HOW TO USE QUALITY TO SEEK TO REDUCE DRAWDOWNS IN EM

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This blog has been updated with data as of March 31, 2020.

There are important differences in emerging market (EM) companies, especially when it comes to those with significant government ownership (state-owned enterprises, or SOEs) and those without it (non-SOEs).

Government ownership may lead to corporate governance issues that arise from the inherent principal-agent problem and cause operational inefficiencies and weaker levels of profitability.

The predominant industries among non-SOEs are those associated with strong earnings and revenue growth potential, such as consumer and technology companies. Non-SOEs also have higher aggregate profitability metrics than the broad index, MSCI Emerging Markets (EM) Index, and provide a significant tilt to the quality factor—companies with clean balance sheets and high profits.

When markets are volatile, exposure to the quality factor can help mitigate volatility while maintaining broad exposure to the markets.

As shown in the chart below, the WisdomTree Emerging Markets ex-State-Owned Enterprises Index (EMXSOE), which excludes companies with significant government ownership, has had higher profitability, lower leverage and faster revenue and earnings growth rates than the MSCI EM Index.

During times of market stress, investors tend to favor the cushion of high profitability and low leverage as well as the potential for stronger growth.

Aggregate Fundamentals (as of 03/31/20)		
Measure	WisdomTree Emerging Markets ex-State-Owned Enterprises Index (EMXSOE)	MSCI EM Index
Return on Equity	12.67%	12.00%
Return on Assets	2.39%	1.70%
Leverage (Assets / Equity)	5.30	7.07
Imp. Growth Rate (ROE x Earnings Retention)	7.99%	7.39%
Trailing 3yr. Revenue Growth	21.80%	16.30%
Trailing 3yr. Earnings Growth	21.80%	19.60%

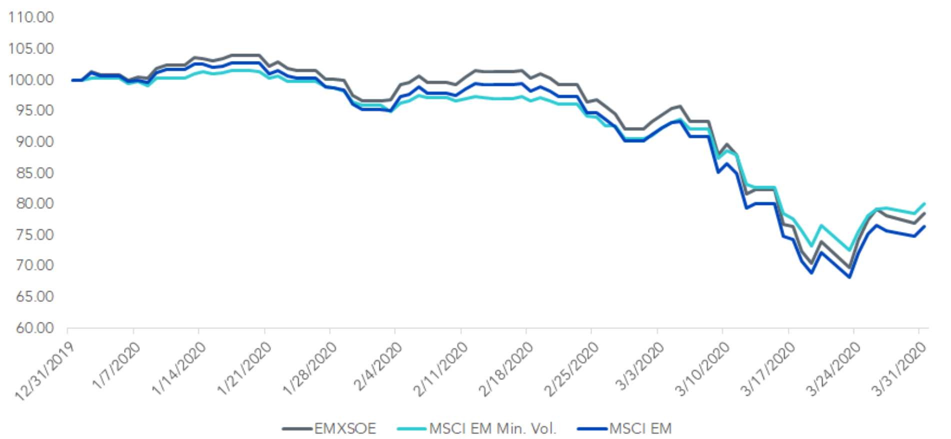
Sources: WisdomTree, FactSet, as of 3/31/20. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

For definitions of terms in the chart, please visit our glossary.

Quality Instead of Low Volatility in EM

As shown below, the WisdomTree Emerging Markets ex-State-Owned Enterprises Index (EMXSOE) has outperformed the broad MSCI EM Index similar to the MSCI EM Minimum Volatility Index (MSCI EM Min. Vol. Index) during recent volatility.

Growth of $100



Sources: WisdomTree, Bloomberg. Data from 12/31/19–3/31/20. Past performance is not indicative of future results.

While providing defensive characteristics in periods of volatility, over a longer time frame as shown below, EMXSOE has been able to also capture the upside and outperform both the MSCI EM and MSCI EM Min. Vol. Indexes.

The low volatility factor has become a favored strategy for investors seeking to reduce volatility in their EM exposure. But there are several drawbacks to low volatility strategies:

- **Higher tracking error:** Potential for high deviation from the broad market's returns over a full market cycle
- **Significant sector and country tilts:** Over-weights to defensive sectors and countries that may dampen returns in up-markets
- **Higher valuations with lower growth:** Because of the popularity of low volatility strategies, and the low interest rate environment, these strategies offer premium valuations with lower earnings growth.

