# WHY WE BELIEVE EMERGING MARKETS ARE CHEAP?

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There has been little question that the performance of the MSCI Emerging Markets Index(MSCI EM) has been lackluster thus far in 2013. Other equity markets, such as those in the United States, have opened up a significant performance gap if one looks at the past three years. It is for this reason that we believe EM Equities deserve closer attention, specifically on the valuation front. **Evaluating the Historical Context** EM Equities has a history extending back to December of 1987 and thus encompasses a variety of market environments. Our goal is to construct a framework allowing us to analyze the valuation levels of EM Equities over a period of approximately 25 years. While one can never know future performance with certainty, we do believe it useful to know whether current valuation levels look closer to being expensive, inexpensive or just about average. **Year-End Dividend Yield as a Potential Valuation Indicator** We believe that the MSCI EM'sdividend yield is an important indicator of its valuation. In fact, as of July 31, 2013, more than 95% of the MSCI EM's weight was in companies that had paid at least one dividend over the preceding 12 months, indicating a strong dividend-paying culture in the region. With respect to comparisons to its own historical levels, our research shows that the MSCI EM's startingtrailing 12-month dividend yield at the beginning of a calendar year had a strong relationship to the subsequent performance over the next 12-month period. The MSCI EM has 24 full calendar years of index data for which year-end trailing 12-month dividend yields can be calculated. We divided these years into two baskets sorted by the trailing 12-month dividend yield as of December 31 of each year: • **"High Dividend Yield Years"**: Years in which the starting trailing 12-month dividend yield was above the median trailing 12-month dividend yield for the MSCI EM. The median trailing 12-month dividend yield was 2.25%. • **"Low Dividend Yield Years"**: Years in which the starting trailing 12-month dividend yield was below the median trailing 12-month dividend yield for the MSCI EM.**Performance: Where the Rubber Meets the Road** We think the figure below paints a clear picture of the differences in returns between periods classified as High Dividend Yield Years and those classified as Low Dividend Yield Years. **Analysis of MSCI Emerging Markets Index Performance Following High and Low Dividend Yield Years (12/31/1988—12/31/2012)**
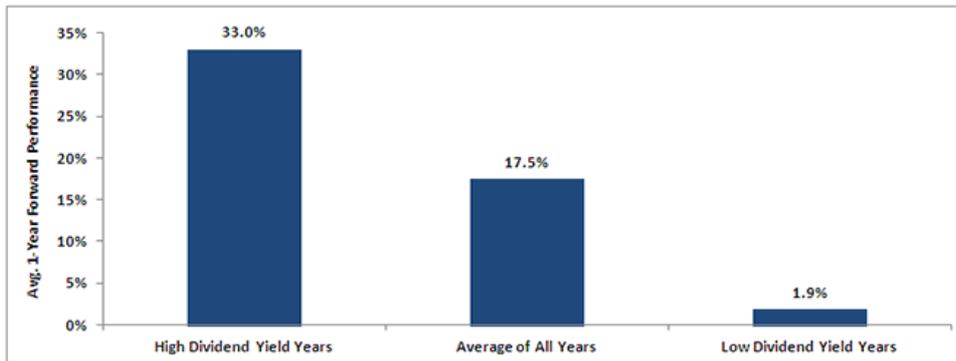
Sources: MSCI, WisdomTree. Past performance is not indicative of future results. You cannot invest directly in an index. 1-year forward performance refers to the cumulative performance occurring over the 1-year following different year-end dividend yields. Year-end dividend yields are trailing 12-month dividend yields observed on 12/31 of each calendar year for each of the 24 years from 12/31/1988 to 12/31/2012. The one year forward performance for the 12/31/1988 trailing 12-month dividend yield observation is the cumulative performance of the MSCI Emerging Markets Index from 12/31/1988 to 12/31/1989. Each subsequent period of the 24 total periods is calculated analogously.

• **Squarely in the High Dividend Yield Year Range:** As of July 31, 2013, the MSCI EM exhibited a trailing 12-month dividend yield of 2.93%. There were five calendar years that started with a higher value, and each was associated with a positive subsequent return. While this past performance cannot guarantee any particular future return, we do believe that 2.93% is a strong potential valuation indicator relative to the performance history of the MSCI EM.• **Big Dispersion from High to Low:** We've certainly pointed to this analysis before, and we'll bring it up again and again to emphasize its importance. The three bars in this figure make the statement that valuation is of paramount importance for the MSCI EM. On average, returns of the High Dividend Yield

Years eclipsed those of the Low Dividend Yield Years by over 30%. **Conclusion** While the dividend yield analysis is a strong and important indicator for the broader market, we also want to look at other factors. We will look at price-to-earnings (P/E) ratios and how they differ across emerging market sectors as well as countries. Additionally, we will close this series with two blog posts aimed at showing that all emerging market equity indexes are not created equal. Each index approach trades off certain attributes to focus on others. A critical question must be asked: If one believes emerging markets are inexpensive and represent a good opportunity, are you best positioned to capture the market's upside? Many investors may not be, and we will try to provide a framework to understand the trade-offs made in various approaches to indexing. Read the full research paper here.

Important Risks Related to this Article

Dividends are not guaranteed, and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments.

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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.

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

Trailing 12-month dividend yield : Dividends over the prior 12-months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

Median : The median is the value within a dataset at which 50% of all observations occur above and 50% occur below.