

# DVEM & DEM: THERE ARE STILL INEXPENSIVE EQUITY MARKETS

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04/12/2018

The headwinds for [value](#) investing over the last decade have been formidable. Ever since the post-Lehman recovery commenced nearly nine years ago, markets have been led by U.S. growth stocks, with emerging markets largely lagging until 2017. Among emerging markets, value stocks had an even tougher run. Opportunity may loom in the [WisdomTree Emerging Markets Dividend Fund \(DVEM\)](#) and the [WisdomTree Emerging Markets High Dividend Fund \(DEM\)](#), two of our ETFs that track broad emerging market exposures with an emphasis on [dividend](#) payers.

Subscribers to a [mean reversion](#) school of thought might take note of sharp performance disparities. In 2017 alone, the [MSCI Emerging Markets Growth Index](#) returned 46.8%, handily outperforming its value counterpart, the [MSCI Emerging Markets Value Index](#) (+28.1%).<sup>1</sup>

Go back longer: In emerging markets, the cumulative return differential between growth and value in the last five years has been 3,032 [basis point \(bps\)](#).<sup>2</sup> The contrast with U.S. equity markets is starker. Whereas broad emerging markets returned 4.6% annually over the last five years and emerging value registered 1.7% gains, the [S&P 500](#) chalked up 16.2% a year.<sup>3</sup> These are “[bull](#) market problems,” but they are still problems. Emerging market value stocks are clear laggards.

DVEM and DEM, our dividend-weighted emerging equity ETFs whose underlying Indexes yield 3.89% and 5.24%, respectively,<sup>4</sup> offer a chance to look at the asset class as a value investor. After all these years in the cold, emerging value’s appealing [fundamentals](#) are striking given the bull market’s age, as seen in the next section.

## Stacking Risk Premiums

On the bar first from the left in figure 1, we see the [MSCI USA Index](#)’s 4.60% [earnings yield](#) (the reciprocal of the [price-to-earnings \[P/E\] ratio](#)), which is 186 bps more than the 2.74% yield on [10-year Treasuries](#). That [equity risk premium \(ERP\)](#) has been dwindling with each stock market uptick.

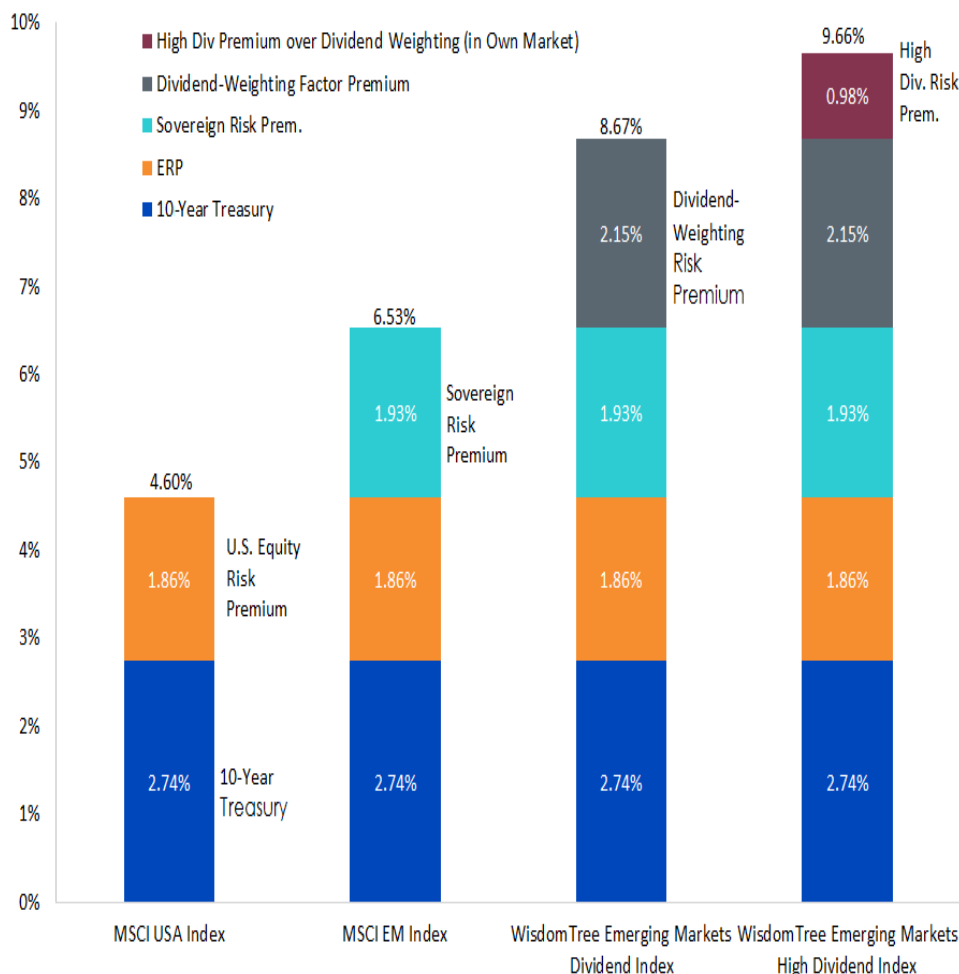
Next to that is the 6.53% earnings yield on the [MSCI Emerging Markets Index](#), giving emerging markets a 1.93% [sovereign risk premium](#) over U.S. equities. That is a sizeable amount of compensation.

