

## The Search for High Quality and Dividend Growth in the Emerging Markets

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In the last few months, WisdomTree has introduced a new family of dividend growth Indexes that cover a spectrum of different equity markets: from large-cap U.S. stocks to U.S. small caps, to global markets outside the U.S., and now an Index dedicated to the emerging markets. The creation of these dividend growth Indexes falls in a time when the market is digesting news from the U.S. Federal Reserve that its unprecedented accommodative easing may be coming to an end. Investors are beginning to contemplate what a higher interest rate environment could mean for high-dividend-yielding stocks, as these have been some of the top performers of the equity market in the last few years.<sup>1</sup>

One surprising element of global equity market performance, to us, has been the subpar performance of the MSCI Emerging Markets Index (EM Equities), which definitely has not kept pace with the S&P 500 Index (U.S. Equities) hitting new highs over the three years ending June 30, 2013. We think the fact that EM Equities have been lagging could present a good opportunity to think about new tools, such as baskets of emerging market dividend growth stocks, that could potentially provide differentiated exposure that adds value to traditional portfolio allocations.

In this Market Insight, we discuss WisdomTree's unique stock selection approach employed in the new WisdomTree Emerging Markets Dividend Growth Index, which are actually the same selection factors and weighting process as used for our U.S. and global ex-U.S. dividend growth Indexes. Below, we'll also have a general discussion on the recent environment for dividends and equity prices in the emerging markets to provide some present-day context on the investment opportunity set represented by this region and asset class.

## THE ENGINE OF GLOBAL GROWTH SHOWING LAGGING EQUITY RETURNS

The emerging markets are known for their strong economic growth potential, driven in large part by favorable demographic traits and an expected convergence of global per capita incomes<sup>2</sup> with the levels of developed countries. In essence, there are large numbers of fairly young people hungry to enhance their standards of living, and as their incomes grow, they should generate greater levels of consumption. We believe there is a high possibility that the emerging market countries will catch up, from an income perspective, with the developed world over the coming decades in a trend central to global economic growth prospects.

Yet despite these favorable long-term economic trends, EM Equities have been among the world's worst-performing markets recently—both in the first half of 2013 and over the last three years. While U.S. Equities have a cumulative 66.2% total return from July 1, 2010, to June 30, 2013 (18.5% per year), EM Equities returned only a cumulative 11.6% over that time frame (just 3.7% per year). The MSCI EAFE Index (Developed Market Equities) rests between U.S. Equities and EM Equities (approximately 10.6% per year).

<sup>3</sup> Source: Bloomberg.

<sup>&</sup>lt;sup>1</sup> Refers to the S&P 500 Consumer Staples, Health Care, Telecommunication Services and Utilities indexes over the period from 6/30/2010 to 6/30/2013.

<sup>&</sup>lt;sup>2</sup> Per capita income: The sum total of goods and services produced in an economy divided by the number of people present in that economy. Higher

numbers indicate more value produced per person.

## WisdomTree Research MARKET INSIGHTS [ July 2013 ]



## FIGURE 1: EM EQUITIES DELIVER LACKLUSTER PERFORMANCE [6/30/2010-6/30/2013]

Source: Bloomberg. Past performance is not indicative of future results.

## DO LAGGING MARKETS CREATE A CONTRARIAN OPPORTUNITY?

One factor related to this lower performance has been a fundamental deterioration in a key metric: trailing 12-month dividends. While U.S. Equities have been buoyed by record-setting three-year average annual dividend growth rates in the double-digit percentages—as well as a one-year cumulative growth rate of 18%, EM Equities experienced a net decrease in dividends over the same one-year period.<sup>4</sup> Going back historically over longer periods, for example 10 or even 20 years, dividend growth rates favor the emerging markets, with the 10-year number (which starts June 30, 2003) being the most favorable for the emerging markets compared to other equity market regions. Certainly, the dividend growth potential is there, but recently the environment has been challenged.



### FIGURE 2: AVG. ANN. TRAILING 12-MONTH DIVIDEND GROWTH OF U.S. EQUITIES VS. EM EQUITIES [6/30/1993-6/30/2013]

Source: Bloomberg. Past performance is not indicative of future results.

<sup>4</sup> Refers to the behavior of trailing 12-month dividends for U.S. Equities and EM Equities over the specified periods through 6/30/2013.

