Asian Equities Valued at a Historically Sweet Spot

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In our last market insight, we detailed our bullish views on emerging markets generally, given the attractive prices we were seeing in the region and how a historical analysis showed a favorable return environment following similar price points in history.

In this piece, we take a deeper dive into a very similar analysis by focusing specifically on Asian stocks. Asia is a large regional bloc in the emerging markets—currently representing about 60% of the broader MSCI Emerging Markets Index (EM equities). Asia has a number of desirable attributes:

+ **Population: Most of these countries exhibit a much younger demographic picture than the U.S., Europe or Japan. As they develop and their incomes rise, we see their economies shifting from export-led to more internally driven, consumption-led economic growth.**
+ **Income Convergence: There is a wide discrepancy in the standard of living between Asia and the developed markets. We believe Asia has the potential to catch up and therefore grow at much faster rates than developed economies for an extended period.**
+ **Better Balance Sheets: While governments in the United States, Europe and Japan have high debt-to-Gross Domestic Product (GDP) ratios—in some cases more than 100%—those of Asian countries are much lower, indicating stronger government balance sheets.**

In short, we believe Asia will be a significant engine propelling the global economy forward in the coming years. But what about the more short-run prospects?

Asian equities, defined in this piece as the MSCI AC Asia Pacific ex Japan Index, have outperformed EM equities by nearly 9% over the last 12 months (as of 2/28/13).

We look at historical valuations[1] of Asian equities, and our conclusion is that Asian equities, like the emerging markets overall, are currently selling at relatively low valuations based on historical ranges—and we found these current valuations to be a "sweet spot" for historical 12-month forward returns[2], as we will detail in the analysis below.

[1] Valuation: Relationship of share price to a financial metric, such as dividends per share or earnings per share. Low values mean that there are more dividends or earnings being generated per dollar of share price.
[2] 12-month forward return: Returns for the 12-month period following an observed trailing 12-month dividend yield.

We recognize that while Asian equities may be attractively priced, they also contain higher elements of risk[3] compared to the S&P 500 Index (U.S. equities) or the MSCI EAFE Index (developed international equities). We thus also review potential risk mitigation strategies. One strategy that we find attractive is combining Asian equities with the HSBC Asian Local Bond Index (ALBI) (Asian bonds) to target a risk profile similar to U.S. equities over the past 10 years.

Specifically, we found that one of the classic "60/40" models (approximately 60% Asian equities and 40% Asian bonds) had a similar risk profile as U.S. equities (detailed analysis to follow). This model provides an example of how one might incorporate an allocation to Asia into a standard U.S. equity portfolio with the potential to limit the impact on the overall risk profile.

DIVIDEND YIELD AS A VALUATION METRIC

One important valuation metric compares prices to the amount of dividends the respective companies pay—or the trailing 12-month dividend yield[4]. This is the same analysis that we compiled for EM equities. Asian companies are, by and large, mostly dividend payers. Almost 95% of the weight of Asian equities is in firms that have paid a dividend within the preceding 12 months.[5] As was the case for EM equities broadly, the trailing 12-month dividend yield has been an important valuation indicator for the subsequent performance of Asian equities.

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 results, and it is important to remind investors that they cannot invest directly in an index.

