Rethinking emerging markets: the case for excluding state-owned enterprises

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Key Takeaways

- Faster economic growth in emerging markets has not reliably translated into stronger equity returns.
- Weak governance is a central cause, and the problem is most acute where the state is the controlling shareholder.
- Where the state dominates, political and social objectives can override shareholder interests and trigger regulatory shocks across entire sectors.
- Excluding state-owned enterprises offers a rules-based way to keep emerging market growth exposure while reducing governance risk.
- The AI-led semiconductor cycle has favoured privately managed companies, but the case does not rest on any single theme.

Emerging markets (EM) have long offered investors stronger demographic tailwinds, faster gross domestic product (GDP) growth, and structurally cheaper valuations relative to the developed world. The headline narrative has always been persuasive. The returns, over much of the past two decades, have not been.

Over the past twenty years, EM equities have matched the performance of developed markets excluding the US, despite the developing world delivering substantially stronger economic growth over the same period. The most striking case is China. Despite hosting one of the fastest-growing large economies in history, Chinese equities have delivered an annualised total return of 5%, behind the US at over 9%, over the past two decades[1]. Understanding why economic dynamism has so consistently failed to translate into equity returns helps unlock a more efficient way to invest in emerging markets.

The governance drag: state ownership as a structural risk factor

The central challenge is governance. Across parts of the emerging world, concentrated ownership and weak minority shareholder protections can create conditions in which value is diverted away from outside investors. State-Owned Enterprises (SOEs) are where this problem is most acute.

When the state is the controlling shareholder, the incentive structure of management shifts materially away from profit maximisation. Political and social imperatives such as employment targets, price controls, cross-subsidisation of affiliated entities, and leverage underpinned by implicit government guarantees

routinely take precedence over commercial logic. The value created by underlying economic growth accrues not to shareholders, but to insiders, through what we describe as tunnelling: the systematic diversion of corporate profits to controlling owners.

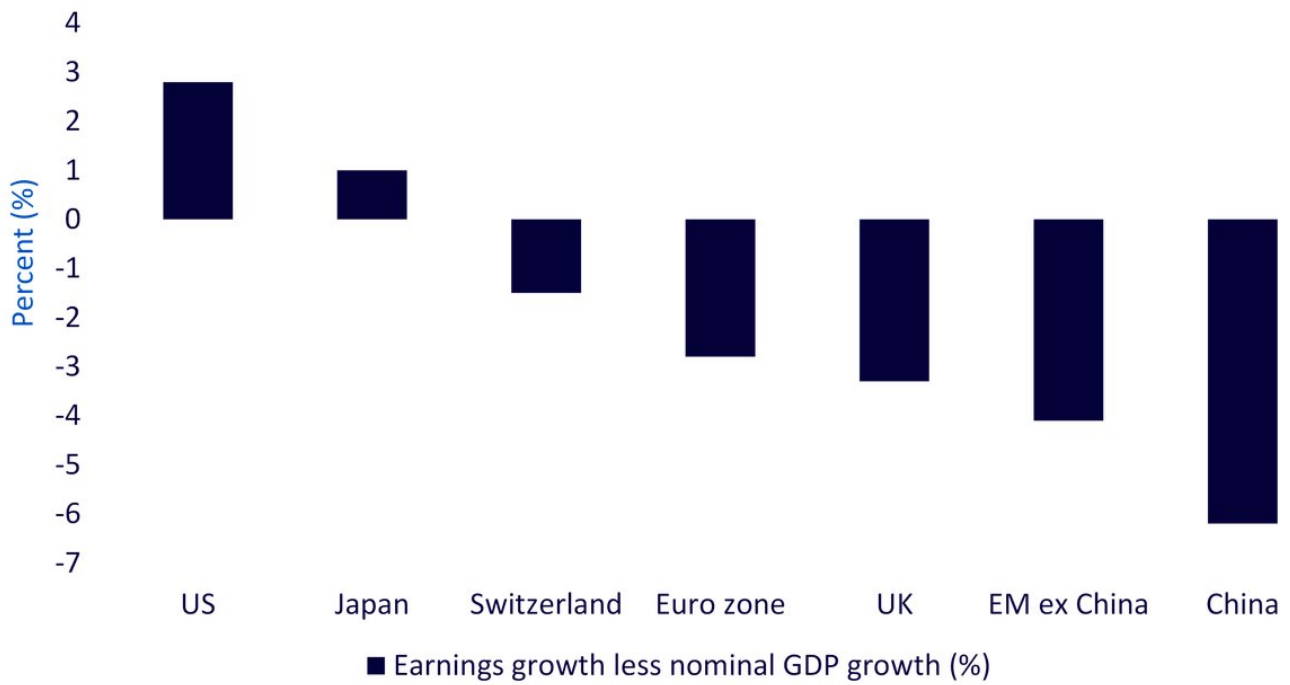
The empirical evidence for the governance premium is compelling. According to a study by the International Monetary Fund, companies with stronger corporate governance and investor protection reduce their vulnerability to global financial crises by about 50%[2]. These stocks are also less volatile and have shown greater resilience during global crises.

