EMERGING MARKET CYCLICAL STOCKS LOOK INEXPENSIVE

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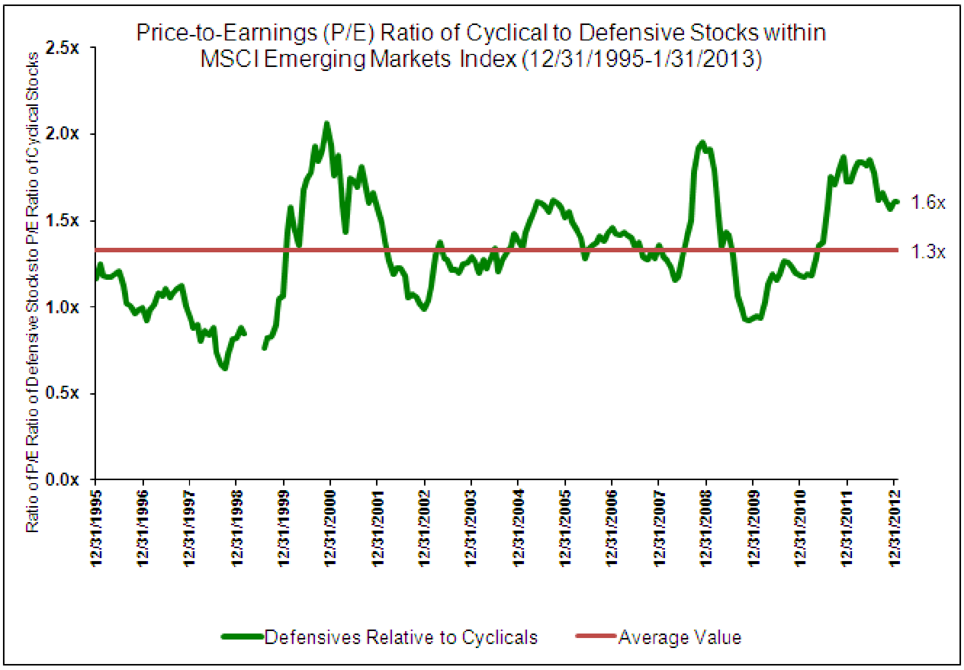
The last blog on emerging market equities discussed my view of being bullish on emerging market equities for 2013 because of relatively attractive valuations and an analysis of forward returns from similarly attractive price points. Yet there are segments within the emerging market equity space that I believe are more attractive than others. The "defensive" stocks in the universe look like they have stretched valuations compared to the "cyclical" stocks. According to a great study on this topic published by Jonathan Garner and his team at Morgan Stanley, for the period from December 31, 1995, to January 31, 2013, "defensive stocks" within the MSCI Emerging Markets Index universe traded at a price-to-earnings (P/E) ratio approximately 1.3x that of "cyclical stocks" from the same universe. The current valuation multiple is 1.6x, which has already started trending down from recent highs of 1.8x.



Source: Morgan Stanley
Past performance is not indicative of future results. You cannot invest directly in an index.

(For definitions of terms in this chart, please see our Glossary.) **Historical Premium for Defensive Stocks** • The P/E ratio for defensives versus cyclicals is likely to remain above 1.0x. Emerging market equities tend to be riskier than equities in other regions in the world, and investors may be willing to pay a higher price to gain exposure to more defensive stocks within this space. • Starting in 2011, emerging market defensive stocks traded at a more significant premium multiple than cyclical stocks. Obviously, this happened before, but there has been a tendency for the relationship to revert toward 1.3x and sometimes well below that level. Put simply, according to the historical relationships exhibited between cyclical and defensive stocks in emerging markets for the period shown in the preceding figure, defensive stocks are currently "too expensive." There are two ways that this situation might correct itself and return to its historical average: • Defensive stocks become less expensive relative to their earnings. • Cyclical stocks become more expensive relative to their earnings. **History Has Shown a Tendency for Correction** Research shows that when defensive stocks have traded at such expensive multiples compared to cyclical stocks in the past, their forward-looking relative performance has suffered: • The 6-month

cumulative underperformance of defensives: -7.8% (meaning they lagged cyclical stocks by this much) • The 12-month cumulative underperformance of defensives: -16.1% (meaning they lagged cyclical stocks by this much) There can be no guarantee that valuations will compress[1] or that this relative performance will always hold, but we believe this research to be a powerful illustration encompassing almost 20 years of returns and historical relationships that Morgan Stanley has identified. **WisdomTree's Current Positioning in Emerging Markets More to Cyclicals** WisdomTree's Emerging Markets Equity Income Index (WTEMHY) undergoes an annual rules-based rebalance, which is based on a screen run on May 31 of each year. As of the most recent rebalance, based on the May 31, 2012, Index screening, the sectors that saw the highest increases in weight at the rebalance were in the cyclical sectors of Energy and Materials, and sectors that received lower weights at the rebalance were in the defensive basket, namely Consumer Staples and Telecommunication Services. At no point during the annual screening does WisdomTree's rebalance process for WTEMHY distinguish between equities that are cyclical and equities that are defensive in nature—the process is purely based on the relationship between dividend growth and price performance over the year leading up to the annual screening date. However, we believe it is worth mentioning WTEMHY's current positioning—specifically, its over-weight toward two sectors that have underperformed for the most recent full calendar year[2]. **Conclusion** While there is no way to know future performance with certainty, history has shown a tendency for defensive stocks within the emerging markets to be about 1.3x as expensive as cyclical stocks on a P/E ratio basis. As of January 31, 2013, this figure was over 1.6x, indicating to us that defensive stocks may be expensive in historical terms. While no guarantee of future performance, this makes us supportive of WTEMHY's current positioning with some of its largest weightings in the Energy and Materials sectors. *For more information on the subject, read our research here.* [1]"Compress" in this context means "become less expensive," observed through a decline in the P/E ratio. [2]Refers to the Energy and Materials sectors within the MSCI Emerging Markets Index for the 2012 calendar year. Source: Bloomberg.

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DEFINITIONS

Defensive stocks : Refers to stocks in the Consumer Staples, Health Care, Utilities and Telecommunication Services sectors.

Cyclical stocks : Refers to stocks in the Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

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.

WisdomTree Emerging Markets Equity Income Index : A subset of the WisdomTree Emerging Markets Dividend Index measuring the performance of the higher-yielding stocks as measured by trailing 12-month dividend yields, weighted by cash dividends.