## EQUITY PRICES ARE MORE VOLATILE THAN THE FUNDAMENTALS

Fundamentals, like dividends, are only one element of the picture. One reason we believe a rules-based rebalancing program adds value to the WisdomTree Index methodology is that equity prices contain an element of noise—and that equity prices often fluctuate more than the fundamental fair values<sup>5</sup>.

As an example of this greater volatility<sup>6</sup> in equity prices, we compare the average annual volatility of equity prices to the average annual volatility of a fundamental metric—in this case dividends. Whether one looks at EM Equities or U.S. Equities, the average annual volatility indicates to us that prices exhibit greater movements (both positive and negative) around their average level than do dividends. This is one indication that equity markets tend to overreact to news or events, and we believe this creates opportunities to rebalance a portfolio back to these fundamental metrics, which are less volatile.

## FIGURE 3: EM EQUITIES VS. U.S. EQUITIES—PRICE VS. DIVIDEND BEHAVIOR [6/30/1993-6/30/2013]

		Avg. Ann. Growth			Avg. Ann. Std. Deviation		
Time Period	Equity Region	Price	Dividends	Price to Dividend Multiple <sup>1</sup>	Price	Dividends	
20-year –	EM Equities	5.0%	7.5%	-2.3%	22.6%	16.7%	
	U.S. Equities	6.7%	5.0%	1.6%	16.4%	8.3%	
10-year –	EM Equities	10.9%	13.4%	-2.2%	23.8%	19.3%	
	U.S. Equities	5.2%	7.5%	-2.2%	16.9%	11.1%	

<sup>1</sup> Price-to-dividend multiple: Refers to the index price divided by the trailing 12-month dividends. Sources: Bloomberg, MSCI. Past performance is not indicative of future results.

## YET EMERGING MARKET DIVIDENDS ARE VOLATILE

There is little question that dividend behavior in emerging markets is significantly different from what is typically seen in the United States. The dividend volatility over 20 years was twice as high for EM Equities as it was for U.S. Equities. There is a different mentality in the United States than in the emerging markets when it comes to dividend policies. U.S. companies do not like to raise and lower their dividends; they try to manage their cash flows to maintain a certain dividend per share every quarter. By contrast, in the emerging markets dividend growth often mirrors the behavior of earnings and fundamentals. As earnings fluctuate, dividends tend to fluctuate in the same direction.

<sup>&</sup>lt;sup>5</sup> Fundamental fair value: What the share price of a firm would be if the sole determinant were the behavior of the underlying fundamental factor, an example of which would be the dividend per share.

<sup>&</sup>lt;sup>6</sup> Volatility: Also standard deviation or risk. Measure of 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.

Prices for EM Equities were also more volatile than those of U.S. Equities—with an average annual standard deviation of 22%, compared to 16% for U.S. Equities—which isn't surprising in that these markets tend to respond with great sensitivity to different global events.

We think the volatility of these dividends in EM Equities helps motivate our new dividend growth Index to focus on stocks that rank highly on our proprietary quality and growth selection factors (see below). We believe that our stock selection factors can also potentially help manage the volatility that we see in emerging market *Dividend Streams*<sup>®</sup>.

## THE LINK BETWEEN DIVIDEND GROWTH AND RETURN: VALUATION

While dividend growth has disappointed recently, the emerging markets still possess some of the best prospects for economic growth over the long term.

When investors get overly enthused about growth prospects, there is a tendency to overpay for this potential growth. A few classic examples of such extreme excitement and, thereby, stretched valuation were the 1989 Japan bubble and U.S. technology stocks in the late 1990s—where thoughts about growth potential trumped considerations about prices being paid. Unfortunately, those who ignored valuation in these periods saw lower subsequent total returns as a result.

From this perspective, it is interesting to contrast how valuation multiples have changed with respect to U.S. Equities and EM Equities over the last 10 and 20 years.

Over the last 20 years U.S. Equities have seen trailing 12-month dividend growth of 5.0% and price appreciation of 6.7% per year. This increase in price level was fueled by an expansion in the price-to-dividend ratio—or a valuation multiple of the market that measures the relationship between the index price level and the index's trailing 12-month dividends.

