EMERGING MARKETS IN FOCUS: VANGUARD CHANGES BENCHMARK, WISDOMTREE HITS FIVE YEAR ANNIVERSARY

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11/28/2012

Vanguard shook up the investment community with its announcement that it would switch index providers from MSCI to FTSE for its international and emerging market equity exchange-traded funds (ETFs). The benchmark change has been positioned primarily as a way to save Vanguard investors millions of dollars in licensing fees that were being paid to MSCI. In WisdomTree's latest research piece I ask: • What is the potential for tracking error between the FTSE Emerging Markets (EM) Index and the MSCI Emerging Markets (EM) Index? • But more critically, is the focus on FTSE vs. MSCI the wrong approach? Are there other alternatives for emerging markets (EM) equities that can provide an improvement in risk-adjusted returns? At WisdomTree, we believe this final question represents the most important bottom line for investors. **The Potential for Tracking Error** Tracking error is a statistic that measures return variability and differentials between two indexes. The larger the number, the greater the chance that there are different return experiences over time. Tracking error can come from differences in the weight and selection of components. We analyzed the trailing three-year rolling tracking error between the FTSE EM and the MSCI EM. **The maximum three-year tracking error between the FTSE EM and the MSCI EM has been approximately 2%[1].** Is 2% an acceptable level of tracking risk? The willingness to accept 2% tracking error will largely be addressed on a case-by-case basis. I also looked at the topic of tracking error from a different perspective: the simple difference in rolling 12-month returns. There have been periods with some substantial differences in rolling 12-month returns. **The maximum outperformance of the FTSE EM was 5.17%, while its greatest underperformance was 3.24%[2].** In my opinion, those are some large differences for indexes tracking the same category. **Is South Korea a Developed or an Emerging Market—and Does It Matter?** The largest differential between the MSCI EM and the FTSE EM concerns South Korea, which represents approximately 15% weight in the MSCI EM but has no weight in the FTSE EM, as FTSE considers South Korea a developed market. Is South Korea a developed or an emerging market? It is a matter of opinion. WisdomTree agrees with MSCI on this matter and classifies South Korea as an emerging market. But rather than focusing on the differences between the MSCI EM and the FTSE EM, which largely boil down to one's current view of South Korea, I believe it is important to consider a different emerging market index, which has delivered a substantial improvement over FTSE EM and MSCI EM in risk-adjusted returns with both stock selection and weighting differences. **WisdomTree's Approach—Relative Value Rebalancing[3] and a Dividend Focus** Emerging market equities, by and large, are dividend payers. By our count, over 90% of the market capitalization of emerging market equities are in dividend-paying stocks[4]. However, WisdomTree's Emerging Markets Equity Income Index (WTEMHY) takes it a step further, introducing a disciplined, annual relative value rebalancing in the selection and weighting of its constituents. The WTEMHY just passed its five-year anniversary earlier this year. I believe its risk-adjusted returns and track record have truly been impressive. A few crucial statistics for comparison over this period: **The Dividend Difference: Higher Returns:** Both the FTSE EM and the MSCI EM have negative returns on a five-year basis as of 9/30/2012—close to -1% per year[5]. The WTEMHY's returns, on the other hand, have averaged 6.18% per year. I believe this represents strong evidence of the difference a dividend selection and weighting methodology can provide for the emerging markets. For full standardized index performance, please see this page. **Less Risk:** Beta is one way to measure risk—specifically, how one index moves relative to another. Since inception, the WTEMHY's beta relative to the MSCI EM is .80, showing 20% lower beta (or risk) compared to the 1.0 beta of the MSCI EM. What about active managers during this turbulent market? The WTEMHY has beaten not only the FTSE EM and the MSCI EM over this five-year period—it's beaten over 98% of the active managers, ETFs and other indexes within the Morningstar Diversified Emerging Markets category[6]. Read our full research report for more details on this performance. **Conclusion** To us, there is no question that the bar for active managers has been raised—and over a very difficult period for emerging market equity investing. Emerging market equity indexes have become a focus for many with Vanguard's news about its adoption of the FTSE EM Index. I believe those analyzing the differences in those indexes should expand the comparison and also consider new alternatives to indexing that provide different stock selection, weighting and risk-return dynamics. I believe that the last five years were a critical stress test of any index methodology, and the WTEMHY has a real-time track record that is impressive compared to traditional market cap-weighted benchmarks and the universe of active managers and ETFs shown above. ***WisdomTree's Jeremy Schwartz discusses the case for investing in Emerging Markets equities with Michael Johnston of ETF Database. Hear the podcast.*** [1]Bloomberg, Zephyr StyleADVISOR [2]Bloomberg, Zephyr StyleADVISOR [3]Relative value rebalancing: Stocks are judged in terms of potential weighting and inclusion based on how their share prices have moved relative to a fundamental metric, in this case trailing 12-month dividends. [4]As measured by the market capitalization of constituents of the MSCI EM as of 9/30/2012. [5]Bloomberg, Zephyr StyleADVISOR [6]The U.S. OE Diversified Emerging Markets Fund category includes all the open-ended mutual funds and ETFs that Morningstar categorizes as “Diversified Emerging Markets” funds.

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