GULF: BEING TRUE TO "GLOBAL" ASSET ALLOCATION

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WisdomTree's Middle East Dividend equity ETF, GULF , gets only a fraction of the attention of our bigger funds, and the reason may be because of human nature: Middle East equities have had a "lost decade" that investors would rather forget.

Since it was incepted in June 2008, the WisdomTree Middle East Dividend Index, which GULF tracks after fees and expenses, has returned -0.36% per year. In contrast, the MSCI Emerging Markets Index and the S&P 500 are up 4.22% and 10.95% per year, respectively.[1]

Yet despite the performance trouble confronted by Middle Eastern equities over those years, GULF witnessed spells during which it had diversified emerging market risk considerably. For example, emerging markets were down 2.4% in 2013, but GULF returned 37.1%. Emerging markets declined marginally the very next year too, and yet GULF posted gains of 11.4% in 2014.[2] Not surprisingly, WisdomTree's Middle East Index has shown historic correlations to emerging, developed and U.S. stock markets of 0.64, 0.68 and 0.64, respectively, potentially aiding in diversification efforts.[3]

Because gains have been elusive through the years, GULF has not witnessed the valuation expansion that tends to pre-occupy investors in other markets; the Index that it tracks is priced at 11.1 times trailing earnings, with a dividend yield of 4.95%.[4]

In contrast, the S&P 500 is trading for 21.3 times trailing earnings, with a 1.93% dividend yield, pricier than broad emerging and frontier markets.[5] That means that these Gulf nations offer a dividend yield spread of 302 basis points (bps) over U.S. equities and a P/E multiple that is essentially half as much as the U.S.

Where it gets interesting is in the credit default swaps (CDS) market, where such yawning valuation disparities are not being confirmed, indicating that an opportunity may be presenting itself in Gulf equities.

Credit Markets Like the Sunni Monarchies

In figure 1, we see the cost of insuring five-year obligations of various governments, with the U.S. and several emerging market nations presented to place the Middle Eastern nations in context.

For an idea of scale, the cost of default insurance for the U.S. is 0.20%, which means that an annual payment of $20,145 per year insures $10 million of U.S. Treasuries.[6] In GULF's case, A1-rated Saudi Arabia, Aa2-rated United Arab Emirates and Aa3-rated Qatar[7] currently combine to 70% of the WisdomTree Middle East Dividend Index, and each has tame sovereign risk in the eyes of the CDS market. At 0.84%, 1.05% and 0.94%, they require annual payments of $83,893, $104,580 and $93,668 to insure $10 million in notional value of government debt, respectively.

Figure 1: 5-Year Credit Default Swaps Pricing

	Weight in WisdomTree Index	CDS	Cost of Insuring Sovereign
Saudi Arabia	25.57%	0.84%	83,893
United Arab Emirates	22.25%	1.05%	104,580
Qatar	22.22%	0.94%	93,668
Kuwait	13.41%	0.54%	54,130
Morocco	4.25%	1.17%	116,815
Egypt	4.06%	2.79%	279,385
Oman	2.88%	N/A	N/A
Jordan	2.77%	N/A	N/A
Bahrain	2.60%	2.60%	259,505
United States	N/A	0.20%	20,145
South Korea	N/A	0.56%	56,166
China	N/A	0.66%	66,082
India	N/A	0.70%	70,195
Indonesia	N/A	0.95%	95,259
Mexico	N/A	1.11%	110,892
Russia	N/A	1.25%	125,223
Brazil	N/A	1.72%	171,605

Sources: Bloomberg, WisdomTree. Past performance is not indicative of future results. You cannot invest directly in an index. Data as of 2/9/18. WisdomTree Index is the WisdomTree Middle East Dividend Index. CDS is the five-year credit default swap USD, except for the U.S., which is in EUR. Cost of insuring sovereign is the annual cost derived from the CDS for insuring against the default of $10 million in principal. Data for Oman and Jordan unavailable.

In many cases, the credit markets view the pricing on Gulf Corporation Council (GCC) state debt somewhere in the middle of the pack if they were classified as emerging markets. Kuwait is one example of a sovereign that can be trusted more than almost all of the listed emerging markets, at least as far as the CDS market is concerned.

And if sovereign debt pricing is any indicator of potential equity risk in these frontier markets, the Mideast could be presenting a basket of stocks that has a risk profile akin to emerging markets, but with a valuation margin of safety included.

Being True to "Global"

Just how global is "global"? As an industry, we often think in terms of indexes like the MSCI All Country World in developing an asset allocation framework. The MSCI Index excludes Saudi Arabia, Kuwait, Morocco and many others, so it's not exactly "All Country." Then, when countries with small total stock market sizes do appear on the list, their proportions are often a rounding error. The result is "global" portfolios that have plenty of exposure to the U.S., Britain, Japan and so on, and little or nothing in the way of markets that have traditionally been left on the outside looking in.

Please consult our big-picture case for GULF, where we discuss concepts such as Saudi cultural reform and China's multitrillion-dollar infrastructure build-out, key issues that could be critical to the success or failure of the GULF investor.

[1]Source: Bloomberg, 6/30/08–1/31/18.

[2]Source: Bloomberg, using MSCI Emerging Markets Index. For most recent month end and standardized performance of GULF, please click *here*. *Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com.*

[3]Monthly correlations with MSCI Emerging Markets, MSCI EAFE and the S&P 500, 6/30/08–1/31/18.

[4]Source: Bloomberg, as of 2/11/18.

[5]Sources: Bloomberg, WisdomTree, as of 2/12/18.

[6]Sources: Bloomberg, WisdomTree, as of 2/9/18.

[7]Source: Moody's, as of 2/12/18. Moody's credit ratings are published rankings based on detailed financial analyses by the credit bureau specifically as it relates to the countries' ability to meet debt obligations. The highest rating is Aaa, second highest is Aa, and the lowest is C. Moody's appends numerical modifiers 1,2, and 3 to each generic classification from Aa through Caa.The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category.

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You cannot invest directly in an index.

DEFINITIONS

MSCI Emerging Market Index : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

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.

Trailing Earnings : The amount of profit that a company produces during prior fiscal year.

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

Basis point : 1/100th of 1 percent.

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.

Credit Default Swap : A swap designed to transfer the credit exposure of fixed income products between parties. The purchaser of the swap makes payments up until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third party debt if this party defaults on the loan.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Gulf Cooperation Council (GCC) : A political and economic union of the Arab states bordering the Persian Gulf and located on or near the Arabian Peninsula.

MSCI All Country World Index : a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed and emerging market countries.