Aswath Damodaran, professor of finance at New York University,<sup>2</sup> theorizes that a market’s equity risk premium should equal that of an established market plus an extra spread that accounts for that nation’s [volatility](#)-weighted default risk premium. For example, if the U.S. has an ERP of 3% and another country has a volatility-adjusted default risk premium of 1.20%, its equity risk premium over [U.S. Treasuries](#) would be 3% + 1.20%, or 4.20%.

We already determined that the U.S. ERP is 1.86%. Looking at five-year USD [credit default swaps](#) for Brazil, Russia, India and China (the BRICs) to get a feel for the emerging market credit environment in some major countries, we find volatility-adjusted default risk premiums of 185 bps, 136 bps, 83 bps and 69 bps, respectively.<sup>6</sup> Those figures suggest that

the MSCI Emerging Markets Index's 190 bps of extra earnings yield over U.S. equities may be generous.

**Figure 1: Components of Earnings Yield**



Sources: WisdomTree, Bloomberg. Example: MSCI USA trailing earnings yield = 4.60%. 10-year U.S. Treasury Yield = 2.74%. Equity risk premium = 1.86%. MSCI Emerging Markets Index earnings yield = 6.53%, or 1.93% more than the MSCI USA earnings yield; differential = Sovereign Risk Premium. WisdomTree Emerging Markets Dividend Index earnings yield = 8.67%, or 2.15 percentage points more than the MSCI Emerging Markets (not 2.14%, due to rounding); differential = value premium accorded dividend-weighted emerging markets over market capitalization-weighted emerging markets. The WisdomTree Emerging Markets High Dividend Index earnings yield is 9.66%, or 99 bps more than the aforementioned WisdomTree Index. Data as of 3/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Moving rightward, the [WisdomTree Emerging Markets Dividend Index](#), which is tracked by DVEM before fees and expenses, has an earnings yield that is 215 bps higher than that, at 8.67%. The WisdomTree Index's earnings yield is thus nearly double that of U.S. equities. Finally, and intriguingly, if we take it one step over to DEM's underlying Index, the [WisdomTree Emerging Markets High Dividend Index](#), we arrive at an earnings yield that is pushing 10%, another 98 bps over and above DVEM's tracking Index.

In P/E terms, the WisdomTree Emerging Markets Dividend Index is trading for 11.5 times earnings, 24.7% lower than the MSCI EM Index. Its high-dividend counterpart, tracked by DEM, is valued at 10.4 times trailing earnings. For context, MSCI USA is at 21.7 times earnings.<sup>7</sup> The WisdomTree ETFs are broad too, with DVEM covering nearly 700 companies and DEM capturing more than 300. With these ETFs' underlying Indexes offering dividend yields in the mid-3% and 5% area, investors also get a buffer over and above the 2.43% and 1.98% yields of the MSCI Emerging Markets Index and the S&P 500, respectively.<sup>8</sup>

<sup>1</sup>Source: Bloomberg. Unless otherwise stated, all data in this report through or as of 12/29/17.

<sup>2</sup>Source: Bloomberg. Growth and value represented by the MSCI Emerging Markets Growth and MSCI Emerging Markets Value Indexes.

<sup>3</sup>Sources: MSCI, S&P, Bloomberg.

<sup>4</sup>Source: Bloomberg. [Trailing 12-month dividend yield](#), as of 4/6/18.

<sup>5</sup>Damodaran Online, <http://pages.stern.nyu.edu/~adamodar/>.

<sup>6</sup>5-year USD credit default swaps (CDS) for Brazil, Russia, India and China of 165 bps, 121 bps, 74 bps and 62 bps, respectively, multiplied by 1.12 to capture Damodaran's 12% volatility adjustment between the volatility of sovereign bond spreads over U.S. Treasuries and emerging market equity risk. Data as of 4/6/18, from Bloomberg.

<sup>7</sup>Source: Bloomberg. Data as of 3/30/18.

<sup>8</sup>Source: Bloomberg. Trailing 12-month dividend yield, 4/6/18.

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

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.

For more investing insights, check out our [Economic & Market Outlook](#)

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You cannot invest directly in an index.

## DEFINITIONS

**Value** : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

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

**Mean reversion** : The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

**MSCI Emerging Markets Growth Index** : A market capitalization-weighted subset of stocks in the MSCI Emerging Markets Index that have higher share prices relative to their earnings or dividends per share.

**MSCI Emerging Markets Value Index** : A market capitalization-weighted subset of stocks in the MSCI Emerging Markets Index that have lower share prices relative to their earnings per share, dividends per share, or lower prices relative to other financial metrics.

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

**S&P 500 Index** : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

**Bullish** : a position that benefits when asset prices rise.

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

**MSCI USA Index** : is designed to measure the performance of large and mid cap segments of the US market.

**Earnings yield** : The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

**Price-to-earnings (P/E) ratio** : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**10- Year Treasury** : a debt obligation of the U.S. government with an original maturity of ten years.

**Equity premium** : the excess return that investors may receive over the risk free rate as compensation for taking on the relatively higher risk associated with equity.

**MSCI Emerging Market Index** : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

**Sovereign Risk Premium** : The incremental return demanded to compensate them for the risk of investing in markets that may have more geopolitical risk than mainstream economies such as the United States.

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

**Treasury** : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

**Credit Default Swap** : A swap designed to transfer the credit exposure of fixed income products between parties. The purchaser of the swap makes payments up until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third party debt if this party defaults on the loan.

**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.