XI VS. MAO: THE EMERGING MARKET BATTLE

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10/08/2018

In the span of most of our lives, so many economic systems have turned on a dime. Look at Poland, under the Soviet thumb as recently as three decades ago, graduating this month to "developed" status in FTSE Russell Indexes. China, even after opening up upon Deng Xiaoping's ascension to power in 1978, remained thoroughly communist for years, really engaging freer market reforms only after its Tiananmen Square fiasco in 1989. Imagine what onlookers a half century ago would have said if their crystal ball told them that 2018 would bring news that Peking University may just ban its student Marxist group.[1]

Talk about a different world.

But the legacy of the old days leaves a tale of two business models:

- The state-owned variety, which typically places profits below political consideration; and
- The modern, profit-focused enterprises that, in many cases, incorporated in more recent decades

China is considered the worst offender when it comes to dominant state-controlled entities, but the intrusion of government in listed companies is endemic across the emerging world. Russia, India, Malaysia and many more are serial culprits. WisdomTree's research of 1,000 emerging market companies found that about 300 of them had more than 20% of their equity owned by the government.[2]

And when you put together investment strategies that cut those companies out, what comes together is a consortium of efficiently run, low-conflict-of-interest enterprises. They are the "Xi Jinping stocks"—served up with some flaws, no doubt, and some bad habits too, but the companies of this century nonetheless. Their counterparts, if you will excuse the labored parallel, are the "Chairman Mao" stocks.

Antiquity vs. Modernity

What is a key factor for determining if a company has heavy state ownership? Its founding year. The monoliths were in most cases created when prior-era rulers, dictators, autocrats, communists created a government-run company. In contrast, many of the companies with zero state ownership never met Chairman Mao or Leonid Brezhnev.

In other words, the big state-owned companies were arms of the government for so long that many never learned how to focus on the income statement. It's not Priority No. 1. Kick them out and you have an index that naturally melts up on multiple intuitive metrics. The list is deep: projected earnings growth, profitability, propensity to grow the dividend, willingness to sack unneeded workers, promotions based on merit and so forth. You create a basket of companies that strive for excellence, not a bucket of Goliaths whose business ventures may have a long list of negative net present value political projects.

Figure 1 shows the largest over-weights in the WisdomTree Emerging Markets ex-State-Owned Enterprises Index. For example, it has 6.77% in Tencent, making it 2.02% over-weight compared to its 4.75% allocation in the MSCI Emerging Markets Index.

Notice that many of WisdomTree's major over-weights were founded in the modern era—after China's 1978 opening and, of course, near or after the 1989 Berlin Wall/Tiananmen exacta.

Figure 1: Founding Year, WisdomTree Emerging Markets ex-State-Owned Enterprises Index's Top 10 Over-Weights

		Company	Domicile	WisdomTree Emerging Markets ex-State-Owned	MSCI Emerging Markets	Amt. WisdomTree Overweight	Founding Year
Largest Overweights	1	Tencent Holdings	China	6.77%	4.75%	2.02%	1998
	2	Alibaba Group	China	5.72%	3.87%	1.85%	1999
	3	Lukoil	Russial	1.80%	0.00%	1.80%	1991
	4	Ping An Insurance Group Co-A	China	1.43%	0.00%	1.43%	1988
	5	Reliance Industries	India	1.71%	0.97%	0.74%	1977
	6	Ping An Insurance Group Co-H	China	1.59%	0.99%	0.60%	1988
	7	Public Bank Berhad	Malaysia	0.92%	0.35%	0.57%	1966
	8	Baidu	China	1.77%	1.20%	0.57%	2000
	9	Novatek PJSC	Russial	0.85%	0.29%	0.56%	1994
	10	Infosys	India	0.94%	0.43%	0.51%	1981
		Average					1988
		Median					1990

Source: WisdomTree, as of 8/31/18. Weights and holdings subject to change.

Figure 2 tells an opposite story, the story of the companies that WisdomTree's Index shuns the most compared to MSCI Emerging Markets weights. For example, its largest under-weight, China Construction Bank, is a "vintage" 1954 firm.

