WITH RECENT VOLATILITY, IS IT TIME FOR ACTIVE MANAGEMENT IN THE EMERGING MARKETS?

Jeremy Schwartz — Global Chief Investment Officer
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A number of concerns have recently flared up for the emerging markets, creating volatility both in the equity markets and the currency markets. Concerns started emerging when the Federal Reserve began talk of tapering its asset purchase program, which many feel will reduce liquidity flows to emerging markets. Moreover, a rebalancing in China from investment-led growth toward domestic consumption has put pressure on commodity prices, with ripple effects through many emerging markets that are sensitive to commodity prices. Also there is concern about a banking crisis in China based on the rapid credit expansion that has occurred over the last five years. Many are also pointing to the underperformance of emerging markets over the last three years as being characterized by high volatility. So is now the time for active managers to pick the best opportunities? In short, my research suggests active managers have a tough time beating traditional index-based benchmarks over longer periods, and I think this particular environment should be no different. **There Are Many Ways to Invest** As emerging markets have become more accessible, there are an increasing number of ways to invest in them, but the decision usually starts with whether to invest in active mutual funds o r passive exchange-traded funds (ETFs) . Recently, some have argued that active managers are best suited to outperform in today's environment, so I want to take a hard look at the numbers. In the table below, I compare how some emerging market indexes have performed against U.S. ETFs and open-end mutual funds within Morningstar's Diversified Emerging Markets category[1]. **Active Managers vs. Indexes**

	Trailing 10-Yr	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
MSCI Emerging Markets Index Return	11.17%	-2.60%	18.22%	-18.42%	18.88%	78.51%	-53.33%	39.39%	32.17%	34.00%	25.55%
Did Active Managers Outperform MSCI EM Index??	No	Yes	Yes	No	No	No	No	No	Yes	No	No
Percent of Active Managers Beaten by the Specified Index (12/31/2003-12/31/2013)											
MSCI Emerging Markets Index	73.0%	42.1%	40.7%	63.2%	54.3%	74.4%	57.6%	66.7%	44.6%	54.3%	58.9%
MSCI Emerging Markets Small Cap Index	86.8%	70.8%	81.2%	3.9%	93.4%	98.6%	17.4%	83.0%	47.3%	33.6%	51.1%
WisdomTree Emerging Markets Equity Income Index	N/A	27.1%	24.9%	97.8%	85.2%	17.1%	100.0%	N/A	N/A	N/A	N/A
WisdomTree Emerging Markets SmallCap Dividend Index	N/A	49.3%	86.3%	44.8%	97.6%	88.0%	86.9%	N/A	N/A	N/A	N/A
Number of Managers	224	642	604	494	445	427	340	311	281	261	244

Sources: WisdomTree, Zephyr StyleADVISOR, Morningstar, 12/31/2003–12/31/2013. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, please visit our Glossary. • **Most Active Managers Underperform** – Over the most recent 10-year period the MSCI Emerging Markets Index (MSCI EM) has outperformed 73.0% of funds in the Morningstar Diversified Emerging Markets category. MSCI EM also outperformed more than 50% of the Morningstar category in seven out of the past 10 calendar years. It is also important to note that the MSCI Emerging Markets Small Cap Index has outperformed 86.8% of the Morningstar category over the past 10 years. • **WisdomTree Emerging Markets Equity Income Index (WTEMHY)** – Since its inception, WTEMHY has outperformed close to 98% of the Morningstar category[2]. I find it impressive that during two of the worst calendar year returns for emerging markets, 2011 and 2008, the Index was able to outperform almost 98% and 100% of the Morningstar category, respectively. • **WisdomTree Emerging Markets SmallCap Dividend Index (WTEMSC)** – Since its inception, WTEMSC has outperformed over 94% of the Morningstar category[3]. On a calendar year basis, WTEMSC was also able to outperform over 85% of the Morningstar category in four out of the past six years, or two-thirds of the time. **Why Emerging Market Indexes?** Mutual fund managers, like all investors, are susceptible to behavioral biases that can negatively affect their investment decisions. This is exhibited through the table above, which shows that the majority of active managers in the Morningstar Diversified Emerging Markets category actually underperformed MSCI EM over the most recent 10-year period and during seven of the last 10 calendar years. For believers of active management, I think these results are even more alarming given the fact that MSCI EM is a market cap-weighted index. Market cap-weighted indexes typically give the greatest weight to the stocks with the highest prices, without regard to any measure of fundamental value. As a result, market capitalization-weighted indexes tend to over-weight more expensive equities, sectors and countries, and under-weight those that may be relatively less expensive. **Why Smart Beta?** I believe it is especially important now to have a disciplined focus on the valuation opportunities present in the emerging markets, specifically cash flow and dividends. WisdomTree Indexes use a rules-based methodology to weight companies by their underlying fundamentals, such as dividends or earnings, because we believe that stock markets are not always efficient. Furthermore, WisdomTree rebalances its Indexes annually to adjust for relative value. While stock prices may deviate from the underlying fundamental value for a number of reasons, one is sentiment, which can result in "herding" behavior. Currently, I feel this is one reason for emerging markets' recent underperformance, but I am confident the market will eventually revert back to its underlying fundamentals. As a result, investors shouldn't abandon the space, but instead have a rules-based strategy that focuses on fundamentals and is not susceptible to psychological biases. [1]The U.S. OE Diversified Emerging Markets category encompasses all the open-ended mutual funds and ETFs that Morningstar categorizes as "Diversified Emerging Markets" funds. [2]Sources: Zephyr StyleADVISOR, Morningstar; Index inception: 06/01/2007. [3]Sources: Zephyr StyleADVISOR, Morningstar; Index inception: 08/01/2007.

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DEFINITIONS

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

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Actively managed mutual funds : Investment strategies that are not designed to track the performance of an underlying index.

Passive exchange-traded funds : Exchange-traded funds that track the performance of an index.

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.

MSCI EM Small Cap Index : Includes small cap representation across 21 Emerging Markets countries. The small cap segment tends to capture more local economic and sector characteristics relative to larger Emerging Markets capitalization segments.

WisdomTree Emerging Markets Equity Income Index : A subset of the WisdomTree Emerging Markets Dividend Index measuring the performance of the higher-yielding stocks as measured by trailing 12-month dividend yields, weighted by cash dividends.

WisdomTree Emerging Markets SmallCap Dividend Index : A subset of the WisdomTree Emerging Markets Dividend Index measuring the performance of the smallest firms by market capitalization weighted by cash dividends.

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.

Fundamental value : The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.

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

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.

Dividend : A portion of corporate profits paid out to shareholders.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Relative value : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.