Why We Are *Still* Bullish on Emerging Market Equities For 2013

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Emerging market equities had a strong year in 2012, delivering returns in excess of 18%.[1] While we believe emerging markets are currently some of the lone bright spots in terms of global economic growth, emerging market equity performance is certainly not without risk. In 2011, for example, the MSCI Emerging Markets Index was down 18.42%, and in 2008 it was down over 50%.[2] We believe one critical factor for the consideration of emerging market equities is valuation[3]—how expensive are the emerging market stocks?

One important valuation metric concerns comparing prices to the amount of dividends the respective companies pay—or the trailing 12-month dividend yield[4]. Emerging market companies are, by and large, mostly dividend payers. Well over 90% of the weight of the MSCI Emerging Markets Index is in firms that have paid a dividend in the preceding 12 months.[5] With such a growth-oriented focus in the region, it may be easy to forget that such a high proportion of firms in the MSCI Emerging Markets Index pay dividends.

Our research shows that the trailing 12-month dividend yield has been an important valuation indicator for the subsequent performance of the MSCI Emerging Markets Index; and it also shows that trailing 12-month dividend yields similar to today's levels have been associated with strongly positive performance in the past. Of course, past performance is not indicative of future performance, and it is important to remind investors that they cannot invest directly in indexes.

Based on the last 24 full calendar years of data on the MSCI Emerging Markets Index, the current trailing 12-month dividend yield, as of 1/31/2013, would rank as a low price point period. Higher trailing 12-month dividend yields indicate that a greater amount of aggregate dividends has been generated over the past 12 months relative to the current share price, while lower trailing 12-month dividend yields indicate the opposite. In the years following these higher trailing 12-month dividend yields[6], the MSCI Emerging Markets Index generated returns that averaged 33.03%.[7] The average return for all 24 calendar years was 17.47%[8]. During periods that ranked as expensive for emerging markets, the average return was just 1.90%. This dramatic difference, to us, is a significant signal for the best time to own these equities.

This historical analysis is why we would say we are still bullish on emerging market equities for 2013.

[1] Emerging market equities: MSCI Emerging Markets Index for period 12/31/2011 to 12/31/2012; Source: MSCI.
[2] Source: MSCI.
[3] Valuation: Relationship of share prices to earnings per share, dividends per share, or other fundamental factors. Lower valuations indicate greater amounts of earnings or dividends per share.
[4] Trailing 12-month dividend yield: Dividends over the prior 12 months are added up and divided by the current share price. Higher values indicate greater dividends per unit of share price.
[5] Source: Bloomberg, as of 1/31/2013.
[6] This refers to the 12 highest year-end trailing 12-month dividend yields falling above the median observation of 2.25% within the 24 calendar-year complete dataset. The median is the value within a dataset at which 50% of all observations occur above and 50% occur below.
[7] This average represents the average of 12 calendar years of performance for the MSCI Emerging Markets Index that specifically follow a trailing 12-month dividend yield included among the 12 highest values over the period. This is not an average annual value.
[8] 17.47% represents a simple average of each of the 24 calendar years taken individually. This is not an average annual figure.

HOW DOES THE MSCI EMERGING MARKETS INDEX TRAILING 12-MONTH DIVIDEND YIELD STACK UP TO ITS OWN HISTORY?

With respect to comparisons to its own historical levels, our research shows that the starting trailing 12-month dividend yield at the beginning of a calendar year the year had a strong relationship to the subsequent performance observed over the subsequent 12-month period for the MSCI Emerging Markets Index.

The MSCI Emerging Markets Index has 24 full calendar years of index data history for which year-end trailing 12-month dividend yields can be calculated. We divided these years into two baskets sorted by the trailing 12-month dividend yield as of December 31 of each year.