Boom, boom, boom, down the list, WisdomTree "kicks out" a bunch of very old companies. The 10 companies our Index shuns the most are a "Who's Who" of ancient companies, and in many cases, ancient mind-sets.

Figure 2: Founding Year, WisdomTree Emerging Markets ex-State-Owned Enterprises Index's Top 10 Under-Weights

			Domicile	WisdomTree Emerging Markets ex-State-Owned Enterprises Index	MSCI Emerging Markets	Amt. WisdomTree Underweight	Founding Year
Largest Underweights	1	China Construction Bank	China	0.00%	1.66%	-1.66%	1954
	2	China Mobile	China	0.00%	1.14%	-1.14%	1997
	3	Ind & Comm Bank of China	China	0.00%	1.00%	-1.00%	1984
	4	Housing Development Finance	India	0.00%	0.84%	-0.84%	1977
	5	Vale SA	Brazil	0.00%	0.79%	-0.79%	1942
	6	Bank of China	China	0.00%	0.70%	-0.70%	1912
	7	Itaú Unibanco	Brazil	0.00%	0.64%	-0.64%	2008*
	8	CNOOC	China	0.00%	0.61%	-0.61%	1982
	9	Samsung Electronics	South Korea	0.00%	0.59%	-0.59%	1938
	10	Taiwan Semiconductor	Taiwan	3.48%	4.06%	-0.58%	1987
		Average					1968
		Median					1980
		Average Using Predecessor Companies for #7 (1945 for Itaú & 1924 for Unibanco)					1961
		Median Using Predecessor Companies for #7 (1945 for Itaú & 1924 for Unibanco)					1966

Source: WisdomTree, as of 8/31/18. Weights and holdings subject to change.

Considerations

WisdomTree has seven broad emerging market ETFs and two that are China-specific. For investors who are keen to focus on the future of the developing world, the WisdomTree Emerging Markets ex-State-Owned Enterprises Index, tracked by the WisdomTree Emerging Markets ex-State-Owned Enterprises Fund (XSOE), is trading for 13.9x forward earnings and has a dividend yield of 2.2%.[3] In contrast, perhaps our deepest value emerging market ETF, the WisdomTree Emerging Markets High Dividend Fund (DEM), tracks the WisdomTree Emerging Markets High Dividend Index. That Index is down to 9.0x forward earnings and has a 5.3% dividend. Being deep value, a trade-off for having single-digit price-to-earnings (P/E) ratios, is a natural inclusion of state-owned firms.

There is something else that investors may want to think about: the so-called "global trade war." Although we have expressed skepticism with respect to its severity in recent blog posts and reports, investors with strong opinions either way can use XSOE and DEM, depending on which side their outlook lies. To the extent that Chinese state-run banks and industrials are more China-focused, they may be more insulated from a deep trade rift with the U.S. That favors DEM. For investors on the other side of sentiment, who anticipate trade resolution or who simply see emerging equities as a contrarian buy opportunity, the non-state-run companies could be the angle. That favors XSOE, which has been pummeled 17.5% since January 26, 2018.[4]

For dedicated China ETFs, a parallel to these concepts is the battle between the S&P China 500 Index and the WisdomTree China ex-State-Owned Enterprises Index. Their respective WisdomTree ETFs are the WisdomTree ICBCCS S&P China 500 Fund (WCHN) and the WisdomTree China ex-State-Owned Enterprises Fund (CXSE).

[1]Source: Financial Times, "Peking University Threatens to Close Down Marxism Society," 9/23/18.

[2]Sources: WisdomTree, FactSet, Standard & Poor's, as of 9/30/17 index screening. Initial companies in index screens are those that pass minimum listing, market cap and liquidity requirements for inclusion.

[3]Source: WisdomTree, data as of 9/27/18 for this and all indexes herein.

[4]Through 9/27/18.

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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.

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

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.

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.

S&P China 500 Index : Comprises 500 of the largest, most liquid Chinese companies while approximating the sector composition of the broader Chinese equity market. All Chinese share classes including A-shares and offshore listings are eligible for inclusion.