Are Investors Under-Allocated to India?

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During the first quarter of 2013, while U.S. equity markets attained new record highs, emerging market equities delivered a lackluster performance. However, there can be little question to us that emerging markets will be important engines of future global economic growth. When people consider an emerging market investment, simplifying this potentially complex landscape of options down to two core factors could lead to the following questions:

+ **Single country allocation?**
+ **Broad-based, multi-country allocation?**

As exchange-traded funds (ETFs) have broadened in scope, investors now have various approaches from which to choose the right strategy for them as more options become available for diversified, multi-country strategies as well as for single-country funds.

OUR ASSETS-UNDER-MANAGEMENT (AUM) FIGURES

We have reviewed all the listed ETFs on U.S. exchanges to determine ETFs focused on tracking the performance of equity market indexes specific to single emerging market countries. Throughout this piece, we'll reference AUM in the following format: ("EM Country" AUM) for clarity, and this represents the total assets in U.S. exchange-listed ETFs tracking equity indexes of that country (data source: Bloomberg, as of March 31, 2013). We also limit our study to the top 10 countries by AUM, based on the MSCI classification of 21 emerging markets.

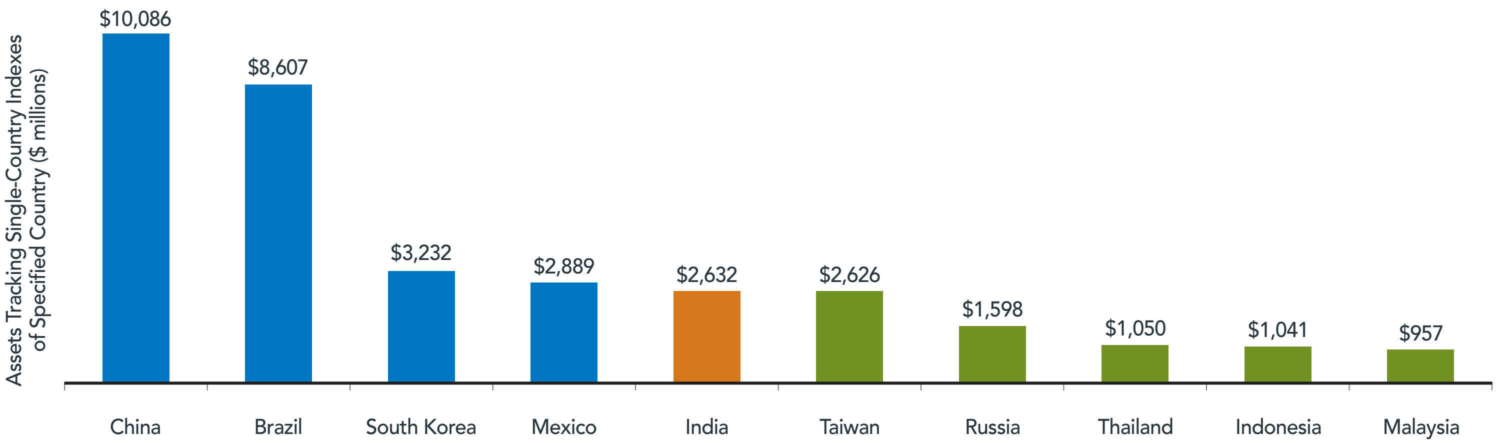
INTRODUCING INDIA

India has the world's second-largest population[1] and one of the best long-term economic growth rates of all emerging market countries[2]. India has an educated workforce and seems to embrace all forms of technology—with, notably, about twice as many cell phone subscribers as there are people in the United States.

But with India being one of the so-called BRIC[3] countries, we have to ask—are investors potentially under-allocating? We believe they are.

[1] Source: CIA World Factbook, July 2013 Population Estimate.
[2] International Monetary Fund, World Economic Outlook, October 2012.
[3] BRIC: Term denoting four of the largest emerging market economies, specifically Brazil, Russia, India and China.