- **"High Dividend Yield Years:" Years in which the starting trailing 12-month dividend yield was above the median[9] trailing 12-month dividend yield for the MSCI Emerging Markets Index. The median trailing 12-month dividend yield was 2.25%.**
- **"Low Dividend Yield Years:" Years in which the starting trailing 12-month dividend yield was below the median trailing 12-month dividend yield for the MSCI Emerging Markets Index.**

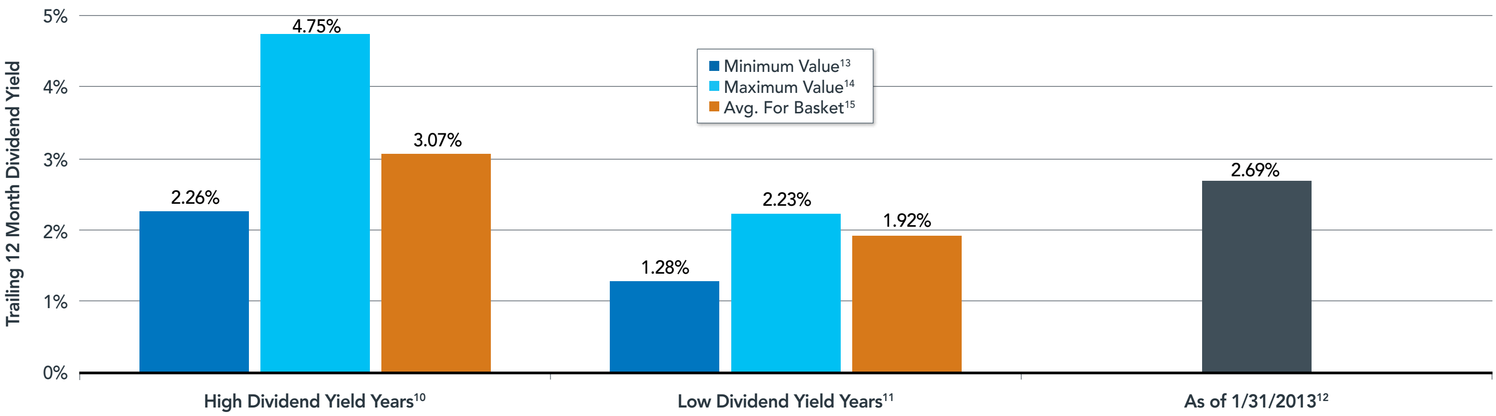
Figure 1 indicates the maximum and minimum trailing 12-month dividend yields observed for the MSCI Emerging Markets Index for both the High and the Low Dividend Yield groups to give an indication of the range of trailing 12-month dividend yields encompassed by each basket. Additionally, we include an average value for each group.

CHARACTERISTIC SUMMARY

- **The average trailing 12-month dividend yield at the start of the high dividend yield years was more than 1 full percentage point higher than the average trailing 12-month dividend yield at the start of the low dividend yield periods.**
- **The trailing 12-month dividend yield as of January 31, 2013, was 2.69%. This value would qualify as a high dividend yield year. Only 6 of the 24 calendar year end-points had higher trailing 12-month dividend yields than that which was shown as of January 31, 2013.**

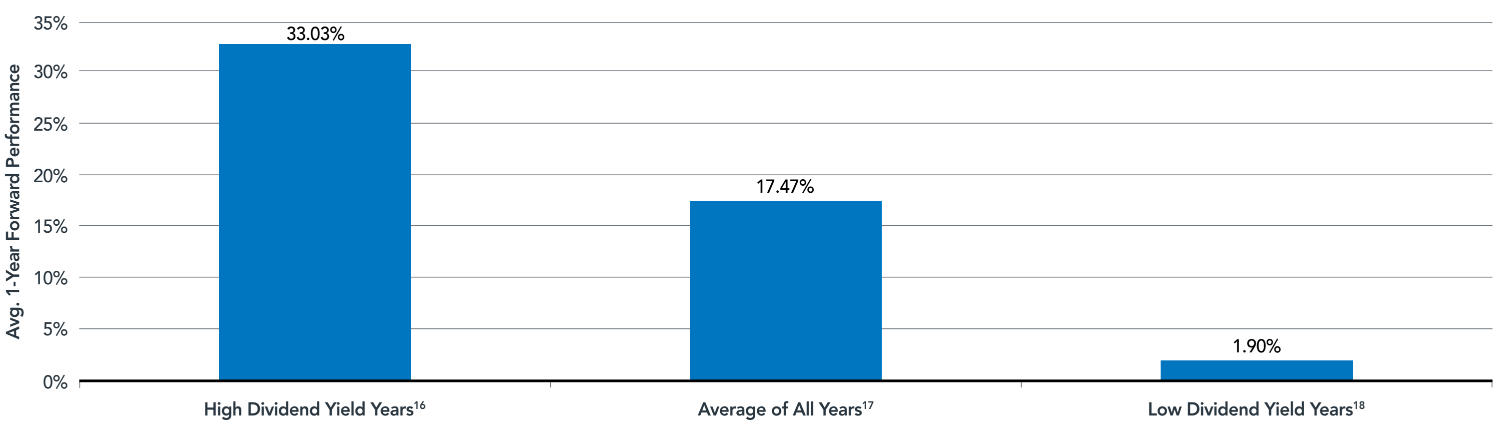
[9] The median is the value within a dataset at which 50% of all observations occur above and 50% occur below.

