
DOES GOVERNMENT OWNERSHIP MAKE A COMPANY A BETTER INVESTMENT?

Bradley Krom — U.S. Head of Research
10/16/2017

As we've highlighted in recent weeks, [flows to emerging markets have accelerated dramatically in 2017](#). While the largest recipients of those flows have been in [market capitalization-weighted](#) strategies, we believe investors may be overlooking a meaningful risk: the role EM government ownership can have on future returns.

Ignoring Risk vs. Managing Risk

When investors allocate outside of developed markets, they inherently accept a fresh set of rules, business conventions and risks. In exchange, they believe their investments will compound at a higher rate of return than similar businesses in the developed world. In our view, the key risk that many overlook when they invest in EM is that a share of equity confers the same rights as their home country. In theory, the board works for shareholders to maximize value. Unfortunately, this is largely an American construct, and making that assumption in other markets could prove costly. Among [megacap](#) companies in emerging markets—so-called national champions—the government retains significant control over not only corporate strategy and decisions, but shareholder rights as well. In our view, being ignorant to this risk is not the same thing as managing it.

Corporate Governance and Oversight

We've written recently about the potentially [troubling issues facing Chinese companies](#) and the formalization of the role of government in their management. The key issue boils down to who the company answer to: the shareholders or government stakeholders. In our view, companies with meaningful government ownership (>20%) are often run as much for government benefit as for their shareholders. Problems arise for investors when these interests are not aligned.

Fundamental Statistics	Market Cap	Sectors		
MXEF Index	MSCI EM	Information Technology	Financials	Consumer Discretionary
Weights		27.6%	23.4%	10.3%
Forward P/E Ratio	13.0x	15.0x	9.4x	18.9x
Long-Term Earnings Growth Estimates	17.2%	20.9%	11.7%	26.4%
Return on Assets	1.9%	9.4%	1.0%	4.0%
Return on Equity	11.3%	16.6%	12.6%	9.8%
Leverage	6.0x	1.8x	12.0x	2.4x
ROE x Earnings Retention	7.4%	11.8%	8.7%	7.3%
Dividend Yield	2.3%	1.5%	2.9%	1.2%

Fundamental Statistics	Ex-State Owned	Sectors		
EMXSOE Index	XSOE Index	Information Technology	Financials	Consumer Discretionary
Weights		33.2%	16.9%	13.7%
Forward P/E Ratio	15.7x	16.9x	11.5x	21.7x
Long-Term Earnings Growth Estimates	19.1%	22.3%	11.8%	28.1%
Return on Assets	2.3%	8.7%	1.0%	4.7%
Return on Equity	12.7%	16.4%	12.0%	11.4%
Leverage	5.5x	1.9x	12.0x	2.4x
ROE x Earnings Retention	8.5%	11.9%	8.4%	8.3%
Dividend Yield	1.8%	1.2%	2.4%	1.1%

Sources: MSCI, WisdomTree, as of 9/30/17. Past performance is not indicative of future results.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

For definitions of terms in the chart, visit our [glossary](#).

In the table above, we contrast the fundamentals of the [MSCI Emerging Markets Index](#) with the [WisdomTree Emerging Markets ex-State-Owned Enterprises \(ex-SOE\) Index](#), along with each Index's top three sectors. Based solely on [forward P/E ratios](#), [ex-SOEs](#) currently trade at a modest premium to market cap. This makes sense given that long-term earnings growth expectations are also higher for less encumbered firms. To access these future higher returns, firms must trade at a slight premium. Put another way, SOEs should trade at a discount based on the risk of government intervention. In our view, this discount is perhaps too low for the risks present in the market, leading to potential excess returns for SOEs. Despite these modest differences, other fundamentals appear broadly in line. The key exception to this appears in the consumer discretionary sector.

Fundamental Focus

Ex-SOEs' [return-on-equity \(ROE\)](#) in this sector is demonstrably stronger than the market. We believe this is largely the result of increased exposure to companies that more effectively and efficiently leverage technology, such as JD.com in retail and Ctrip.com in travel. To be fair, these companies are also included in the MSCI EM Index, but their weights are diminished compared to a more selective index methodology. As a result, investors were able to capture more attractive quality metrics per dollar invested. Additionally, they need not be overly concerned that company profits will be used to plug governmental budget gaps or be subject to shifts in political priorities.

While government ownership can be essential in the early stages of a company's development, our view is that businesses that do reach scale can be most efficiently run for the benefit of shareholders, not the government. While there may be certain instances where government ownership can also benefit shareholders, we believe this remains a significantly underappreciated risk for investors with exposure to emerging markets.

¹For daily holdings of the WisdomTree Emerging Markets ex-State-Owned Enterprises Index, visit our website.

Important Risks Related to this Article

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.

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](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

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.

Mega Cap : Market Capitalization over \$100 Billion.

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.

Forward P/E ratio : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

Ex-SOEs : ex-state owned enterprises or companies that are neither wholly or partially owned and operated by a government.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.