- + When price growth equals dividend growth, there is no change in the price-to-dividend ratio—as dividends didn't become any more or less expensive relative to prices.
- + When dividends grow faster than prices—the price-to-dividend ratio drops and this reflects the markets getting cheaper—there are greater amounts of dividends per unit of prices.

Over these last 20 years, U.S. Equities experienced a valuation expansion of 1.6% per year (prices growing faster than dividends) although much of that was the first 10-year period (from June 30, 1993, to June 30, 2003); over the last 10-year period (June 30, 2003, to June 30, 2013), the U.S. price-to-dividend multiple has contracted by 2.2% per year (meaning that dividends grew faster over this period).

In the emerging markets, the price-to-dividend ratios have contracted over the last 10 and 20 years, as price growth lagged dividend growth by more than 2.2% per year over both long-term periods.

These contracting valuation multiples (dividends becoming less expensive relative to prices) for the emerging markets would be a reason why we believe that these stocks may be becoming attractive from a valuation perspective. The question is: How does one want to capitalize on these opportunities?

## COMBINING A FOCUS ON DIVIDEND GROWTH STOCKS WITH RELATIVE VALUE REBALANCING

WisdomTree believes that a focus on growth-oriented companies must be married with a disciplined focus on valuations, and when we consider dividend growth potential as a component of index methodology, we always marry it with other elements that yield a sensitivity to valuation.

Specifically, WisdomTree uses a rules-based rebalancing program that involves tying Index constituent weights back to the *Dividend Stream*<sup>®</sup> to focus on valuations—as it does in all its dividend-based Indexes. What is unique about this new growth Index methodology is that the selection factors focus on stocks we have identified as important drivers of dividend growth over time. These factors diverge from a sole focus on past dividend growth behavior to determine potential future dividend growth behavior.

## INTRODUCING THE WISDOMTREE EMERGING MARKETS DIVIDEND GROWTH INDEX (WTEMDG): SELECTION CRITERIA AND RATIONALE

- + Starting universe is stocks in WisdomTree Emerging Markets Dividend Index (WTEMI), a universe of 1,210 stocks with a combined market capitalization<sup>7</sup> of \$7.4 trillion as of 6/30/2013.
- + Must have a dividend coverage ratio<sup>8</sup> greater than 1.0x
- + The Index comprises the top 50% of companies with the best combined rank of growth and quality factors from this universe
  - Growth Ranking 50%: Long-term earnings growth expectations<sup>9</sup>
  - Quality Ranking 50%: Evenly split between three-year average return on assets (ROA)<sup>10</sup> and three-year average return on equity (ROE)<sup>11</sup>

Weighting: The Index is dividend weighted to reflect the proportionate share of the aggregate cash dividends.

**Single Holding and Sector Caps:** At the annual rebalance, the following caps apply: No single stock can represent more than 5% of the Index, and no sector or country can represent more than 20%.

<sup>&</sup>lt;sup>7</sup> Market capitalization: Share price x number of shares outstanding.

<sup>&</sup>lt;sup>8</sup> Dividend coverage ratio: Earnings per share divided by dividends per share. Higher numbers indicate a firm has a greater amount of earnings per share relative to its dividend payments.

<sup>&</sup>lt;sup>9</sup> Long-term earnings growth expectations: Compilation of analyst estimates of the growth in operating earnings expected to occur over the next full business cycle, typically three to five years.

<sup>&</sup>lt;sup>10</sup> Return on assets (ROA): Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

<sup>&</sup>lt;sup>11</sup> Return on equity (ROE): Measures a corporation's profitability, revealing how much profit a company generates with the money shareholders have invested.

## FIGURE 4: WISDOMTREE EMERGING MARKETS DIVIDEND GROWTH INDEX KEY CHARACTERISTICS [6/30/2013]

	Long-Term Earnings Growth Expectations	ROE	ROA	Leverage <sup>1</sup>	Earnings Retention <sup>2</sup>	ROE x Earnings Retention
WisdomTree Emerging Markets Dividend Growth Index	14.8%	22.0%	12.1%	1.8x	68.4%	15.1%
WisdomTree Emerging Markets Equity Income Index	7.6%	16.1%	9.2%	1.8x	45.4%	7.3%
MSCI Emerging Markets Index	11.1%	15.8%	7.3%	2.2x	70.7%	11.2%
MSCI Emerging Markets Value Index	9.5%	14.3%	6.4%	2.2x	68.7%	9.8%
MSCI Emerging Markets Growth Index	12.3%	17.7%	8.2%	2.2x	73.2%	12.9%

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

<sup>1</sup> Leverage: Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

<sup>2</sup> Earnings retention: The percentage of a firm's earnings that are not paid out to shareholders in the form of a dividend. Higher numbers indicate greater reinvestment in the firm as a percentage of the firm's total earnings.