FIGURE 1: CHARACTERISTICS OF HIGH VS. LOW TRAILING 12-MONTH DIVIDEND YIELD BASKETS [12/31/1988–1/31/2013]



Sources: WisdomTree, MSCI
Past performance is not indicative of future results. You cannot invest directly in an index.

FIGURE 2: PERFORMANCE SUMMARY OF MSCI EMERGING MARKETS INDEX FOR CALENDAR YEAR FOLLOWING HIGH AND LOW TRAILING 12-MONTH DIVIDEND YIELDS [12/31/1988–12/31/2012]



Sources: WisdomTree, MSCI
Past performance is not indicative of future results. You cannot invest directly in an index.

[10] High Dividend Yield Years: Year-end trailing 12-month dividend yields characterized by being above the median of the 24 values.
[11] Low Dividend Yield Years: Year-end trailing 12-month dividend yields characterized by being below the median of the 24 values.
[12] As of 1/31/2013: Trailing 12-month dividend yield of the MSCI Emerging Markets Index as of 1/31/2013; shown as a point of reference since it is not a year-end value and would not be included in either group for the analysis.
[13] Minimum Value: Minimum trailing 12-month dividend yield within the specified group.
[14] Maximum value: Maximum trailing 12-month dividend yield within the specified group.
[15] Average for Basket: Average of the trailing 12-month dividend yields within each group.
[16] High Dividend Yield Years: Average of the 1-year forward performance, taken for each individual 1-year period, following year-end trailing 12-month dividend yields above the median value for all 24 values. This is not an average annual return.
[17] Average of All Years: Average of the 1-year forward performance for all 24 years for which data exists. This is an average of the individual calendar years taken separately, not an average annual return.
[18] Low Dividend Yield Years: Average of the 1-year forward performance, taken for each individual 1-year period, following year-end trailing 12-month dividend yields below the median value for all 24 values. This is not an average annual return.

PERFORMANCE SUMMARY

- **The average performance of the MSCI Emerging Markets Index during years following high dividend yield values was 33.03%, more than 31 full percentage points above the return following low dividend yield years.**
- **The years following high trailing 12-month dividend yields had performances that averaged over 15 percentage points more than the average performance of all 24 calendar years. The years following low trailing 12-month dividend yields on average performed about 15 percentage points worse than the average performance of all 24 calendar years.**
- **Four of the five best yearly return periods for the MSCI Emerging Markets Index followed trailing 12-month dividend yields that ranked among the five highest of all 24 calendar year returns. Notably, at the 2008 year-end, the dividend yield on the MSCI Emerging Markets Index was 4.75% (the highest value) and the 12-month forward return of the index was 79.02% (the highest 12-month forward return).**
- **On the other hand, the lowest observed year-end trailing 12-month dividend yield for the MSCI Emerging Markets Index was observed on December 31, 1999, and it was followed by the second-worst of all 24 yearly returns studied, specifically -30.61%.**

While certainly a valuable illustration of the point—namely that there has been an association between relatively higher or lower trailing 12-month dividend yields and subsequent higher or lower returns in the past—this may not always be the case and should not be viewed as an exact science.

