CHINESE G IN ESG: GOVERNANCE TILT YIELDS STRONG RETURNS

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In June 2017, WisdomTree and MSCI announced that they would be adding Chinese A shares to their indexes[1] in order to broaden the investable universe to include Chinese-listed firms. MSCI will be adding China A shares in June 2018, whereas WisdomTree implemented these changes to two of its emerging market Indexes on August 11, 2017.

While the inclusion of locally listed firms is certainly a milestone for Chinese capital markets, we believe the listing venue may be of secondary importance in evaluating the merits of a Chinese equity index.

There is a lot of work on various investment factors—things such as value, momentum and quality. One of the big stories is how ownership stakes by the Chinese government are associated with higher levels of leverage, lower quality and Profitability Metrics; deep concentration in state-run banks; and potentially conflicted corporate governance (the G in ESG: environmental, social and governance) as it relates to shareholders' best interests.

Below, we highlight a recent development for Hong Kong-listed firms that exemplifies these issues.

The State of State-Owned Enterprise (SOE) Reform

Beginning in the early 1990s, the Chinese government began a slow-moving process whereby state ownership in certain sectors of the economy would be reduced. Fast forward to 2013 and SOE reform was supposedly at the top of President Xi Jinping's list. While the market appeared hopeful, progress on this front remains unclear. The government's plan broke down SOE reform into 34 distinct initiatives that would be governed by a number of state agencies. Those agencies have in turn published at least 36 different plan supplements and launched 21 different reform trials.[2]

For markets, it appears as though President Xi wanted firms to be more efficiently managed, but only if that efficiency led to higher returns to the government. Similarly, leaders in Beijing have prioritized combining smaller firms to form larger, national champions as opposed to fostering growth. Although it may have been naïve to think that reform could mean privatization, state control has remained stubbornly entrenched in so-called strategic industries such as natural resources, financials, and telecom.

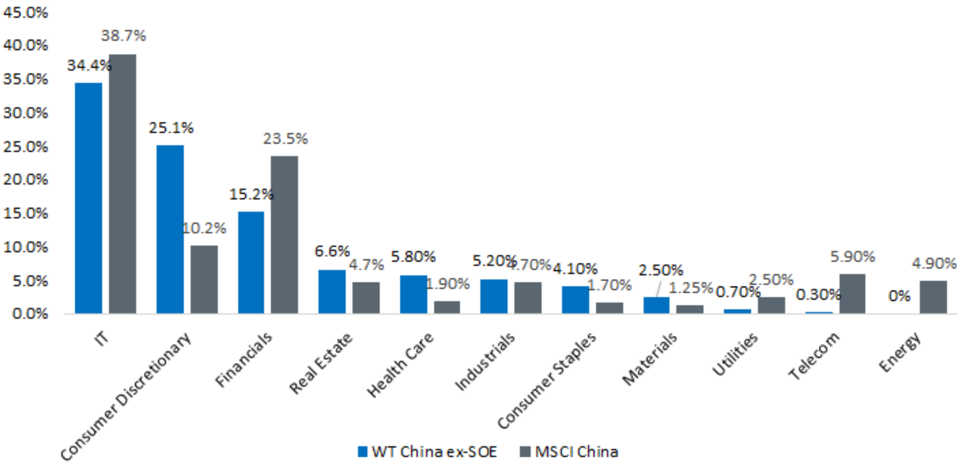
Troubling Exports: Corporate Governance in Hong Kong

As long-hoped-for shareholder-friendly reforms stalled, many investors simply accepted that SOEs were run as much for government benefit as their own. Recently, this has been formalized through the amendment of corporate charters on the mainland that appoint Communist Party committees to an oversight capacity of corporate boards. The obvious concern is that business interests could take a back seat to government priorities and initiatives.

While these conversions remain ongoing, 32 state-owned enterprises listed in Hong Kong, which account for over $1.25 trillion in market value (32% of the Hong Kong market), have undergone this shift.[3] Time will tell how the government will balance corporate interests with those of the government.