Sources: Bloomberg, WisdomTree.

- + Long-Term Earnings Growth Expectations: WTEMDG had earnings growth expectations that were over 3 percentage points higher than the MSCI Emerging Markets Index and 7 percentage points ahead of WTEMHY, which focuses stock selection on the highest-dividend-yielding stocks.
- + ROE & ROA: WTEMDG had significantly higher ROE and ROA than the MSCI Emerging Markets Index or its value and growth subsets. Leverage was also lower. Combined, we believe that these metrics indicate the potential for high-quality exposure to emerging market companies.
- + Earnings Retention: While every constituent of WTEMDG is a dividend payer, on average these firms retained a significant share of their earnings—almost 70%—as a means to invest in future growth. While by no means a certainty, we do believe that earnings retention such as this is a crucial component in determining future potential dividend growth. Earnings that are retained and then utilized efficiently (through a high ROE) could indeed become future dividend payments.

### THOUGHTS ON THE SELECTION FACTORS

The above gives an overview of our Index construction process for WTEMDG as well as some key characteristics in comparison to EM Equities, the MSCI Emerging Markets Growth Index (EM Growth) and the MSCI Emerging Markets Value Index (EM Value). But why do we do it this way? Well, we believe that the combined ranking of earnings growth and quality factors is a key element of our process of identifying stocks with the greatest potential to increase dividends.

**On Earnings Growth Expectations:** We believe that the companies that can grow their earnings have the most potential to raise their dividends, which is why we focus on long-term earnings growth expectations as a factor making up 50% of our selection criteria. Just to note other index providers that also look at earnings growth expectations as part of their classification of growth companies: The Russell family and MSCI family of indexes include a similar earnings expectations variable in their model to determine whether stocks are part of the growth or value indexes.<sup>12</sup>

<sup>&</sup>lt;sup>12</sup> "Russell U.S. Equity Indexes Construction and Methodology," Russell Indexes, March 2013.

On Quality Rankings: We also find that dividend growth companies tend to be considered high quality companies that display above-average quality factors such as return on equity and return on assets. We have used these quality criteria as part of our selection methodology as we believe companies with better profitability metrics are potentially better able to fund growing dividend distributions to their shareholders.

Some investors who focus on quality metrics rely on just the return on equity as a key gauge of profitability. We also include return on assets to penalize companies that provide high returns on equity predominantly through the use of leverage. This is because the difference between return on equity and return on assets actually comes down to leverage. The math works as follows.

- 1) Return on Equity (ROE) = Profits / Equity.
- 2) Return on Assets (ROA) = Profits / Assets
- 3) Leverage = Assets / Equity
- 4) ROE = ROA x Leverage, or, for those who like to see a formula: (Profits / Equity) = (Profits / Assets) x (Assets / Equity); the red "Assets" cancel each other out, and one is left with simply (Profits / Equity) or ROE.

Others Who Look at Quality: Warren Buffett often says in his annual letters that he looks for "businesses earning good returns on equity while employing little or no debt." Since high leverage implies the use of debt, using a quality ranking that incorporates both return on equity and return on assets enables us to mitigate the use of leverage as a sole driver of ROE.

Companies that achieve a high return on assets are often able to grow their business without needing large capital expenditures. This frees more of their profits to be returned to their shareholders in the form of dividends.

Since Warren Buffett is one of the most vocal proponents of using quality metrics as stock selection criteria, below we give you some of his insights on the topic. The final quote is from Charlie Munger, Buffett's long-time business partner.

Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down.

- Warren Buffett, Berkshire Hathaway Inc., Annual Report, 2008.

It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price.

- Warren Buffett, Berkshire Hathaway Inc., Annual Report, 1989.

"We've really made the money out of high quality businesses . . . If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result."

- Charlie Munger at USC Business School in 1994.