TOP 10: ETF ASSETS TRACKING EMERGING MARKET SINGLE-COUNTRY EQUITY INDEXES



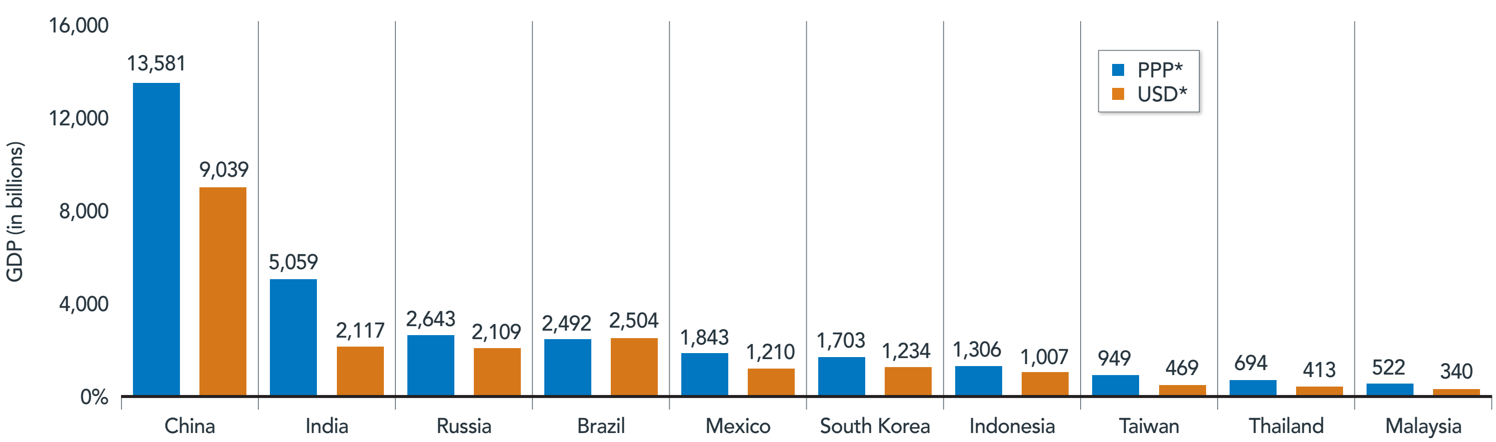
Source: Bloomberg, data as of 3/31/2013.

+ **Brazil & China: China AUM is by far the highest, followed by Brazil AUM. After Brazil, there is quite a drop-off.**
+ **South Korea & Mexico: These countries are not part of BRIC, but the asset picture indicates significant interest. Both are ahead of the other two BRIC country AUMs, India and Russia.**

ASSETS VS. ECONOMIES

China is the second-largest economy in the world, trailing only the United States. Brazil, which had the second-highest AUM figures, is a substantially smaller economy, closer in economic size to South Korea, Mexico, India or Taiwan, all of which are quite similar in size when gross domestic product (GDP)[4] is measured in U.S. dollar terms. While we don't believe that asset levels should directly track economic size, it is interesting to consider whether investors tend to place more money into strategies tracking indexes tied to single-country equity markets within larger economies.

GDP BY COUNTRY IN BOTH U.S. DOLLARS & ACCORDING TO PURCHASING POWER PARITY (PPP) EXCHANGE RATES



Source: International Monetary Fund World Economic Outlook, October 2012.
*Purchasing power parity (PPP) is an economic concept that in simplified form indicates that similar goods should cost similar amounts across different countries. It does not indicate which way an exchange rate between any two currencies should move in the short term, but it could indicate the potential for longer-term appreciation or depreciation. USD indicates that the GDP in local currency for each country has been converted to U.S. dollars in order to make comparisons across economies in one currency.

[4] Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

- **On a PPP basis, India is the second-largest economy on this list behind China. In terms of the comparison between PPP GDP and USD GDP, India's PPP level is more than twice as high—the biggest relative gain of any of the economies shown on this list from making the switch in exchange rate measurement. Ultimately, this indicates to us that India's currency is the most undervalued of all the currencies represented by the economies shown. It doesn't necessarily imply immediate or significant appreciation of India's currency, but we believe that it could be supportive of India's currency over a longer period.**
- **India, Russia and Brazil are very similarly sized on a USD GDP basis. However, Brazil AUM is about five times the size of Russia AUM and about three times the size of India AUM.**

