials are selling at an aggregate 41% discount to their 10-year median P/E ratios, and these four large Chinese banks are at even greater discounts. **Figure 1: Chinese Financials Trade at Steep Discount**

P/E Ratios	10 Yr Median	3/31/2015	Discount
MSCI China Index	12.7x	11.0x	-13.0%
MSCI China Financials	12.5x	7.3x	-41.1%

Figure 2: Attractive Valuations, Higher Return on Equity (ROE) and Higher Income Opportunity

For definitions of indexes in the charts, visit our glossary. • **Chinese Banks Have an Asset Base That Is 35% Larger:** The total market capitalization of the four major Chinese banks is USD 876 billion, while the four largest U.S. banks amount to USD 826 billion. While their market capitalizations are comparable, total assets of the four major Chinese banks add up to USD 11.05 trillion, while the total assets of the four major U.S. companies sum to USD 8.21 trillion. • **On Average, Chinese Banks Have Return on Equity (ROE) That Is Double That of U.S. Banks:** The largest four banks in China have ROE of 18.8%, roughly twice that of the four largest U.S. banks, which average 9.1%. • **Chinese Banks Have Income-Generating Potential:** The four Chinese banks have on average a 5.7% dividend yield, which is 3.4 times that of the U.S. banks. • **Retained Earnings Building Equity:** Importantly, the dividends are all very well covered by earnings, as the average dividend payout ratio from these banks is only 35.7%, meaning 64.3% is retained earnings that can help build greater equity cushions in case more loans start to turn bad and impact future write-offs. **Capturing These Types of Stocks in Diversified Strategy** For a diversified investment strategy that replicates a value-seeking investment approach exemplified by these four stocks with P/E ratios less than 5.5x, we would encourage investors to take a look at the WisdomTree Emerging Markets Equity Income Index (WTEMHY). As of 3/31/2015 China Construction Bank, Industrial and Commercial Bank of China, Bank of China and Agricultural Bank of China represent 4.63%, 3.68%, 2.97% and 0.84%, respectively, of WTEMHY, for a combined weight of 12.12% in the Index. WTEMHY's methodology employs a process to pick the highest 30% of companies ranked by their dividend yield from a starting universe of 1,200 dividend payers in emerging markets (EM). This selection process—and a further weighting process to magnify higher dividend payers' weights—offers a strict value-oriented approach. As a byproduct of its methodology, the Index has a dividend yield of more than 6%[1]. Emerging markets remain one of the more out-of-favor segments of global markets, and this income-oriented approach is one worth consideration.

[1]Dividend yield as of 3/31/15.

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DEFINITIONS

Shanghai Composite Index : A stock market index of all A shares and B shares that are traded on the Shanghai Stock Exchange.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Dividend : A portion of corporate profits paid out to shareholders.

Capital adequacy ratio : A measure of a bank's capital. It is expressed as a percentage of a bank's risk-weighted credit exposures.

Tier 1 : Core measure of a bank's financial strength from, and is composed of, core capital, which consists primarily of common stock and disclosed reserves.

Basel III : a global, voluntary regulatory framework on bank capital adequacy, stress testing and market liquidity risk. Introduced by the Basel Committee on Banking Supervision in 2010–11, and most recently scheduled to be implemented by 31 March 2019.

Net profit : A measure of profitability after accounting for all costs.

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

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

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

Dividend Payout Ratio : The percentage of earnings paid to shareholders in dividends. Calculated as yearly dividends per share over earnings per share.