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## **RETURN ON EQUITY AND THE DIVIDEND DISCOUNT MODEL**

Moreover, in the finance literature, return on equity is critically linked to dividend growth and intrinsic value of companies through the dividend discount model (DDM).<sup>13</sup> The DDM model for stock valuation states: The **value of a stock = DPS(1) / (R-G)** 

## Where

- + DPS(1) = Dividends per share expected to be received in one year
- + R = The required rate of return for the investment
- + G = Growth rate in dividends = ROE x earnings retention (or 1 minus dividend payout ratio)

The growth rate equals the return on equity times the reinvestment rate; in other words, the growth of dividends is determined by what fraction of earnings is put back into the firm and how profitable those earnings are.

The earnings retention variable measures how much capital builds up shareholder equity, and the return on equity measures the growth in earnings that results from that reinvestment. A sustainable growth rate in dividends is thus critically linked to the returns on equity.

## DIFFERING EXPOSURES IN EQUITY INCOME AND DIVIDEND GROWTH FOR THE EM

This new Emerging Markets Dividend Growth Index is, of course, not the first dividend-focused index WisdomTree created for the emerging markets opportunity set. Our first Index—the WisdomTree Emerging Markets Equity Income Index, which now has a sixyear live history, focused on stocks with the highest dividend yields. The last six years involved two strong down markets, in 2008 and 2011, that stress tested the high-yield selection and weighting methodology of the equity income index.

The beta of the EM Equity Income Index has been 0.81 since its inception . High-dividend-yield stocks are often thought of as having lower volatility and lower beta, and this Index's live track record has borne that out. But in the last few years, the exposure to more cyclical sectors has increased as their dividend yields have increased. Notably, energy and materials stocks , which have the two highest betas of the 10 sectors , constitute 17% and 19.7%, respectively, of WTEMHY as of June 30, 2013, and have contributed to WTEMHY's increased beta. WTEMHY's rules-based process has identified these sectors as being less expensive in terms of the relationship between the dividends per share and the share prices of their constituents, and this process is positioning the Index for a potential rebound in these sectors.

### POSITIONING OF DIVIDEND GROWTH VS. VALUE

The EM Dividend Growth Index is new and has a very different stock, sector and country composition than WTEMHY.

For starters, there is not much overlap between WTEMHY and WTEMDG. As of June 30, 2013, the two Indexes shared only 41 constituents out of a total of 382 for WTEMHY and 253 for WTEMDG.

<sup>&</sup>lt;sup>13</sup> William L. Silber & Jessica Wachter, "Equity Valuation Formulas," New York University, 2013.

<sup>&</sup>lt;sup>14</sup> Sources: Bloomberg, Zephyr StyleADVISOR. Measured against the MSCI Emerging Markets Index for the period from 6/1/2007 to 6/30/2013.

<sup>&</sup>lt;sup>15</sup> Refers to those stocks in the MSCI Emerging Markets Energy and Materials indexes.

<sup>&</sup>lt;sup>16</sup> Sources: Bloomberg, Zephyr StyleADVISOR. Betas are calculated for the MSCI Emerging Markets Energy and Materials indexes against the MSCI Emerging Markets Index and then ranked against the 10 MSCI Emerging Markets sector indexes.

- + The common constituents represent only 17% of the weight of WTEMHY, which means that most of WTEMDG's stocks are additive and new compared to 83% of WTEMHY.
- + The common holdings represent 33% of WTEMDG, meaning two-thirds of its weight is not in WTEMHY and would be completely additive exposure.

While WTEMDG does not have a history of past performance to examine, we can calculate a combined beta of the Index based on the historical volatility of its underlying components. Rather than being an exact measure, we view this as a way to gauge the collective volatility of the stocks being selected.

The figure comes out to 0.92 for WTEMDG versus 1.03 for WTEMHY, which may imply that the expected volatility of the new growth Index is lower than the expected volatility of the high-dividend-yield Index. Of course there is no way to know how this will play out in the future, but we believe it is of interest to point out that two completely different Index methodologies are picking very different mixes of underlying stocks.