In March 2015, WisdomTree sought to create an index that would provide exposure to Chinese equities but limit co-investing alongside the Chinese government: the [WisdomTree China ex-State-Owned Enterprises Index](). As a result, our Index will not invest in companies with more than 20% government ownership. In our view, companies that are less subject to government interference may lead to a significant divergence in returns—and at the very least our Index has a different sector mix and diversification than traditional market indexes.

Sector Differences by Limiting Investment in SOEs

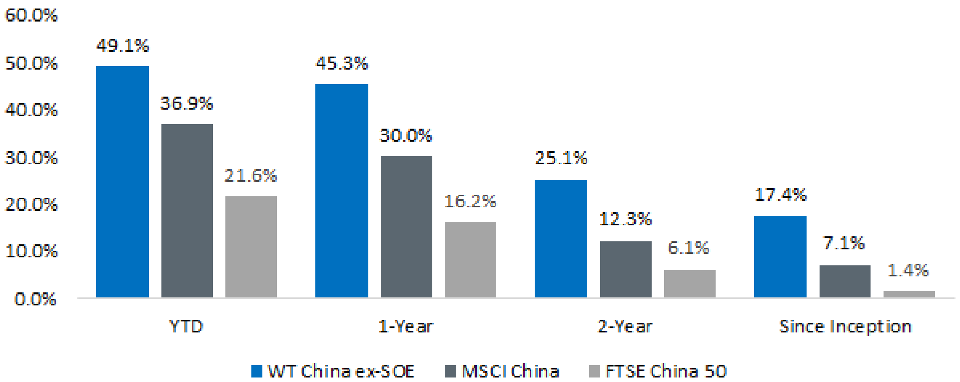


Source: WisdomTree, as of 8/12/17. You cannot invest directly in an index.

As we show above, by limiting exposure to SOEs, investors can significantly reduce exposure to the Chinese Financials, Telecom and Energy sectors while boosting exposure to the Chinese Consumer Staples and Health Care sectors. This differentiated sector exposure has been a primary driver of our return advantage over time.

Additionally, as China seeks to transition its economy from export-led growth to domestic consumption, we believe our Index better reflects the "new" china economy versus "old" China. In the chart below, we show the sizable performance differential between WisdomTree's ex-SOE strategy, the MSCI China Index and the FTSE China 50 Index. As you can see, over every time period, limiting to exposures to SOEs has helped to boost returns and limit volatility.

WT China ex-SOE vs. MSCI China vs. FTSE China 50



Source: Bloomberg, as of 8/16/17. You cannot invest directly in an index.

Ultimately, investors will need to decide if their financial interests will always remain aligned with members of the Chinese government. While it may be impossible to fully limit the influence of the government on Chinese firms, limiting exposure to SOEs could prove prudent should current trends in globalization continue or intensify. And at the very least, the sector differentials in the ex-state-owned version of China yields a more consumer-oriented future of the country compared to the traditional state-run banks and energy firms in older China indexes. ESG investing is becoming more mainstream, and for China, focusing on the G in ESG has made a quantifiable difference.

[1]WisdomTree China ex-State-Owned Enterprises Index, MSCI Emerging Markets Index, MSCI China Index.

[2]"Reform of China's Ailing State-Owned Firms Is Emboldening Them," The Economist, 7/22/17.

[3]See, for instance, Tom Mitchell, "China's Communist Party Writes Itself into Company Law," Financial Times, 8/14/17.

Important Risks Related to this Article

Investments focused in China increase the impact of events and developments associated with the region, which can adversely affect performance.

For more investing insights, check out our [Economic & Market Outlook]

View the online version of this article [here].

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You cannot invest directly in an index.

DEFINITIONS

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 tim.

Momentum Factor : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Profitability metrics : financial identities and ratios that assess how effectively a company is able generate revenue in excess of its expenses.

State-owned enterprise : Companies in which governments have a significant ownership stake and the potential to influence the firms' actions over time.

MSCI China Index : A free float-adjusted, market capitalization-weighted equity index designed to measure the performance of the Chinese equity market.

FTSE China 50 Index : a market capitalization weighted index tracking the top 50 Chinese companies. Stocks are weighted by H or Red Chip share cap as appropriate.