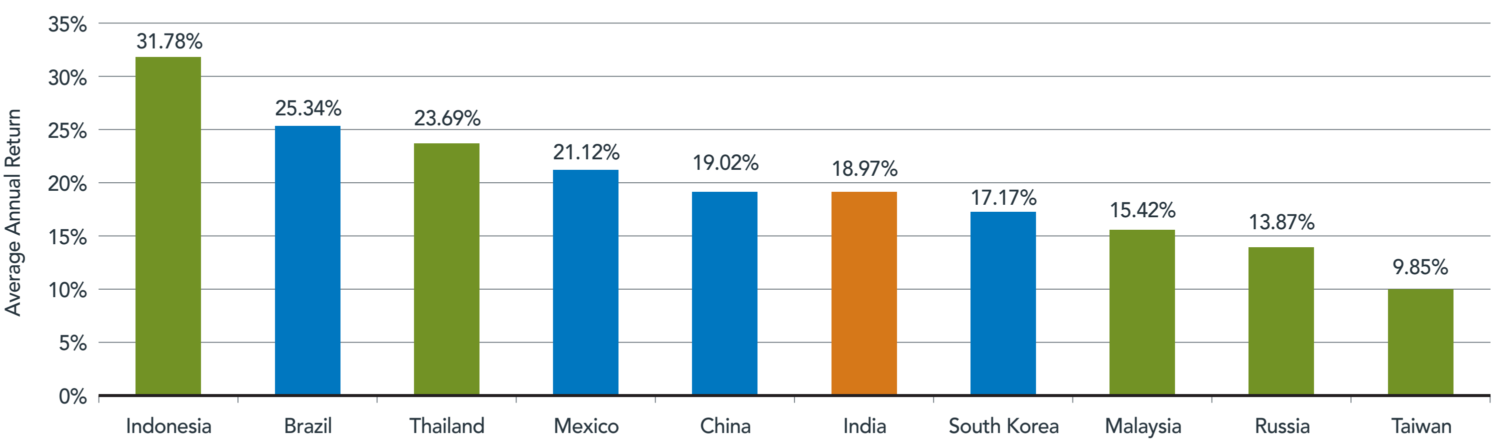
Based on economic size, it makes sense that China AUM ranks first—it's the largest economy on this list by a significant margin, whichever exchange rate measurement is used. However, what makes less sense to us (again, just looking at the GDP data) is that South Korea and Mexico AUM are larger than India AUM and that the margin between Brazil AUM and India AUM is so great. In what follows, we consider a series of factors that may influence these results and we'll try to make the case that the level of India AUM may indicate a meaningful under-allocation.

FACTOR 1: RETURNS

The first stop in considering these ranks must be a consideration of past returns. We know that return-following behavior (i.e., chasing performance) occurs. Therefore, the asset levels might indicate a logical hypothesis: In the past, equity markets in Mexico, Brazil and South Korea must have generated stronger returns than India, and that's why more assets follow equity indexes of these countries.

For this analysis, we looked at the past 10 years and therefore have included both significant bull and significant bear markets. Additionally, for ease of comparison we have selected the MSCI country-specific index of equity performance for each of the 10 countries shown within our prior figures. For more information with respect to these indexes, please see the index definitions at the end of this piece.

AVERAGE ANNUAL RETURNS: 10 YEARS



Source: Zephyr StyleADVISOR.
Period: 3/31/2003 to 3/31/2013. Each country represents the performance of the respective MSCI country index over this period.
Past performance is not indicative of future results. You cannot invest directly in an index.

- **Indonesia Tops the List: Oddly, the country that came in ninth out of the top 10 in terms of AUM came in first in terms of average annual returns over the past decade. In fact, Indonesia was the only equity market to crack 30% on an average annual basis.**
- **Brazil: In our view, Brazil makes sense, in that it ranked second in AUM and had the second-strongest average annual returns of the MSCI country indexes shown. It may be a natural question whether Brazil's performance advantage can continue going forward.**
- **China & Mexico: Interestingly, Mexico's performance was ahead of that of China, and Thailand's was ahead of both Mexico and China.**
- **India Ranks Sixth: India comes in sixth with average annual returns of approximately 19% per year, a figure placing it ahead of South Korea.**