## FIGURE 5: SECTOR WEIGHTS AND UNDERLYING BETAS [ as of 6/30/2013 ]

	Sector Exposures			Sector Betas <sup>4</sup>		
Index	Energy, Materials & Financials <sup>1</sup>	Defensive Sectors <sup>2</sup>	Consumer Sectors <sup>3</sup>	Energy, Materials & Financials <sup>1</sup>	Defensive Sectors <sup>2</sup>	Consumer Sectors <sup>3</sup>
WT Emerging Markets Dividend Growth Index	35.1%	42.1%	28.4%	1.13	0.74	0.80
WT Emerging Markets Equity Income Index	62.0%	26.3%	5.3%	1.17	0.70	0.81
FTSE Emerging All Cap ex-Taiwan Diversified Capped Div Growth 50 Index	55.6%	30.0%	19.0%	1.12	0.76	0.83
Dow Jones Emerging Markets Select Dividend Index	40.3%	31.8%	13.5%	0.98	0.86	0.81
S&P Emerging Markets Dividend Opportunities Index	42.6%	39.0%	3.4%	1.15	0.84	0.82
MSCI Emerging Markets Index	47.9%	22.4%	18.0%	1.11	0.75	0.88

Sources: WisdomTree, Standard & Poor's, Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index. Sectors subject to change.

<sup>1</sup> Energy, Materials & Financials: These sectors tend to be among the more globally sensitive, with exposures that have typically been of relatively higher volatility. <sup>2</sup> Defensive sectors: Comprising Consumer Staples, Health Care, Telecommunication Services and Utilities.

<sup>3</sup> Consumer sectors: Comprising Consumer Staples and Consumer Discretionary.

<sup>4</sup> Sector betas: Calculated as the beta of those stocks in each respective sector grouping for each Index measured against the MSCI Emerging Markets Index. Values above 1.00 indicate greater volatility than the MSCI Emerging Markets Index, the benchmark used in the calculation. Beta is a Measure of the volatility of an index or investment relative to a benchmark. A reading of 1.00 indicates that the investment has moved in lockstep with the benchmark; a reading of -1.00 indicates that the investment has moved in the exact opposite direction of the benchmark.

The primary means through which WTEMDG exhibited the lowest combined weighting to Energy, Materials and Financials is through its lower allocation to the Energy and Financials sectors. The largest over-weighted position in the new WTEMDG vs. WTEMHY is the 20% position in Consumer Staples stocks, which have a 0.75 beta vs. EM Equities; this sector receives a marginal

<sup>&</sup>lt;sup>13</sup> William L. Silber & Jessica Wachter, "Equity Valuation Formulas," New York University, 2013.

<sup>&</sup>lt;sup>14</sup> Sources: Bloomberg, Zephyr StyleADVISOR. Measured against the MSCI Emerging Markets Index for the period from 6/1/2007 to 6/30/2013.

<sup>&</sup>lt;sup>15</sup> Refers to those stocks in the MSCI Emerging Markets Energy and Materials indexes.

<sup>&</sup>lt;sup>16</sup> Sources: Bloomberg, Zephyr StyleADVISOR. Betas are calculated for the MSCI Emerging Markets Energy and Materials indexes against the MSCI Emerging Markets Index and then ranked against the 10 MSCI Emerging Markets sector indexes.

weight in WTEMHY, at only a 2%, as its dividends are lower relative to its prices. The other significantly over-weighted sectors (Consumer Discretionary, Technology) also have expected betas of 0.92.



## FIGURE 6: SECTOR EXPOSURES OF WTEMDG MINUS WTEMHY [as of 6/30/2013]

Sources: WisdomTree, Standard & Poor's. Past performance is not indicative of future results. Sectors subject to change.

The sector exposures discussed above are intertwined with the country exposures. For instance, we mentioned that WTEMHY has a large position in energy stocks that have a higher beta, and many of those stocks happen to be found in Russia, which is the largest country position in WTEMHY. On the other hand, with respect to relative country weighting, Russia is the third-largest under-weight position in WTEMDG vs. WTEMHY. In fact, only Taiwan and China are more significant under-weights—and all three receive at least 7 percentage points less weight in WTEMDG than they do in WTEMHY. China and Russia are two of the higher beta countries and help explain the lower beta of WTEMDG.<sup>17</sup>

The countries that receive the greatest over-weight in WTEMDG vs. WTEMHY are Indonesia, Mexico and Thailand, each with over 10% weight in WTEMDG and each at least 5 percentage points over-weight compared to WTEMHY. The stocks in WTEMDG from Indonesia and Thailand have expected betas of .75 and .73, respectively, and again help motivate the different beta positions of WTEMDG vs. WTEMHY.