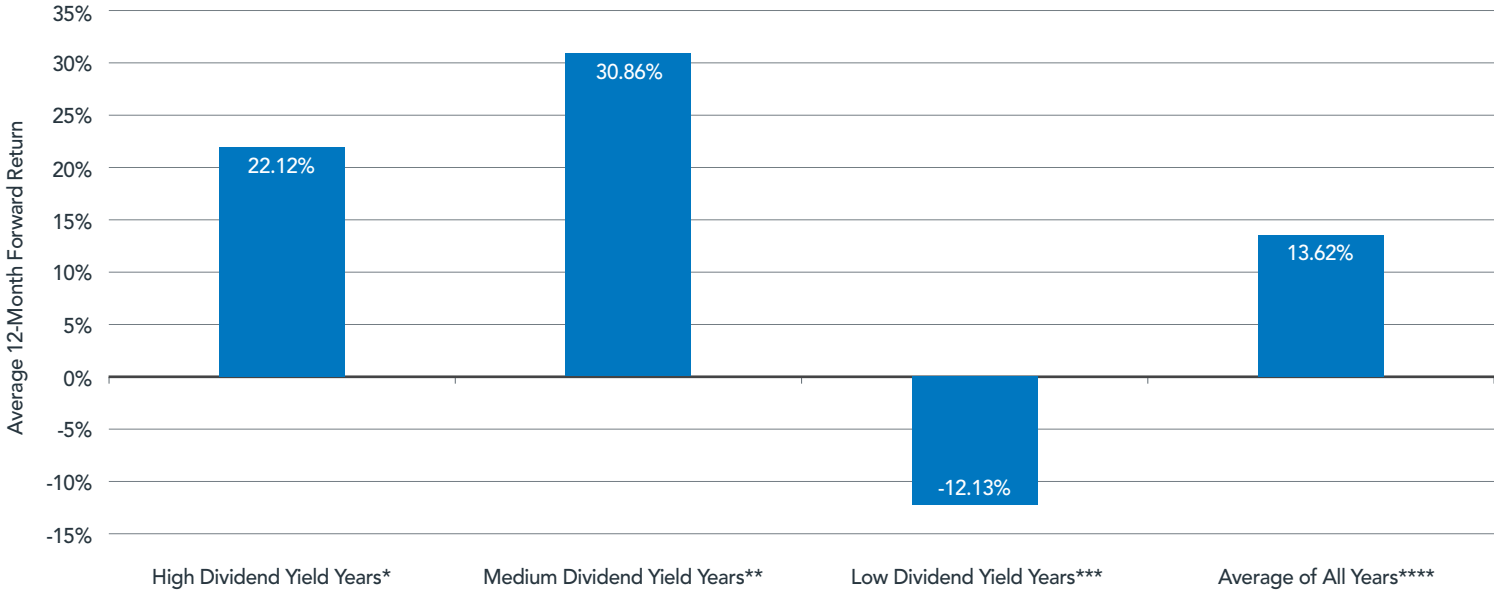
Based on the last 24 full calendar years of data available for Asian equities, we have created three subsets, each with eight component years:

- **High Dividend Yield Years: These comprise the years following the top eight trailing 12-month year-end dividend yields. The highest was 5.60% (12/31/2008), while the lowest was 3.30% (12/31/2005).**
- **Medium Dividend Yield Years: These comprise the years following the middle eight trailing 12-month year-end dividend yields. The highest was 3.26% (12/31/1992), while the lowest was 2.54% (12/31/2010).**
- **Low Dividend Yield Years: These comprise the years following the lowest eight trailing 12-month year-end dividend yields. The highest was 2.52% (12/31/2007), while the lowest was 1.69% (12/31/1999).**

The crucial question we ask is: Were there noticeable differences in average 12-month forward returns following High, Medium or Low Dividend Yield Years, and did these tend to be above or below the average for all 24 years?

[3] Risk: Standard deviation, which measures the dispersion of actual returns about an average value over a particular period. Higher values indicate a higher probability for returns to be farther from this average value.
[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 2/28/2013.

FIGURE 1: PERFORMANCE SUMMARY FOR ASIAN EQUITIES FOR 12-MONTH FORWARD RETURNS FOLLOWING HIGH, MEDIUM 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.
*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 among the 8 highest of all 24 values. This is not an average annual return.
**Medium 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 not among the 8 highest or 8 lowest of all 24 values. This is not an average annual return.
***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 among the 8 lowest of all 24 values. This is not an average annual return.
****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.

