CXSE: A TACTICAL OPPORTUNITY AHEAD OF MSCI REBALANCE

Jeremy Schwartz — Global Head of Research
04/19/2016

In my recent blog post "Old China vs. New China," I argued that old-style China indexes like the FTSE China 50 Index, dominated by about 75% exposure to state-run banks, telecommunication companies and energy companies, fail to reflect the economic future of China, which is a shift toward consumption and services driving its growth. WisdomTree developed what can be referred to as a "new China"-oriented ETF, the WisdomTree China ex-State-Owned Enterprises Fund (CXSE), which is designed to track, before fees and expenses, the WisdomTree China ex-State-Owned Enterprises Index, an Index that excludes state-owned enterprises. WisdomTree believes CXSE better represents the long-term rebalancing in China's economy, with approximately two-thirds of its exposure in technology and consumer companies. **Large Outperformance in One Year: Why?** Since the inception of the WisdomTree China ex-State-Owned Enterprises Index, it has outperformed the FTSE China 50 Index by more than 1,300 basis points (bps) and the MSCI China Index by 1,100 bps as of March 31, 2016. See standardized performance of the WisdomTree China ex-State-Owned Enterprises Index here. One way WisdomTree sought to differentiate this new China Index from the beginning was to include a broad cross section of China—including the H-shares trading in Hong Kong, as well as U.S.-listed American Depository Receipts (ADRs) that are often in the technology sector. We viewed these companies as key to driving China's growth and included them from the inception of the Index. On June 10, 2015, there was a major decision focused on adding China A-shares to the MSCI Index family. MSCI delayed the addition of A-shares, which marked the peak of the Shanghai Composite Index in 2015, as investors became disappointed that there would not be an influx of capital into China A-shares.[1] (Note: WisdomTree does not include A-shares in its Indexes yet either.) All eyes will be on MSCI's 2016 announcement in anticipation of MSCI adding the A-shares at a future date. But A-shares inclusion is not the only important MSCI inclusion story. **MSCI Adding ADRs** One important factor causing CXSE to outperform the traditional China indexes is that CXSE already includes in major weights China ADRs trading in the U.S., while the traditional MSCI Indexes are in the process of adding exposure to them. Importantly, MSCI's inclusion of these technology- and consumer-oriented China ADRs is being phased in in two tranches: the first occurred in November 2015, and the second is set to occur in May 2016. While there is uncertainty around the timing of A-shares' inclusion in MSCI Indexes, we know with certainty that MSCI will double its weight in the ADRs that are already included in CXSE at full weights. Let's look at performance during the last MSCI inclusion window for indications of which buying and selling pressures may impact relative performance in the coming weeks. **MSCI Inclusion Factor: Set to Occur Again in May** Over the period from October 15 to November 30, 2015, CXSE banked more than 1,250 basis points of outperformance versus the MSCI China Index. See standardized performance of CXSE here. Below we list the performance of the 10 largest ADRs by weight in CXSE and how they performed in the six weeks ahead of the first MSCI inclusion. As an example, Baidu.com averaged almost an 8% weight in CXSE but zero weight in the MSCI China Index over this period. This stock was up 45% over the six-week period ahead of the MSCI rebalance. MSCI China was down 4.61% over this period.[2] Given that MSCI index-tracking Funds largely do not like to experience tracking error, it is unlikely that index Funds have their full exposure to these stocks yet. There is likely going to be buying ahead of the MSCI inclusion of greater weight to these ADRs.[3] The ADRs now being added to MSCI China represent more than a third of CXSE weight and around 11% of the traditional cap-weighted MSCI China. We anticipate further selling in the other stocks in MSCI China, as they must make room for the addition of the new ADRs, and there will be buying pressure on these existing ADRs.[3]

Ticker	Name	Sector	Average Weight Over Period		Security Performance
			CXSE	MSCI China Index	
JD US	JD.COM INC-ADR	Consumer Discretionary	8.23%	0.00%	16.83%
BIDU US	BAIDU INC - SPON ADR	Information Technology	7.97%	0.00%	45.08%
BABA US	ALIBABA GROUP HOLDING-SP ADR	Information Technology	7.72%	0.00%	17.14%
CTRP US	CTRIP.COM INTERNATIONAL-ADR	Consumer Discretionary	4.47%	0.00%	52.54%
NTES US	NETEASE INC-ADR	Information Technology	2.15%	0.00%	25.37%
VIPS US	VIPSHOP HOLDINGS LTD - ADR	Consumer Discretionary	1.88%	0.00%	-10.11%
EDU US	NEW ORIENTAL EDUCATIO-SP ADR	Consumer Discretionary	1.22%	0.00%	29.44%
QIHU US	QIHOO 360 TECHNOLOGY CO-ADR	Information Technology	1.13%	0.00%	26.63%
WX US	WUXI PHARMATECH CAYMAN-ADR	Health Care	1.03%	0.00%	3.39%
MR US	MINDRAY MEDICAL INTL LTD-ADR	Health Care	0.76%	0.00%	10.37%
Weight/Average Performance			**36.56%**	**0.00%**	**21.67%**

Sources: WisdomTree, MSCI, 10/15/15–11/30/15. The above ADRs were chosen because they represented the 10 largest ADRs by Fund weight over the selected period. Subject to change. You cannot invest directly in an index.

Visit the CXSE page for current holdings. **Bottom Line** WisdomTree believes investors in Chinese ETFs should re-evaluate their exposures to China. The long-term motivation is that we believe the sector exposures in CXSE are more consistent with the economic policy and changes occurring in the region. But there is also some additional timely motivation that suggests now would be a very good time to make the switch—ahead of the second tranche of ADRs being added to the MSCI China Index, given the large weight these stocks represent in CXSE. [1]Sources: WisdomTree, Bloomberg, refers to the Shanghai Composite Index level high on 6/12/15. [2]Sources: WisdomTree, Bloomberg, 10/15/15–11/30/15. [3]Source: MSCI, as of 3/31/16.

Important Risks Related to this Article

Double-digit returns were achieved primarily during favorable market conditions. Investors should not expect that such favorable returns can be consistently achieved. A fund's performance, especially for very short periods, should not be the sole factor in making your investment decision.

Past performance is not indicative of future results.

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Fund focuses its investments in China, thereby increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in emerging or offshore 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.

The Fund's exposure to certain sectors may increase its vulnerability to any single economic or regulatory development related to such sectors. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For more investing insights, check out our Economic & Market Outlook

FTSE China 50 Index : a market capitalization weighted index tracking the top 50 Chinese companies. Stocks are weighted by H or Red Chip share cap as appropriate.

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

Basis point : 1/100th of 1 percent.

MSCI China Index : A free float-adjusted, market capitalization-weighted equity index designed to measure the performance of the Chinese equity market.

H-Share : A share of a company incorporated in the Chinese mainland that is listed on the Hong Kong Stock Exchange or other foreign exchange.

ADRs : American Depository Receipts, shares of a firm incorporated outside the U.S. but issued by a global bank and traded in the U.S., denominated in U.S. dollars.

A-share : shares traded on the Shanghai and Shenzhen stock exchanges. This is contrast to Renminbi B shares which are owned by foreigners who cannot purchase A-shares due to Chinese government restrictions.

Shanghai Composite Index : A stock market index of all A shares and B shares that are traded on the Shanghai Stock Exchange.

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.