The Emerging Markets Dividend Growth Index gives more weight to Mexico, Indonesia and Thailand ("MIT") than it does Brazil, Russia, India and China (the "BRIC" countries). By contrast, the MSCI Emerging Markets Index gives almost four times more weight to BRIC countries than to MIT.

South Korea and Taiwan are two other countries that often get mentioned as being on the fringe of being developed countries rather than truly emerging market countries—combined, they represent just over one-quarter of the weight of the MSCI Emerging Markets Index. These two countries represent less than 10% of the WisdomTree Emerging Markets Dividend Growth Index.

<sup>&</sup>lt;sup>17</sup> Source: Bloomberg. Beta is calculated collectively for the Russian and Chinese companies in the MSCI Emerging Markets Index versus the broad MSCI Emerging Markets Index benchmark and compared to that of the collective holdings in other countries. As of 6/30/2013, the Russian and Chinese stocks exhibited some of the highest values.

	Country Exposures			Country Betas <sup>1</sup>		
Index	BRIC	South Korea & Taiwan	Mexico, Indonesia, Thailand	BRIC	South Korea & Taiwan	Mexico, Indonesia, Thailand
WT Emerging Markets Dividend Growth Index	34.9%	7.3%	35.9%	1.07	0.89	0.81
WT Emerging Markets Equity Income Index	46.9%	16.2%	8.7%	1.21	0.85	0.76
FTSE Emerging All Cap ex-Taiwan Diversified Capped Div Growth 50 Index	41.8%	0.0%	25.5%	1.15	N/A	0.86
Dow Jones Emerging Markets Select Dividend Index	23.7%	32.7%	9.9%	1.14	0.81	0.74
S&P Emerging Markets Dividend Opportunities Index	34.5%	24.2%	6.5%	1.20	0.94	0.57
MSCI Emerging Markets Index	42.1%	26.7%	11.3%	1.09	1.04	0.86

## FIGURE 7: COUNTRY WEIGHTS AND UNDERLYING BETAS [as of 6/30/2013]

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

<sup>1</sup> Country Betas: Calculated as the beta of those stocks in each respective sector grouping for each Index measured against the MSCI Emerging Markets Index. Values above 1.00 indicate greater volatility than the MSCI Emerging Markets Index, the benchmark used in the calculation. Beta is a Measure of the volatility of an index or investment relative to a benchmark. A reading of 1.00 indicates that the investment has moved in lockstep with the benchmark; a reading of -1.00 indicates that the investment has moved in the exact opposite direction of the benchmark.

## VALUATION COMPARISONS

The MSCI EM Index was selling at one of the lowest valuable multiples compared to other regional equity indexes as of June 30, 2013. WTEMHY, which does focus on valuation criteria—by selecting stocks with high dividend yields—has the lowest median<sup>18</sup> P/E ratio of the indexes discussed here: 10.6x. A trade-off of selecting stocks with the highest dividend yields is that they often have lower expected growth potential. The expected earnings growth on WTEMHY is 7.6%, which is a few percentage points below that of the broader MSCI EM Index.

WTEMDG specifically includes long-term earnings growth expectations as part of its selection focus, so it is natural for it to have a higher expected earnings growth than the other indexes. WTEMDG has a median P/E ratio of 15.2x, which is about 25% higher than the MSCI EM Index, but it also has 3.7% higher long-term earnings growth expectations.

The introduction of WTEMDG allows for a more precise targeting of exposure in the dividend-paying section of the emerging markets. Investors can balance high-dividend-yield selection criteria (WTEMHY) against the dividend growth potential selection criteria (WTEMDG) to judge where the best opportunities in the emerging markets asset class exist.

## FIGURE 8: EARNINGS GROWTH, VALUATION AND PAYOUT CHARACTERISTICS [as of 6/30/2013]

Index Name	WT EM Equity Income	MSCI EM Index	WT EM Dividend Growth
Median Price-to-Earnings (P/E) Ratio <sup>1</sup>	10.6x	12.1x	15.2x
Long-Term Earnings Growth Expectations	7.6%	11.1%	14.8%
Median Dividend Yield	5.2%	2.4%	2.1%
Earnings Yield <sup>2</sup>	9.4%	8.2%	6.6%
Dividend Yield / Earnings Yield	54.6%	29.3%	31.6%

Sources: WisdomTree, Bloomberg.