STARTING VALUATION IMPORTANT FOR DETERMINING POTENTIAL RETURNS

- **Highest Dividend Yield Periods: The average performance of Asian equities during years following high dividend yield values was 22.12%, nearly 10% higher than the average of all years.**
- **Sweet Spot for Returns: The highest average actually corresponded to the performance of Asian equities during medium dividend yield years: 30.86%, which is more than 17% ahead of the average for all years. This is the range we refer to in the title of this piece—the "sweet spot" for valuations.**
- **Worst Return Periods: The lowest average performance, -12.13%, corresponded to Low Dividend Yield years (or markets being most expensive)—a lag of almost 26% relative to the average for all years.**
- **During the High or Medium Dividend Yield Years, only four of the 16 periods exhibited losses, and the worst return was approximately -16%. The picture looks drastically different for the Low Dividend Yield Years: Five out of eight years saw negative returns, the worst being -51.63%.**

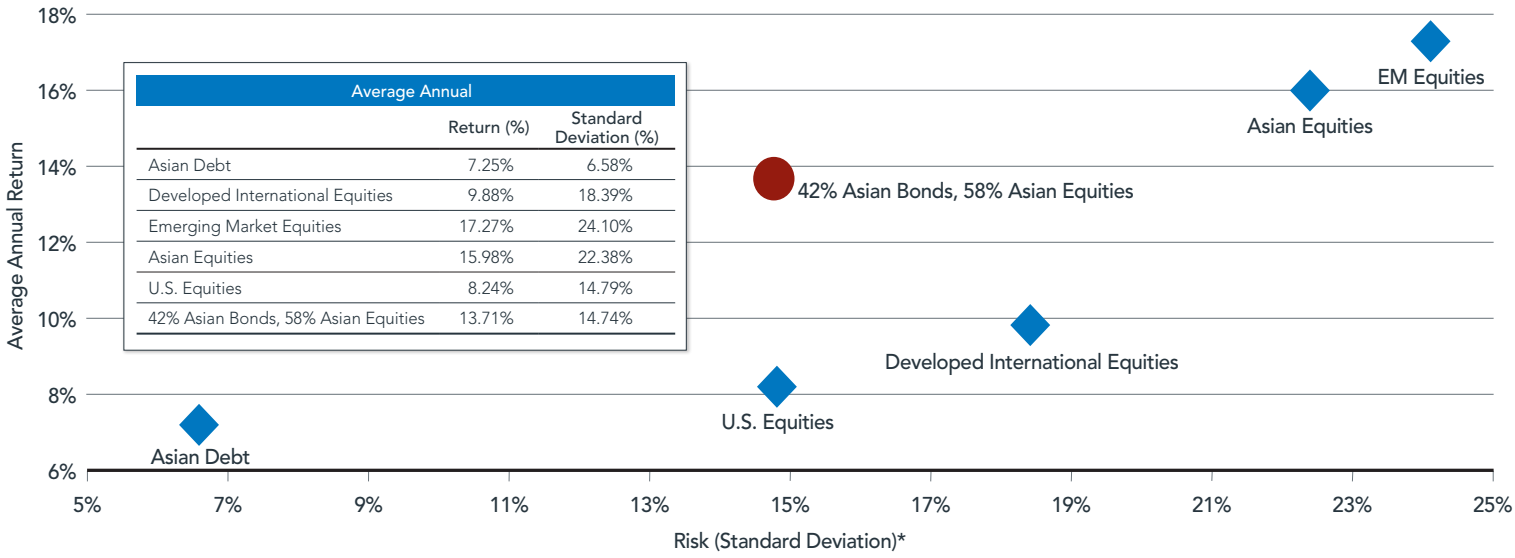
While certainly a valuable illustration of the point—namely that there has been an association between relatively higher or lower trailing 12-month dividend yields and subsequent higher or lower returns in the past—this may not always be the case and should not be viewed as an exact science.

OTHER ASIAN ASSET CLASSES

While we believe the potential for Asian equities is high, given the historical returns analysis just presented, we recognize that Asian equities have higher risk levels than U.S. equities or developed international equities. One way we believe investors can lower the risk of Asian equities is a portfolio framework that combines allocations with Asian debt, another potential avenue for exposure.

Asia's debt—specifically sovereign debt[6]—registered a yield to maturity[7] of 3.59% and a duration[8] of 5.63 years—all while being 94% investment grade as of February 28, 2013.

