

# WHAT HIDDEN GEM ETF BEAT THE MSCI EMERGING MARKETS INDEX BY NEARLY 1,000 BPS IN 2017?

Luciano Siracusano — Chief Investment Strategist  
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In January, I was invited to speak at the Inside ETFs conference in Florida about a WisdomTree exchange-traded fund (ETF) that the organizers had selected as one of the industry's "hidden gems." There was only one catch: I would, like the other nominees, be given only three minutes to explain why this ETF was a diamond in the rough. Here is a brief summary of those 180 seconds.

As many investors know, broad emerging markets were the best-performing major asset class last year. But what "hidden gem" emerging markets ETF beat the [MSCI Emerging Markets Index](#) by nearly 1,000 [basis points \(bps\)](#) in 2017?

The answer is [XSOE, the WisdomTree Emerging Markets ex-State-Owned Enterprises Fund](#). How did it do so? And how did it manage to outperform the MSCI Index over the past three years, a period in which it also outperformed 91% of its Morningstar peer group?

## Peer Group Performance Ranks Against Mutual Funds and ETFs

|   | 1/1/17 -12/31/17 |                 |                        | 1/1/15-12/31/17 |                 |                        |
|---|------------------|-----------------|------------------------|-----------------|-----------------|------------------------|
|   | Total Return     | Peer Group Rank | % of Peer Group Beaten | Total Return    | Peer Group Rank | % of Peer Group Beaten |
| WisdomTree Emerging Markets ex-State-Owned Enterprises Fund | 46.50%           | 43              | 95                     | 11.33%          | 60              | 91                     |
| MSCI Emerging Markets Index                                 | 37.28%           | 335             | 58                     | 9.10%           | 249             | 62                     |
| <b>Total Number of Funds</b>                                | <b>804</b>       |                 |                        | <b>647</b>      |                 |                        |

Sources: WisdomTree, Morningstar Direct, as of 12/31/17. Peer group: US ETF/MF Diversified Emerging Markets

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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](http://www.wisdomtree.com).

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

For XSOE standardized performance and expenses, please click [here](#).

The short answer is that the Fund stayed true to its name—it avoided the [state-owned enterprises \(SOEs\)](#) in the emerging world. WisdomTree defines a SOE as a company where governments control at least 20% of the outstanding shares. In October, that represented some 300 emerging market companies with a combined market value of approximately \$2 trillion. Much of that value is concentrated in the Chinese banking and Russian energy sectors, although SOEs can be found in most developing nations. WisdomTree estimates that about 25% to 35% of the market capitalization of broad emerging market indexes are typically made up of state-owned entities.

### Why Does WisdomTree Believe State Ownership Is a Risk Factor in the Emerging World?

Managing an enterprise well is a far greater challenge when executives are asked to serve two masters: private shareholders and government stakeholders. SOEs not only need to maximize shareholder value, they may also need to be mindful of public interests, as defined by politicians and bureaucrats. Sometimes those two imperatives conflict—and this may, over time, lead to suboptimal investment results for investors.

We have seen anecdotal evidence that this has, indeed, occurred over the past decade. In Brazil, the large multinational energy company Petrobras became involved in a huge corruption scandal after the leftist Workers' Party (PT) government of Luiz Inácio Lula da Silva appointed political allies to some of the company's most important executive positions.<sup>1</sup> As the scandal unraveled, Petrobras' stock lost nearly 60% of its value between 2014 and 2016.<sup>2</sup> Although we don't typically see SOEs in the U.S., investors were introduced to the downside of publicly traded government sponsored enterprises when Freddie Mac and Fannie Mae saw 99% of their stock values wiped out during the housing crash and subsequent financial crisis of 2007–2009.

By screening once a year based on this metric, WisdomTree avoids SOEs and adds back companies within those countries so that country weights approximate comparable capitalization-weighted indexes. WisdomTree also weights individual stocks based on their market values, and it constrains sector tilts at the [annual rebalance](#) of the WisdomTree Index. This allows WisdomTree to isolate its bet on companies that are freer to compete globally. If non-state-owned enterprises continue to outperform state-owned enterprises in the future, this strategy is designed to tap into that differential in returns as a potential source of alpha for emerging market investors.

### Conclusion

XSOE allows investors to gain broad exposure to emerging markets without assuming the risk of owning state-owned enterprises. Last year, that simple strategy returned 46.5% at NAV, outperforming the MSCI Emerging Markets Index by 912 bps in 2017, and by 220 bps annualized over the prior three years. We believe this innovative WisdomTree ETF sets a new standard for measuring the returns of "private sector beta" across emerging market equities.

<sup>1</sup>Joe Leahy, "What Is the Petrobras Scandal That Is Engulfing Brazil?," The Financial Times, 3/31/16.

<sup>2</sup>Note: Petrobras is contained in other WisdomTree ETFs.

#### Important Risks Related to this Article

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investment merit and the Fund does not attempt to outperform its Index or take defensive positions in declining markets. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of XSOE please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/xsoe>

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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## 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.

**Basis point** : 1/100th of 1 percent.

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

**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.