IN EMERGING MARKETS—VALUE, GROWTH OR EX-STATE OWNED?

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More Sophisticated Emerging Market Equity Allocations

Five or 10 years ago, the majority of exchange-traded fund (ETF) emerging market investors were focused on the same exact benchmark—the MSCI Emerging Markets Index. This Index is currently exposed to 23 markets and a variety of sectors. It has gone from a very heavy commodity focus about a decade ago running into the oil run-up (think summer of 2008[1]) to now being very tech focused.[2] But as equity investors look for "smart beta" factors, we encourage you to take a look at a specific risk factor: government involvement in companies, what we refer to as state ownership risk.

"I Don't Want to Invest Alongside Emerging Market Governments"

On August 18, 2014, WisdomTree began live calculation of its Emerging Markets ex-State-Owned Enterprises Index, tracked by the WisdomTree Emerging Markets ex-State-Owned Enterprises Fund (XSOE).

The Goal: To have similar country exposures as a market capitalization-weighted universe[3] of emerging market equities, while eliminating exposure to those firms with greater than 20% ownership from a government entity, which made up approximately 30% of the MSCI Emerging Markets Index back in August 2014, representing five of the 10 top individual companies.[4]

If one thinks instead of the WisdomTree Emerging Markets Dividend Index—a way to look solely at dividend payers in emerging markets weighted by the dividends that they pay—eight of the top 10 individual companies in August 2014 would have been state-owned by our methodology.[5]

With the introduction of XSOE, investors gained a choice to no longer have to naively invest alongside emerging market governments, thereby managing an important risk from a U.S. investor's perspective. In many ways, this is focusing on the "G in ESG"—environmental, social and governance investing—with the focus, of course, being on the governance more aligned with shareholders and not with a state actor.

Value, Growth or ex-State Owned?

As is always the case when introducing something completely new, a critical question regards how it fits in the current landscape. The value/growth distinction is very well known, whereas what it means to be "ex-state owned" is not. We examine the sector picture to note any similarities.

XSOE Seems to Fall Somewhere between "Growth" and "Core" on Sector Basis

Sector Name	XSOE	MSCI Emerging Markets Growth Index	MSCI Emerging Markets Index	MSCI Emerging Markets Value Index
Consumer Discretionary	15.0%	14.3%	10.5%	6.4%
Consumer Staples	8.3%	10.2%	6.5%	2.6%
Energy	6.2%	2.2%	6.5%	11.2%
Financials	18.8%	12.8%	23.7%	35.3%
Health Care	2.7%	4.1%	2.3%	0.3%
Industrials	4.0%	5.4%	5.6%	5.8%
Information Technology	32.2%	40.7%	26.9%	12.2%
Materials	5.6%	4.5%	7.3%	10.2%
Real Estate	3.5%	1.7%	2.8%	4.1%
Telecommunication Services	2.9%	2.4%	5.3%	8.3%
Utilities	0.9%	1.8%	2.6%	3.5%

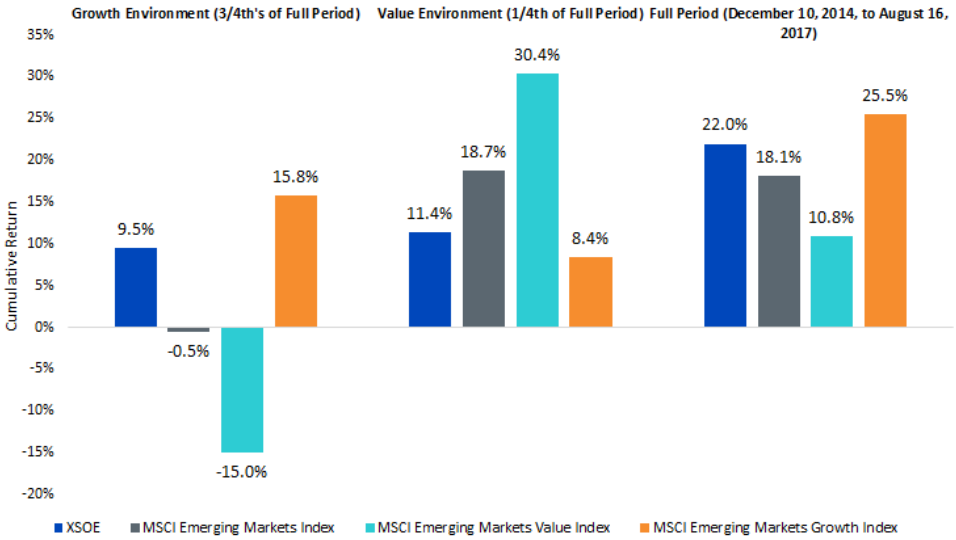
Sources: WisdomTree, MSCI, with data as of 7/31/17, the most recent month-end for which MSCI sector data was available as of this writing.
You cannot invest directly in an index. Weights subject to change.