FIGURE 2: RISK AND RETURN OF ASIAN EQUITIES AND DEBT RELATIVE TO OTHER REGIONAL EQUITY INDEXES
[2/28/2003–2/28/2013]



*Risk (Standard Deviation): Measure of the dispersion of returns about a particular average. A high standard deviation means a higher chance of being farther away from that average during any given time period.
Sources: Zephyr StyleADVISOR, Bloomberg
Past performance is not indicative of future results.

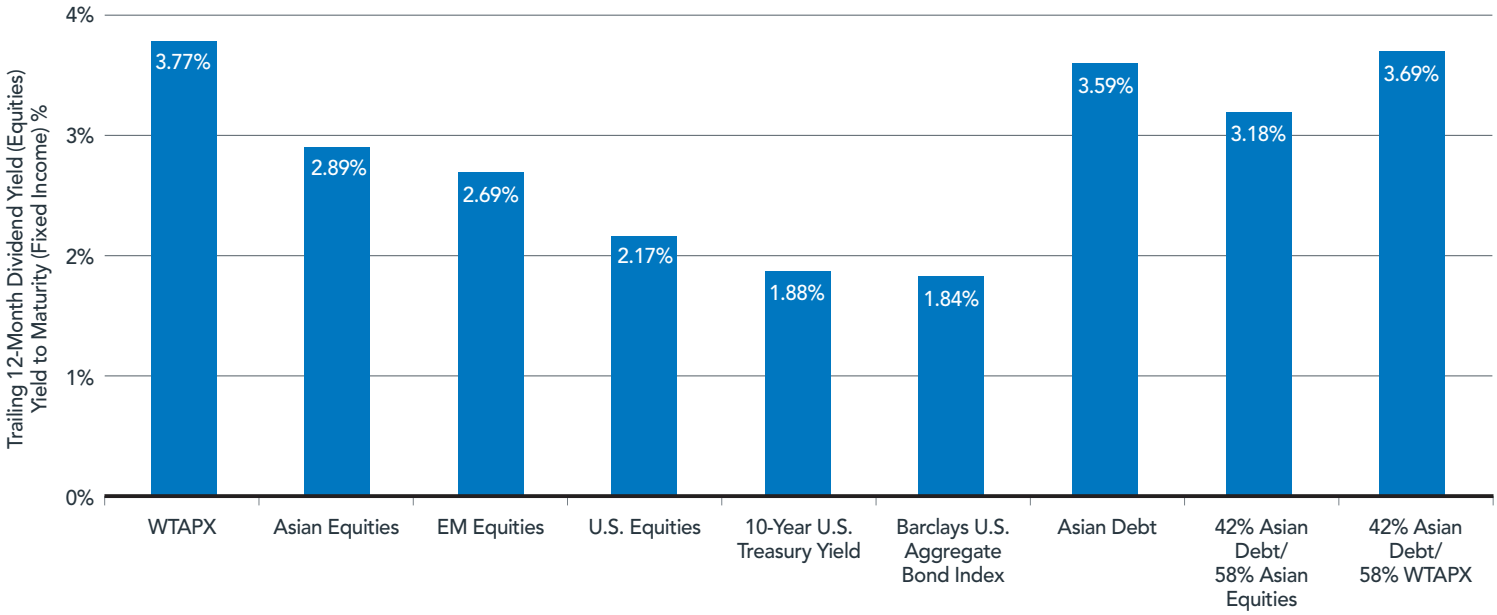
[6] Sovereign Debt: Debt obligation for which interest and principal payments are the responsibility of a government issuer.
[7] Yield to maturity: A measure of bond returns accounting for both the bond's potential price appreciation to its par value and its coupon payments. Higher yields to maturity, barring default, are indicative of greater potential returns.
[8] Duration: A measure of a bond's sensitivity to interest rate movements. Specifically, a duration of 5.63 years indicates that for a 1.00% rise in interest rates, the bond value would be expected to drop approximately 5.63%. Longer duration is indicative of greater sensitivity to interest rates.