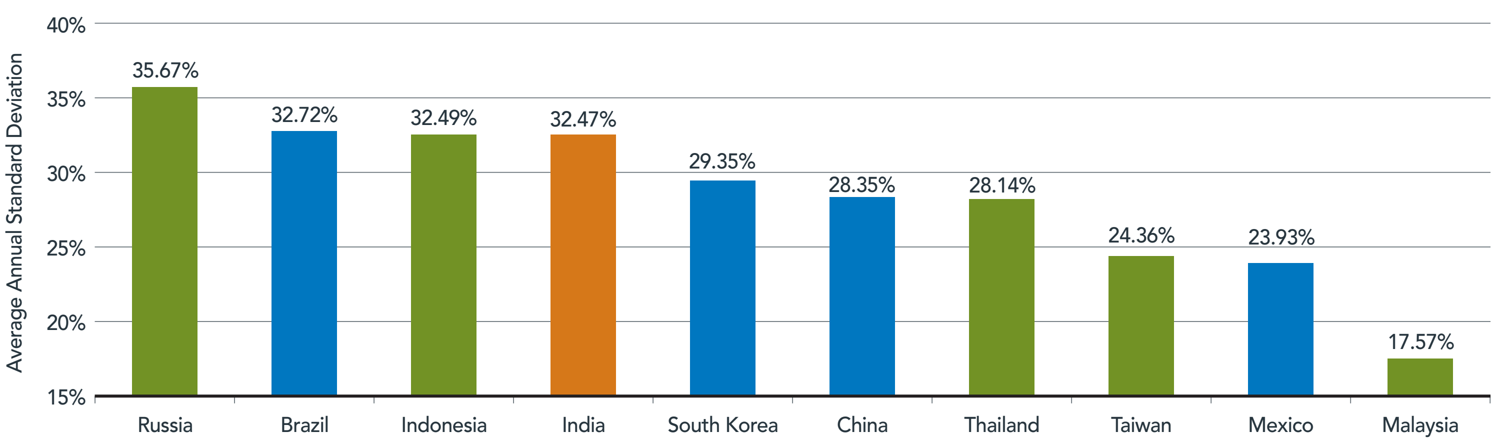
What's clear from these results is that the assets-under-management story may be related to, but is not completely explained by, the returns witnessed in these markets over the past decade. There are likely additional factors at work.

FACTOR 2: RISK

After considering the propensity of investors to chase returns, a secondary (and very logical) consideration regards risk[5]—namely risk avoidance. Maybe India's equities are the most risky, or at least significantly more risky than those of Brazil, South Korea, Mexico and China.

For this analysis, we adhered to the same convention used in the earlier figure: looking at the past 10 years of data and utilizing the respective MSCI country index to measure the average annual standard deviation of each equity market.

AVERAGE ANNUAL STANDARD DEVIATION: 10 YEARS



Source: Zephyr StyleADVISOR.
Period: 3/31/2003 to 3/31/2013. Each country represents the performance of the respective MSCI country index over this period.
Past performance is not indicative of future results. You cannot invest directly in an index.

[5] Risk: Also standard deviation, which measures the dispersion of actual returns around an average value over a specific period. Higher values indicate a higher probability for returns to be farther from this average value.

- **Malaysia Exhibited the Lowest Risk: Malaysia AUM (ranked 10th out of 10) exhibited the lowest average annual standard deviation over the past 10 years—a level that was less than 3% higher than that of the S&P 500 Index. Clearly, investors are not flocking toward the lowest-risk equity market on this list, at least judging by average annual standard deviation over the past 10 years.**
- **Brazil vs. India: Brazil had the second-highest average annual standard deviation of all the countries shown. India is widely known as being a high-volatility equity market, and while investors may use this as part of their rationale to avoid it, Brazil AUM—even given its higher risk levels over the past decade—is about three times higher.**

Of course, this is merely one way to view "risk" in the context of investing, and these emerging market economies certainly are subject to other factors that might be of more concern to certain countries and of less concern to others. Since we're focusing on India, many investors are concerned with what has been characterized as a difficult policy environment. It has been suggested that a more accommodative monetary or fiscal policy could potentially be helpful to encourage investment. Unfortunately, inflation remains stubbornly high—largely due to food prices—and the government already faces a fiscal deficit[6] that inhibits its ability to spend further to stimulate consumption. There is also a current account deficit[7] in India, which relates to the fact that the country tends to import more than it exports. Ultimately, these factors create a tricky macroeconomic picture in that many announcements of government policy, though positive, are not quite positive or clear enough to inspire immediate investment action and a market rally.

That's not to say that the other countries on this list have the perfect solution—they all have their own unique economic issues that market participants need to be aware of.