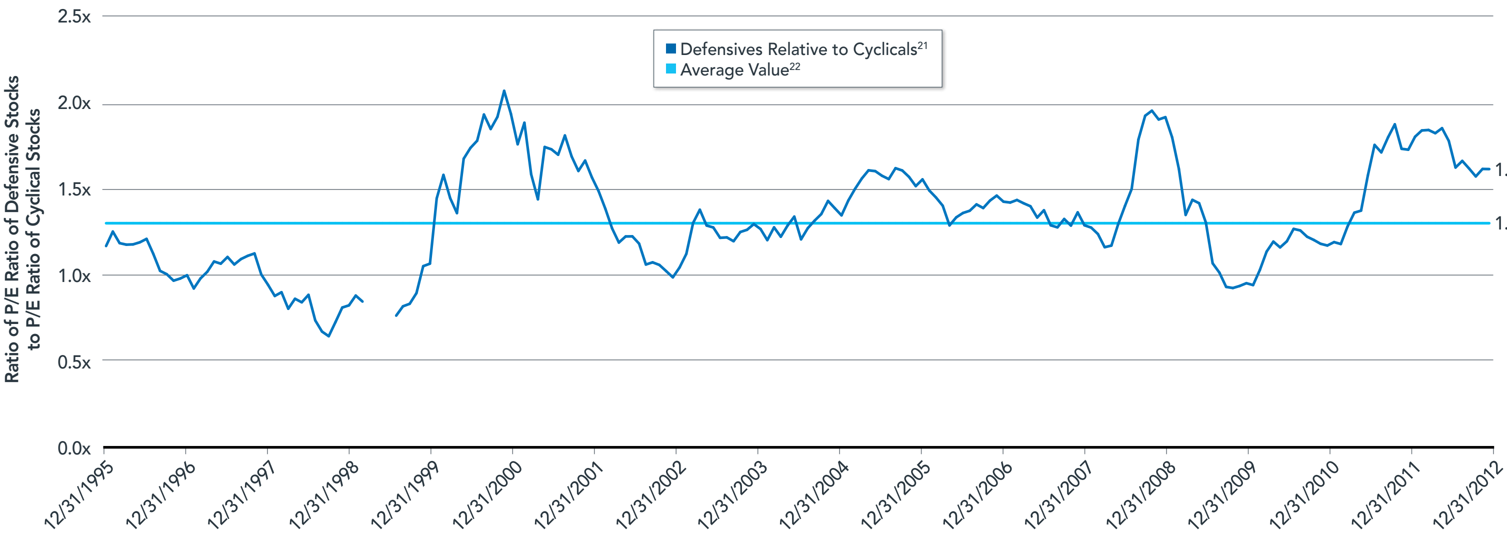
EMERGING MARKET DEFENSIVE STOCKS SHOW EXPENSIVE MULTIPLES

Just as valuation metrics have been a good indicator of emerging market equity performance in general, there is also compelling research that within emerging markets, valuations have been a good guide to the future relative performance of various sectors.

According to a study by Jonathan Garner and his team at Morgan Stanley, which we cite in the text that follows, for the period from December 31, 1995, to January 31, 2013, "defensive stocks" within the MSCI Emerging Markets Index universe have tended to trade at a price-to-earnings (P/E) ratio approximately 1.3x that of "cyclical stocks" from the same universe.[19] This is also of little surprise when one realizes another important statistic cited in this Morgan Stanley research: during 2012, defensive stocks outperformed cyclical stocks by 966 basis points[20].

[19] In this study, "defensive stocks" refers to those within the Consumer Staples, Health Care, Utilities and Telecommunication Services sectors; "cyclical stocks" refers to those within the Energy, Materials, Consumer Discretionary and Industrials sectors.
[20] Basis point: 1/100th of 1 percent.

FIGURE 3: PRICE-TO-EARNINGS (P/E) RATIO COMPARISON OF DEFENSIVE TO CYCLICAL STOCKS FROM WITHIN THE MSCI EMERGING MARKETS INDEX [12/31/1995–1/31/2013]