+ **Asian debt delivered an average annual standard deviation that was approximately one-quarter that of Asian equities and less than half that of U.S. equities. This risk profile is why combining Asian equities with Asian debt can help target a risk profile similar to that of U.S. equities.**
+ **The combination of 58% Asian equities and 42% Asian debt (very close to a 60%/40% equity/bond model) delivered approximately the same level of average annual standard deviation as exhibited by U.S. equities over the past 10 years. However, the 58/42 equity/bond combination exceeded the average annual return of U.S. equities by nearly 5.5% per year.**

ANOTHER TOOL IN THE SEARCH FOR INCOME GENERATION

In the current low-yield environment for many traditional income-oriented asset classes, we believe it is important to consider the full spectrum of income-producing asset classes. Asian equities and Asian debt are great examples of asset classes that, as of February 28, 2013, provide the potential for a "yield advantage" over U.S. equities, the 10-year U.S. Treasury yield and even EM equities.

FIGURE 3: DIVIDEND YIELD & INTEREST RATE COMPARISON [as of 2/28/2013]



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

WISDOMTREE'S TAKE ON ASIAN EQUITIES

Within Asia's equity markets outside Japan, WisdomTree has developed a methodology to emphasize a dividend-focused exposure with its WisdomTree Asia Pacific ex-Japan Index (WTAPX). WTAPX includes the 300 largest stocks by market capitalization[9] from the dividend-paying universe represented by the same countries as the MSCI AC Asia Pacific ex Japan Index analyzed earlier. These firms are weighted on the basis of the cash dividends they have paid as of the annual screening date, giving greater weight to firms with larger dividend streams. The strict focus on dividend payers and weighting by cash dividends paid gives the Index the potential to increase the trailing 12-month dividend yield relative to the market cap-weighted index of Asian equities.

WISDOMTREE'S TAKE ON ASIAN DEBT

We believe the majority of bond indexes—which are weighted according to the market capitalization of bonds outstanding—have a fundamental problem built into their structure: In essence, the largest debtor—be it a country or a company—garners the highest weight in these indexes. This approach fails to factor in what we believe is one of the most important elements to considering the debt markets, namely the debtor's ability to fulfill its obligation to make timely payments. When we consider the debt markets, we believe in an approach that applies a disciplined fundamental process to determining how weight is distributed. In the case of sovereign debt, this means looking at a country's economic prospects and determining which markets have both enough issuance to provide a liquid market and solid prospects for paying down their obligations. We think that top-weighted positions should not indicate those debtors that have issued the most debt but rather those that appear to have the best prospects for paying back their creditors. This is how we structure our own portfolio that invests in the Asian debt markets.

[9] Market capitalization: Share price multiplied by number of shares outstanding.

CONCLUSION

We believe that Asian asset classes—specifically equities and debt—have the potential to offer an attractive return picture, both because of current valuations and due to longer-term economic trends. In the end, a disciplined process that focuses on calibrating index weights back toward fundamentals and away from either large amounts of issuance or price appreciation could be of particular importance.

Unless otherwise stated, data source is WisdomTree.

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Barclays U.S. Aggregate Bond Index: Widely cited measure of the performance of U.S. investment grade fixed income. MSCI AC Asia Pacific ex Japan Index: An index designed to measure the equity performance of 12 developed and emerging markets within Asia and the Pacific region, outside Japan. Weighting is by market capitalization. S&P 500 Index: A capitalization-weighted index of 500 stocks selected by the Standard & Poor's Index Committee, designed to represent the performance of the leading industries in the United States economy. MSCI Emerging Markets Index: A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. MSCI EAFE Index: A market cap-weighted index composed of companies representative of the developed market structure of 22 developed markets in Europe, Australasia and Japan. HSBC Asian Local Bond Index (ALBI): An index designed to measure the performance of the debt of Asian governments in local currency. WisdomTree Asia Pacific ex-Japan Index (WTAPX): An index designed to measure the performance of the 300 largest dividend-paying companies ranked by market capitalization in Australia, China, Hong Kong, India, Indonesia, Malaysia, New Zealand, the Philippines, Singapore, South Korea, Taiwan and Thailand. Weighting is by cash dividends paid.

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