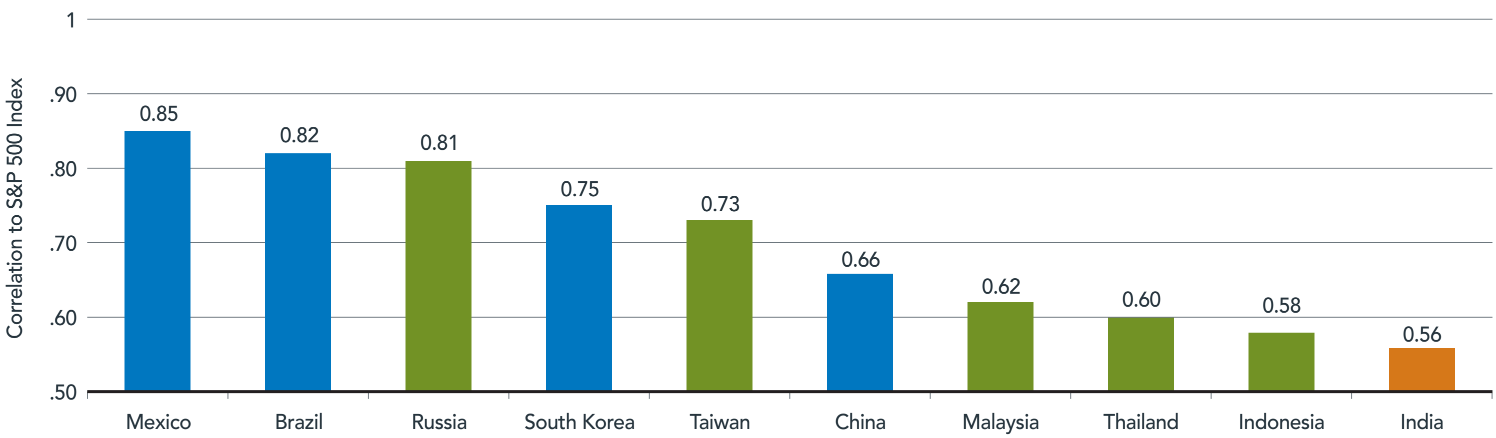
PAUSE: DIVERSIFICATION POTENTIAL

The combination of risk and return over past periods can be said to give a sense of the diversification potential of a particular exposure. One way to measure this is through correlation[8], with lower correlations indicating a greater tendency for two sets of returns to move in different directions at any specific time. Of course, correlation doesn't tell us whether this will occur in any future period, but we believe it is useful to consider its past behavior.

Over the past few years, U.S. equities (shown through the S&P 500 Index) have performed very well, and it is no secret that many U.S. investors have equity portfolios that are heavily biased toward domestic stocks. Therefore, when they consider their exposures outside the U.S., noting the correlation statistic of another index to the S&P 500 Index could be of particular interest. A lower figure could indicate a greater diversification potential had existed over the period in question.

[6] Fiscal deficit: Situation where government spending exceeds government revenue.
[7] Current account deficit: Situation where a country has a greater level of imports than exports.
[8] Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly opposite directions.