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

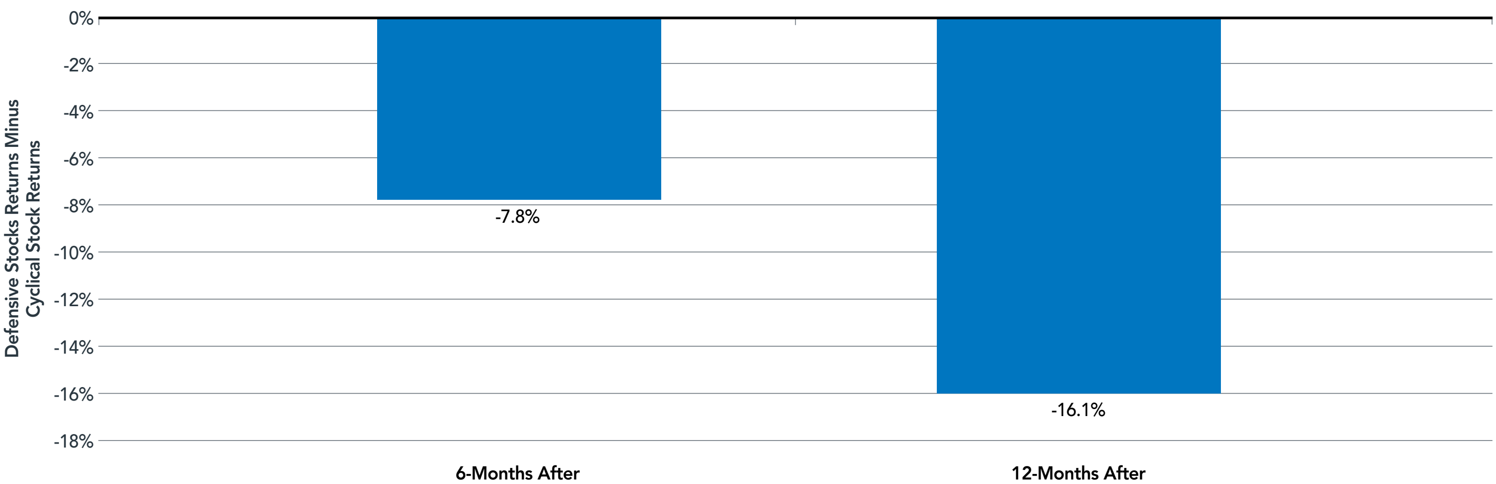
+ **We believe the P/E ratio for defensives versus cyclicals is most likely to remain above 1.0x. Emerging market equities tend to be riskier than equities in other regions in the world, and investors may be willing to pay a higher price to gain exposure to more defensive stocks within this space.**
+ **Starting in 2011, emerging market defensive stocks have been trading at a more significant premium multiple relative to cyclical stocks. Obviously, this has happened before, but there has been a tendency for the relationship to go back toward 1.3x. While there is no way to guarantee that this relationship would occur in the future, historical precedent does certainly exist for the valuation premium to compress back to its historical average.**

Put simply, according to the historical relationships exhibited between cyclical and defensive stocks in emerging markets for the period shown in figure 3, 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.**

[21] Defensives Relative to Cyclicals: The P/E ratio of defensive stocks divided by the P/E ratio of cyclical stocks. Higher values indicate that defensive stocks are rising more in price relative to their earnings per share than are cyclical stocks.
[22] Average Value: The average value of the "Defensives Relative to Cyclicals" values over this period.

FIGURE 4: DEFENSIVES HAVE TENDED TO UNDERPERFORM CYCLICALS OVER THIS PERIOD WITH RELATIVE P/E RATIOS AT THESE LEVELS [12/31/1995–1/31/2013]



Source: Morgan Stanley
Past performance is not indicative of future results.

Morgan Stanley 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:

