HOW WE CAME TO DEVELOP AN EX-STATE-OWNED EMERGING MARKETS INDEX

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On last week's podcast, we spoke to Tim Reynolds, emerging markets portfolio manager at Employee Retirement System (ERS) of Texas. Reynolds has worked in investment management for 25 years. His start was in real estate investing, managing REIT portfolios, before he gravitated to domestic growth investing, where he would look for management tone changes in evaluating opportunities. ERS presented him with an opportunity to get more global in his perspective, which he appreciated.

Managing Emerging Market Portfolios Is Like Being a Wine Enthusiast

Reynolds started the conversation with a great analogy on how managing investments, particularly for emerging markets, is like being a wine enthusiast. He suggested that people who are very informed on wines can almost never be "true" experts. With different microclimates every year, different vintages and different types of grapes, you can be informed and knowledgeable, but things are always changing. This is how Reynolds thinks you can add value as an investment manager as things are always changing.

ERS Generally and Return Expectations

ERS is a $25 billion trust—a fairly mature plan. It used to be a plain-vanilla stock and bond plan, but in the last 10 years ERS has developed a greater set of portfolio sleeves to include alternatives, private equity, private direct real estate investing and hedge funds. Emerging markets is 4% of total trust assets, and much of that management is done in-house. ERS employs a mix of external investors and in-house managers.

The internal portfolio tends to be run as very inexpensive in-house beta tracking close to MSCI benchmarks, but it also looks to overlay very inexpensive in-house alpha on top of that. ERS looks to external managers when it thinks alpha potential is higher with strategies it cannot implement on its own.

Motivations to Look at Ex-State-Owned Universes

Reynolds started thinking about ex-state-owned investing with the company Petrobras, a giant energy company that transformed itself into a poorly run company that was the most indebted in the world. That caused Reynolds to wonder if governments were equipped to run publicly traded companies in the right way. Then he looked at comparing oil companies and saw a chart comparing ExxonMobil to PetroChina. They both had similar levels of revenue—$400 billion—and similar levels of profit—$30 billion. PetroChina had more than 500,000 employees, while Exxon had 75,000 employees. That knowledge led him to think about state-owned companies differently.

Exclusion-Based Investing

Reynolds talked about how everyone wants to find the next Netflix or Amazon in looking for portfolio winners, but he said another way to beat the benchmark is what you exclude. He thought that looking at excluding state-owned enterprises could be another way to add value over a traditional benchmark.

How to Think about Country/Sector Tilts

When WisdomTree evaluated the idea of creating an ex-state owned enterprises broad emerging market index, one of the observations we had was that 30% of a broad index could be state owned. But importantly, just removing these could leave one exposed to very important country mismatches.

Reynolds said getting country allocations right could be useful to return streams but that doing so is extremely difficult to get right. He was concerned that if we removed state-owned enterprises and just had major country misweights, that could become a dominating factor instead of the ex-state-owned screen. He guided us to focus on controlling for country differentials even more than sector differentials.

Creating Novel Index Exposures

WisdomTree loves to partner with sophisticated investors like ERS to create unique, innovative index exposures and access vehicles. In this case, Tim Reynolds was a guiding beacon who awakened us to the market opportunity and provided valuable feedback as we constructed our novel indexing approach. That has since led us to expand the suite from just a broad emerging market ex-state-owned enterprises index to include a China Ex-State-Owned Enterprises Ind ex. WisdomTree will be forever grateful to the collaboration we had with Reynolds, and we thank him for joining us on our podcast to share the ideas more broadly.

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DEFINITIONS

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.