MEASURING DIVERSIFICATION POTENTIAL WITH CORRELATION TO THE S&P 500 INDEX



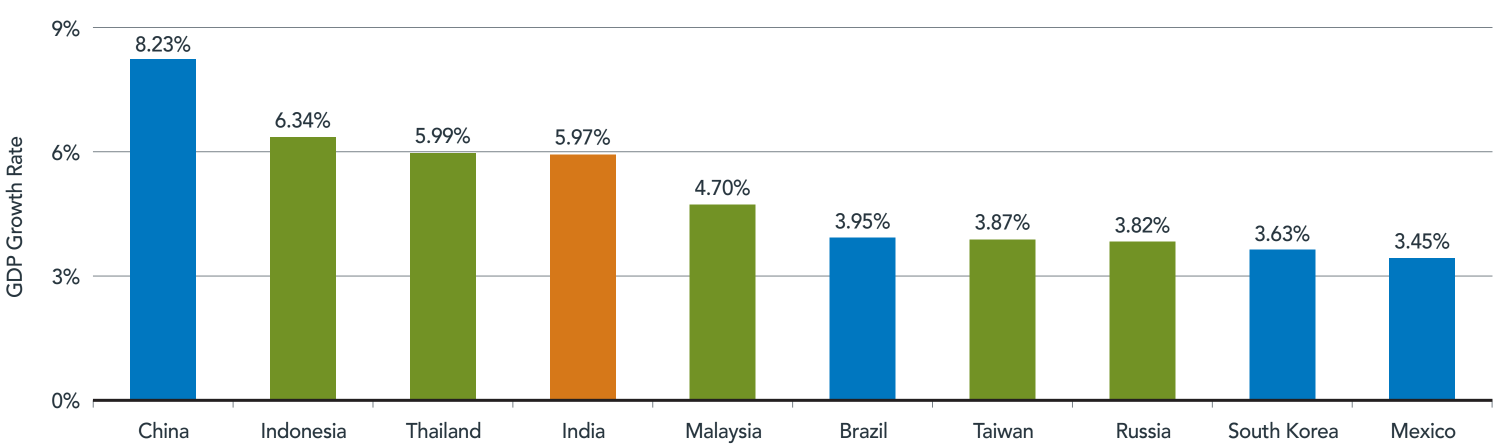
Source: Zephyr StyleADVISOR.
Period: 3/31/2010 to 3/31/2013. Each country represents the correlation of the respective MSCI country index to the S&P 500 Index over this period.

- **Of the countries shown, India had the lowest correlation to the S&P 500 Index over the past three years ending March 31, 2013. That's not to say that these correlation figures are static and that India always has the lowest correlation to the S&P 500 Index of all these other indexes, but we find it interesting that this was the case during a period of particular strength in U.S. equities.**
- **Mexico is notable for its high correlation to U.S. equities. This doesn't necessarily surprise us, given the proximity of the two countries, but it does indicate a potentially lower diversification capability, at least compared to other emerging markets.**

FACTOR 3: ECONOMIC GROWTH

Admittedly, absolute economic size (which we reviewed earlier) is only part of the story, in that at times greater reward goes to those countries that can consistently exhibit strong growth potential. The ideal, of course, is a large economy *and* strong growth.

ECONOMIC GROWTH ESTIMATES FOR 2013



Source: International Monetary Fund, World Economic Outlook, October 2012. Period refers to 12/31/2012 to 12/31/2013 and references the GDP growth estimates of the International Monetary Fund's economists for this period.

+ **India Ranks Fourth: Of the countries shown, India exhibits the fourth-highest GDP growth rate based on International Monetary Fund estimates for 2013. This places it ahead of Brazil, South Korea and Mexico. In fact, by this metric, South Korea and Mexico are ranked 9th and 10th, respectively.**

CONCLUSION

While it is clear that none of our five factors mirror the rankings of the initial assets under management chart, thereby explaining it perfectly, each indicates what we believe is an interesting data point. China is assuredly the economic dynamo, likely garnering its number one position in assets under management on the perception of its economic potential. However, outside of China, the field becomes much more mixed. India makes a particularly strong case against Brazil as being a faster-growing market as well as lower risk over the past 10 years. If there was one surprise country, it probably wouldn't be Brazil, Mexico or South Korea but, rather, Indonesia—an economy with impressive growth potential and greater than 30% average annual returns over the past 10 years.

With the transparency of the growing ETF landscape, it will be interesting to keep track of this list at regular intervals to see if the picture of inflows becomes strong enough to change any of the rankings. China and Brazil are far ahead of the field for the time being, but Mexico and South Korea could be well within reach.

Unless otherwise stated, data source is WisdomTree.

Diversification does not eliminate the risk of experiencing investment losses.

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S&P 500 Index: Market capitalization-weighted index of 500 stocks selected by the Standard and Poor's Index Committee, designed to represent the performance of the leading industries in the United States economy. MSCI China Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the Chinese equity market. MSCI Brazil Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the Brazilian equity market. MSCI Mexico Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the Mexican equity market. MSCI South Korea Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the South Korean equity market. MSCI India Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the Indian equity market. MSCI Russia Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the Russian equity market. MSCI Taiwan Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the Taiwanese equity market. MSCI Malaysia Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the Malaysian equity market. MSCI Indonesia Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of the Indonesian equity market. MSCI Thailand Index: A free float-adjusted market capitalization-weighted equity index designed to measure the performance of Thailand's equity market.

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WIS005197 4/2014