Governance failures do not stay contained. In emerging markets, they tend to trigger regulatory shocks that follow. India's mid-2010s surge in non-performing loans within the public-sector banking system was rooted in lax oversight of state-directed infrastructure lending. Brazil's government-backed national champions became vehicles for systemic corruption, as exposed by the Lava Jato investigation. China provides the most instructive case studies.

The 2020-2022 technology sector crackdown reduced the aggregate market capitalisation of Chinese internet companies from approximately US$3.4trn at their peak to US$1.97trn within two years[3]. In China, the education sector Double Reduction policy was even more abrupt: revenues at leading operators collapsed by approximately 70% within twelve months, and a US$120bn listed sector was effectively legislated out of existence in a single policy stroke. The Three Red Lines policy for property developers caused new residential sales to fall by around 50%, triggering a cascade of defaults and bank earnings erosion[4].

Over the past 20 years, corporate revenue growth in China has trailed adjusted nominal GDP growth by approximately 6% annually compared to the broader emerging world where the shortfall averages around 4%. In the US, by contrast, earnings per share growth has exceeded nominal GDP growth by 2.9% per year. The gap is not solely macroeconomic. Structural factors, including state ownership, play an important role.

Figure 1: Corporate revenue growth trails nominal GDP growth across emerging markets



Source: MSCI, IBES, LSEG from May 2006 to May 2026. Please note: GDP measured as composite global nominal GDP weighted according to each market's revenue exposure. **Historical performance is not an indication of future results and any investments may go down in value.**

The implication for allocators is not to abandon the asset class. The structural growth opportunity in the developing world remains substantial. The implication is to own it with greater precision: tilt deliberately towards companies where growth reaches shareholders, and away from those where it is absorbed by the state, diverted to political objectives, or exposed to the regulatory shocks that poor governance consistently generates.

The WisdomTree Emerging Markets ex-State-Owned Enterprises UCITS ETF (Ticker: XSOE) is built around precisely this thesis. By excluding all companies in which a government holds more than 20% of outstanding shares, the fund systematically removes from the portfolio those entities most susceptible to state-directed capital allocation, regulatory interference and value diversion. The ex-SOE filter retains commercially managed businesses that are accountable to minority shareholders and incentivised to convert economic growth into investor returns. The WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened Index (Ticker: EMXSOEUT) is up 19% year-to-date in 2026[5], reflecting the tailwind from non-SOE outperformance. Index performance does not represent the performance of the ETF and does not account for the fund's fees and expenses. Historical performance is not an indication of future results and any investments may go down in value.

How the methodology shapes the portfolio

The fundamental strength of the ex-SOE approach is that it is not contingent on any single market theme. Standard market-cap-weighted EM benchmarks embed significant state ownership by design, because SOEs are frequently among the largest listed companies in their home markets. Investors accessing the

asset class passively are therefore systematically absorbing governance risk without explicitly intending to. XSOE offers a rules-based alternative: a replicable, transparent filter that addresses this embedded structural flaw while preserving the economic growth exposure that makes EM appealing in the first place.

The portfolio implications of the ex-SOE filter are meaningful. State-controlled energy majors, SOE-heavy financial institutions, and government-linked industrial conglomerates are screened out, precisely the parts of the EM universe where earnings are most susceptible to policy direction rather than commercial logic.