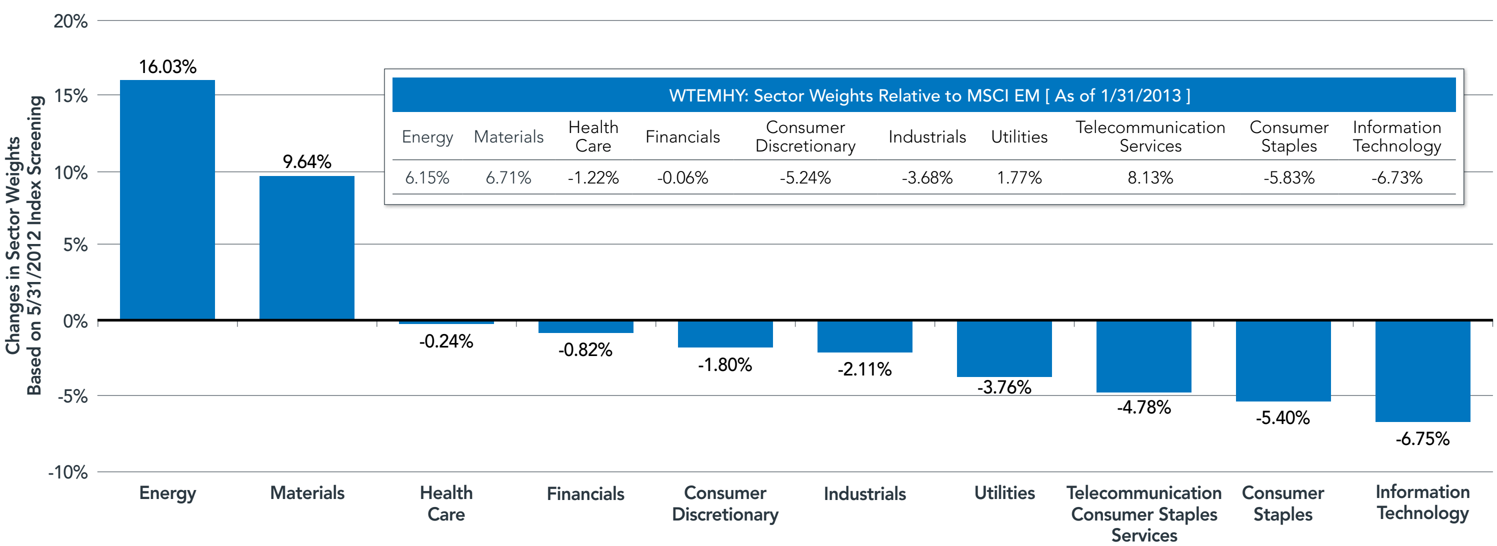
+ **The 6-month cumulative underperformance of defensives: -7.8% (meaning they lagged cyclical stocks by this much)**
+ **The 12-month cumulative underperformance of defensives: -16.1% (meaning they lagged cyclical stocks by this much)**

There can be no guarantee that this will in fact always be the case, but we believe it to be a powerful illustration encompassing almost 20 years of returns that Morgan Stanley has studied.

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 31st of each year. As of the most recent rebalance, based on the May 31, 2012, Index screening, some of 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.

FIGURE 5: WTEMHY INDEX SCREENING CHANGES IN SECTOR WEIGHTS AND SECTOR POSITIONING RELATIVE TO MSCI EM



WTEMHY: Sector Weights Relative to MSCI EM [As of 1/31/2013]

Energy	Materials	Health Care	Financials	Consumer Discretionary	Industrials	Utilities	Telecommunication Services	Consumer Staples	Information Technology
6.15%	6.71%	-1.22%	-0.06%	-5.24%	-3.68%	1.77%	8.13%	-5.83%	-6.73%

Sources: WisdomTree, Bloomberg, Standard & Poor's, MSCI

WisdomTree's rules-based methodology for its equity income Index is designed to help identify the more inexpensively-priced stocks in the emerging markets by its strict screening requirement for selecting the 30% of the dividend-paying stocks with the highest trailing 12-month dividend yields. The methodology identified Energy and Materials stocks as being relatively cheap, as did Morgan Stanley, and many of the defensive stocks as being relatively expensive.

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.[23]

CONCLUSION

Our research shows that the prices of emerging market equities are relatively low, which makes us bullish about the prospects for emerging market equities in 2013. Drilling down further, Morgan Stanley research has showed that emerging market defensive stocks could be relatively expensive compared to their cyclical counterparts. Valuations such as these have tended to be followed by cyclicals outperforming defensives, on average, for 6 to 12 months. With respect to WTEMHY, based on the May 31, 2012, Index screening, two of the larger sector over-weights compared to the MSCI Emerging Markets Index are in Energy and Materials, sectors that are typically considered very cyclically sensitive. We believe that we have reason to remain bullish on emerging market equities and in particular on WTEMHY.

[23] Refers to the Energy and Materials sectors within the MSCI Emerging Markets Index for the 2012 calendar year. Source: Bloomberg

WisdomTree Emerging Markets Equity Income Index: A subset of the WisdomTree Emerging Markets Dividend Index, measuring the performance of the top 30% of stocks with the highest trailing 12-month dividend yields, weighted by cash dividends. MSCI Emerging Markets Index: A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

Unless otherwise stated, data source is WisdomTree.

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