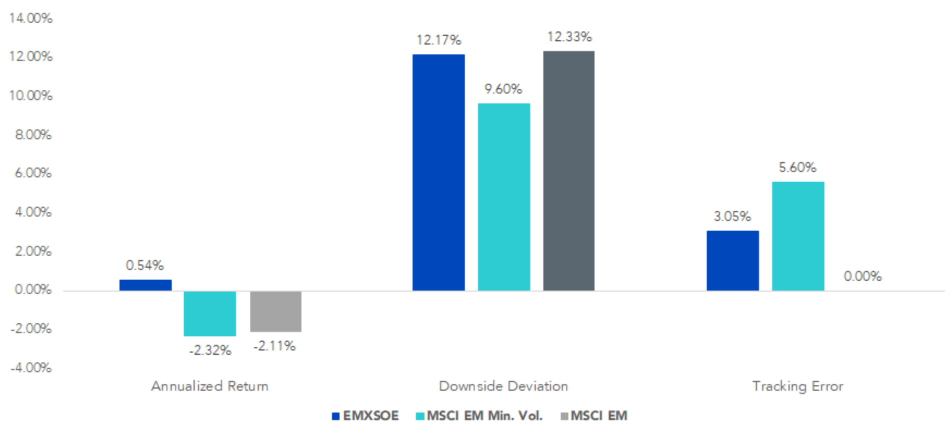
Full-Cycle Characteristics

As shown below, since EMXSOE's inception in August 2014, the strategy's balance of growth and quality has helped it outperform an almost flat MSCI EM Index.

Despite a slightly higher standard deviation, EMXSOE shows a lower downside deviation[1] compared to the broad market. EMXSOE's tracking error to MSCI EM over the period has been 3.05%, significantly less than MSCI EM Min. Vol.'s 5.60%.

EMXSOE's Sortino ratio[2]—which measures excess return adjusted for downside deviation—is also higher than MSCI EM Min. Vol as of March 31, 2020[2]. This means that EMXSOE has provided 4 basis points (bps) of excess return for every unit of downside deviation[1], while MSCI EM Min. Vol. has a -0.24 ratio. So, despite showing lower downside volatility, it hasn't provided excess returns.

Performance and Growth Characteristics

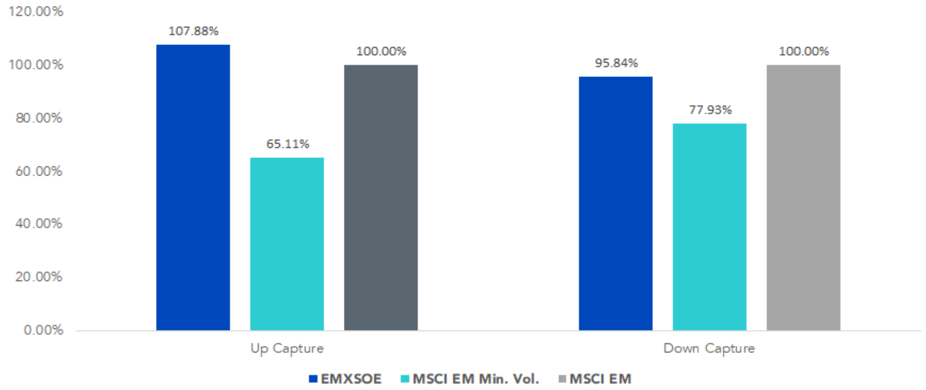


Sources: WisdomTree, Zephyr StyleADVISOR. Data from 8/31/14–3/31/20. Past performance is not indicative of future results. You cannot invest directly in an index.

Looking at up- and down-capture validates the idea of EMXSOE's balance of growth potential and quality to seek to manage drawdowns.

Since August 2014, EMXSOE has managed to capture close to 108% of the broad market's upside while also capturing less than 100% of the downside.

Up- & Down-Capture



Sources: WisdomTree, Zephyr StyleADVISOR. Data from 8/31/14–3/31/20. Past performance is not indicative of future results. You cannot invest directly in an index.