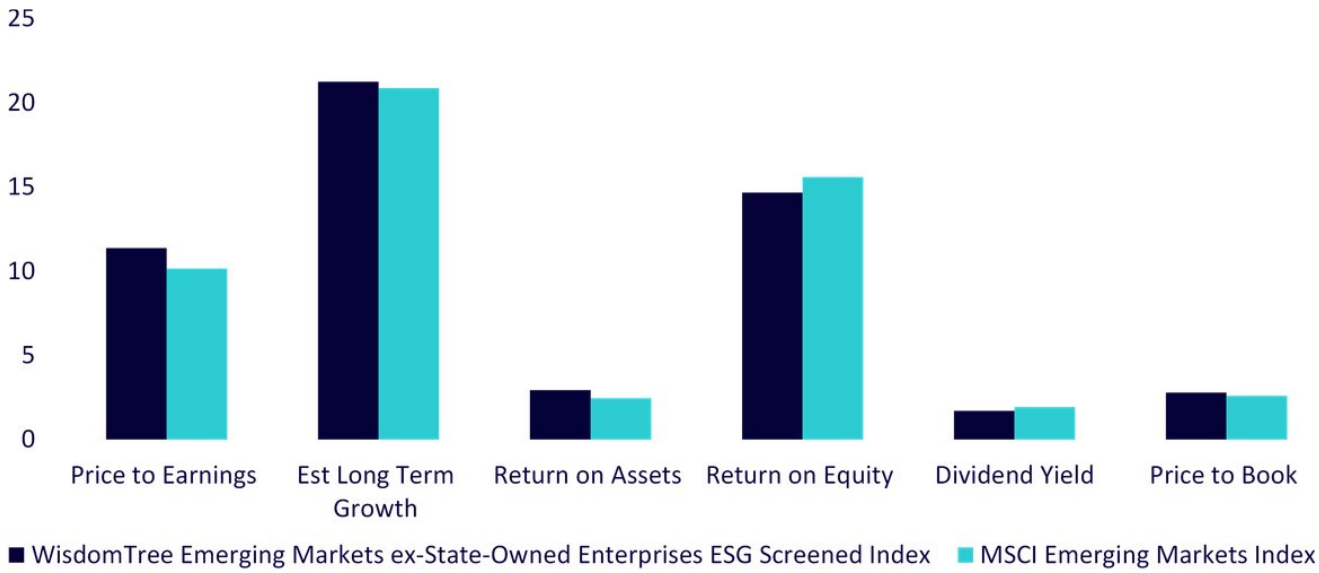
What remains are companies whose capital allocation and governance reflect genuine private-sector discipline, such as TSMC, Samsung Electronics and SK Hynix. Private-sector anchors of the global semiconductor supply chain and primary beneficiaries of the AI-driven capital expenditure cycle pass the screen cleanly. The result is a portfolio that differs materially in its earnings quality, governance profile and return potential from a standard market-cap-weighted EM benchmark.

The additional ESG screen embedded in the underlying the WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened Index (Ticker: EMXSOEUT) provides a further quality overlay, filtering for stronger environmental, social and governance credentials across the remaining investable universe. For institutional investors with responsible investment mandates, this alignment between investment conviction and fiduciary requirements is built into the index architecture.

The current market environment provides an instructive explanation for the margin of advantage. The EM rally over the past year has been led disproportionately by AI-linked semiconductor companies. These are precisely the privately managed, governance-sound businesses that the ex-SOE filter retains. State-Owned sectors including banks, energy companies, and SOE-heavy industrials, have been relative laggards in this cycle. In this regime, the ex-SOE tilt has been a measurable performance driver.

The ex-SOE tilt comes at a modest valuation premium. The index trades slightly above the MSCI Emerging Markets Index on price-to-earnings and price-to-book, with marginally higher estimated long-term growth and a stronger return on assets. Return on equity and dividend yield are slightly lower, the latter consistent with the exclusion of high-payout state-owned banks and energy companies.

Figure 2: Comparison of valuations



Source: FactSet, WisdomTree as of 30 September 2026. **Historical performance is not an indication of future results and any investments may go down in value.**

Conclusion

Emerging markets have never lacked growth. What they have lacked is a reliable mechanism for turning that growth into shareholder returns. State ownership is one of the clearest reasons why, and standard market-cap-weighted benchmarks carry it by default. The WisdomTree Emerging Markets ex-State-Owned Enterprises UCITS ETF offers a transparent, rules-based way to reduce that exposure while keeping the growth that makes the asset class attractive. The AI-led semiconductor cycle has favoured exactly the private-sector companies the filter retains, but the case does not rest on any single theme. It rests on owning companies that are run for the shareholders.

While excluding state-owned enterprises may reduce exposure to certain governance risks, it does not eliminate the broader risks associated with emerging market equities, including political and regulatory uncertainty, currency fluctuations and market volatility. The exclusion of SOEs may also result in sector and country exposures that differ from traditional emerging market benchmarks, potentially leading to periods of underperformance.

[1] Source: Bloomberg Finance L.P. from 29 September 2006 to 29 September 2026.
[2] Source: International Monetary Fund, Global Financial Stability Report, October 2016, Chapter 3: Corporate Governance, Investor Protection, and Financial Stability in Emerging Markets.
[3] Source: Bloomberg Finance L.P, as from 13 December 2020 to 28 October 2022.
[4] Source: Bloomberg Finance L.P. from February 2021 to February 2022 includes New Oriental Education, TAL Education, Xueda Xiamen Education and China New Higher Education.
[5] Source: Bloomberg Finance L.P. from 31 December 2025 to 30 September 2026.

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