- **XSOE Exhibited Some Similarities to Growth:** Certain sector positioning looked quite similar to that of the MSCI Emerging Markets Growth Index, such as Consumer Discretionary, Consumer Staples, Telecommunication Services and Utilities. Information Technology is also notable—not quite at the 40.7% seen in the MSCI Emerging Markets Growth Index, but still at a significant over-weight compared to the MSCI Emerging Markets Index. WisdomTree constrains the sector weights in a band around its starting universe market cap,[6] while the MSCI Emerging Markets Growth Index does not—hence why the tilts are more extreme there.
- **XSOE Exhibited Some Similarities to Core:** Certain sector positioning looked quite similar to that of the MSCI Emerging Markets Index, such as Energy, Health Care and Real Estate.
- **Quite Difficult to Compare XSOE to Value:** What's clear is that the MSCI Emerging Markets Value Index tilted exposure away from Consumer Discretionary, Consumer Staples and Information Technology, but toward Energy, Financials, Materials, Telecommunication Services and Utilities. Our research indicates that the classic "value" approaches to emerging markets tend to tilt TOWARD state-owned companies.

When "Value" Has Led, Has "ex-State Owned" Held Up?

This is the critical question, since we also know that styles like value and growth tend to come in and out of favor. Can the approach employed to avoid state-owned companies mitigate some of these ups and downs?

Was This a "Good" Period for Growth or a "Bad" Period for Value?



Sources: WisdomTree, Bloomberg, with data calculated from the inception (12/10/14) of XSOE. Growth environment indicates when the MSCI Emerging Markets Growth Index is in a trending period of outperforming the MSCI Emerging Markets Value Index. Value environment indicates when the MSCI Emerging Markets Value Index is in a trending period of outperforming the MSCI Emerging Markets Growth Index. End date is 8/16/17. Returns shown are cumulative, not annualized. You cannot invest directly in an index. Past performance is not indicative of future results.

- It's important to take a step back, first considering what accounted for the rather large difference in overall cumulative returns for the growth and value environments. Notably, the growth environment saw the price of oil decline by nearly 65% on a cumulative basis. In emerging markets, one of the primary characterizations of a "value" exposure has tended to be a large weight to Energy, and it's notable that many of the largest oil-focused Energy firms are in fact state-owned. Therefore, what we're really noting here is that in a tough emerging market environment, tilting in the "growth" direction also steered away from one of the hardest-hit areas of the market at that time.
- Similarly, the value environment encapsulated those times when the oil price was rallying back. Also notable (and related to the price behavior of oil) is that, during the growth environment, the U.S. dollar was trending toward strength, and during the value environment, the U.S. dollar was trending toward weakness. Big picture: A weaker dollar has tended to be another boon to those investors focused on emerging markets.

Growth May Be More Defensive in Market Downdrafts Driven by the Energy Sector

Intuition tells us that value strategies have historically delivered outperformance during tougher market environments, but since "value" in emerging markets has become entwined with Energy, depending on the nature of a given correction, growth may actually tend toward more defensive characteristics. XSOE, by tracking the WisdomTree Emerging Markets ex-State-Owned Enterprises Index, has naturally tilted away from this sector, leading to a fairly interesting early track record of performance.

[1]Source: Bloomberg; refers to the price per barrel of Brent Crude oil, which closed at $146.08 on 7/3/08.

[2]Source: Bloomberg; refers to weight of Information Technology firms, 26.87%, in the MSCI Emerging Markets Index as of 8/16/17. This was the largest sector weight.

[3]Refers to WisdomTree’s total universe of emerging market companies prior to removing the state-owned enterprises.

[4]Sources: WisdomTree, Bloomberg, with data as of 8/29/14, the closest month-end after the start of live calculation for the WisdomTree Emerging Markets ex-State-Owned Enterprises Index.

[5]Sources: WisdomTree, Bloomberg, with data as of 8/29/14.

[6]After country weights are adjusted, should any sector of the WisdomTree Emerging Markets ex-State-Owned Enterprises Index have a weight that is more than 3% higher or lower than the starting universe, its weight will be adjusted such that it becomes 3% higher or lower than its original starting universe weight.

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You cannot invest directly in an index.

DEFINITIONS

MSCI Emerging Markets Index : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as “emerging markets” by MSCI.

Smart Beta : A term for rules-based investment strategies that don’t use conventional market-cap weightings.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

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.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

MSCI Emerging Markets Growth Index : A market capitalization-weighted subset of stocks in the MSCI Emerging Markets Index that have higher share prices relative to their earnings or dividends per share.

MSCI Emerging Markets Value Index : A market capitalization-weighted subset of stocks in the MSCI Emerging Markets Index that have lower share prices relative to their earnings per share, dividends per share, or lower prices relative to other financial metrics.