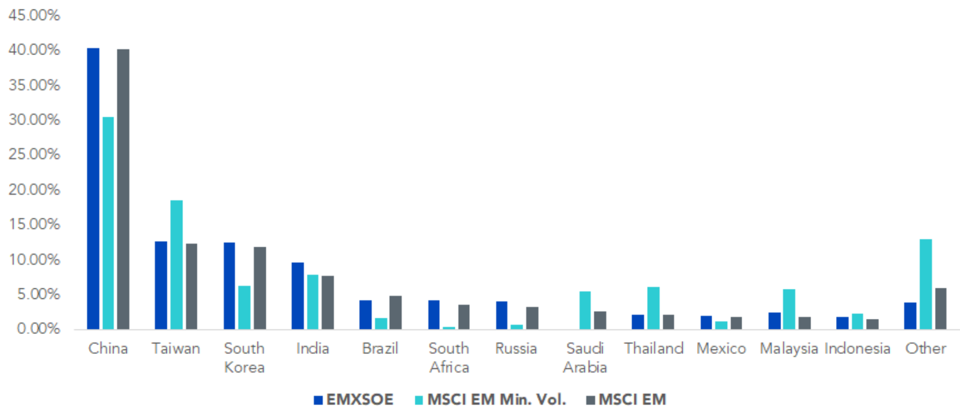
Country & Sector Exposures

Thanks to constraints embedded in its methodology, EMXSOE has more consistent country and sector exposures compared to the MSCI EM, with modest over-weights in the Information Technology and Consumer Discretionary sectors while being under-weight in Financials and Energy.

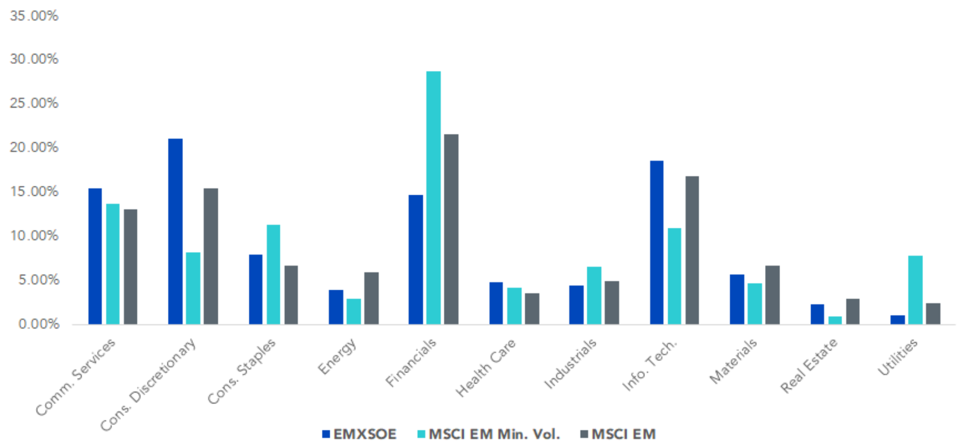
On the other hand, the constraints for the MSCI EM Min. Vol. Index allow it to deviate more from the broad market index.

As other traditional low volatility strategies, MSCI EM Min. Vol. index is over-weight in the defensive sectors and under-weight in cyclical sectors, while also being under-weight in China, South Korea and Brazil in favor of Taiwan, Thailand and Malaysia.

Country Exposure



Sector Exposure



Sources: WisdomTree, FactSet, as of 3/31/20. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion

In periods of market volatility, having the WisdomTree Emerging Markets ex-State-Owned Enterprises Fund (XSOE)—which seeks to track the price and yield performance, before fees and expenses, of the EMXSOE index—within your portfolio's EM exposure can help on several levels.

XSOE historically has better aggregate quality (profitability) than the broad market and can help mitigate drawdowns.

XSOE aims to provide investors with a broad exposure to the EM space, avoiding significant country and sector tilts that come from targeting the low volatility factor.

XSOE seeks to achieve a balance between higher growth potential while reducing downside risk compared to the broad market.

Figure 7_std performance

[1] Downside deviation measures volatility in periods of negative return, addresses a shortcoming of standard deviation which makes no distinction between upside deviations and downside deviations.

[2] Sortino ratios: 0.04 for EMXSOE, -0.24 for MSCI EM Min. Vol and -0.17 for MSCI EM.

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You cannot invest directly in an index.

DEFINITIONS

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

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.

Quality Factor : Excess returns achieved by companies exhibiting higher quality or profitability vs the market. Typically measured using operating profitability, return on equity and/or return on assets. .

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Low Volatility : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

MSCI Emerging Markets Minimum Volatility Index : An index with constituents selected from the MSCI Emerging Markets Index, with a focus on an optimization process subject to constraints, that attempts to generate lower volatility than the MSCI Emerging Markets Index.

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

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.

Standard deviation : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

Basis point : 1/100th of 1 percent.

Defensive sectors : Consumer Staples, Health Care, Telecommunication Services and Utilities.

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.