<sup>1</sup> Median price-to-earnings (P/E) ratio: P/E ratio of index constituents where 50% of constituent values fall above and 50% fall below.

<sup>2</sup> Earnings yield: Technically, the median earnings yield due to the fact that the earnings yield is calculated as 1/median price-to-earnings (P/E) ratio. Higher values indicate greater earnings for a given share price.

<sup>18</sup> Median: The value within a dataset at which 50% of all observations occur above and 50% occur below.

## CONCLUSION: A DIFFERENTIATED EXPOSURE FOR EMERGING MARKET EQUITIES

At the beginning of the past decade, when people considered emerging market equity indexes, they were largely left with one option: float-adjusted market capitalization<sup>19</sup>. In the time since, a variety of index methodologies have come to the fore.

WisdomTree has been a pioneer in creating options around the universe of dividend payers in the emerging markets. Over 90% of the market capitalization of emerging market equities is in dividend-paying firms, so we believe a focus on dividend payers in emerging markets doesn't sacrifice any breadth of coverage or representativeness of the universe.

However, we've noticed what we believe is a window of opportunity brought on by the unique nature of dividend behavior in emerging markets. In the United States, since many dividend payers announce their dividends ahead of time and then maintain them with strict regularity, indexes can require anywhere from 5 to 20 years of consecutive dividend payments and growth. Similar screens in emerging markets—where companies don't set their dividend policies in such a regimented way—would not lead to very many qualifying constituents (if any). Therefore, while many dividend-focused indexes in emerging markets focus on yield and valuation, there is a dearth of options that focus on dividend growth. We believe that the WTEMDG approach with its flexibility to respond to growth potential rather than past dividend behavior exhibits greater congruence with actual underlying dividend behavior. Just like the other dividend growth indexes we have created, we believe the WisdomTree Emerging Markets Dividend Growth Index represents the future of dividend growth-oriented indexing.

<sup>19</sup> Float-adjusted market capitalization: Share price x number of shares outstanding, adjusted for the fact that in many emerging markets not all of the shares outstanding regularly trade, which leads to a reduction in the number of shares outstanding used in the calculation.

Unless otherwise stated, data source is WisdomTree.

# Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, call 866.909.WISE (9473) or visit wisdomtree.com. Read the prospectus carefully before you invest.

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments focusing on a single sector generally experience greater price volatility. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation, intervention and political developments.

#### You cannot invest directly in an index.

WisdomTree U.S. Dividend Growth Index: A fundamentally weighted index designed to track the performance of dividend-paying companies in the U.S. that WisdomTree believes have the potential to increase their dividends due to certain factors, which include estimated earnings growth, return on equity and return on assets. Weighting is by indicated cash dividends. <u>WisdomTree U.S. Small Cap Dividend Growth Index</u>: A fundamentally weighted index designed to track the performance of dividend-paying companies in the U.S. small-cap equity universe that WisdomTree believes have the potential to increase their dividends due to certain factors, which include estimated earnings growth, return on equity and return on assets. Weighting is by indicated cash dividends. WisdomTree Global ex-US Growth Index: Designed to measure the performance of dividend-paying companies outside the United States with what WisdomTree believes to be potential for future dividend increases. Weighting is by dividend stream. MSCI Emerging Markets Index: A broad market cap-weighted index showing performance of equities across 21 emerging market countries defined as "emerging markets" by MSCI. <u>S&P 500 Index:</u> A market capitalization-weighted benchmark 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. <u>WisdomTree</u> Emerging Markets Dividend Growth Index: A fundamentally weighted index designed to track the performance of dividend-paying emerging market companies that WisdomTree believes have the potential to increase their dividends due to certain factors, which include estimated earnings growth, return on equity and return on assets. Weighting is by trailing 12-month cash dividends. MSCI EAFE Index: A market cap-weighted index composed of companies representative of the developed market structure of 22 developed countries in Europe, Australasia and Japan. Wisdom Tree Emerging Markets Dividend Index: A cash dividend-weighted index measuring the performance of dividend-paying equities incorporated in emerging markets. WisdomTree Emerging Markets Equity Income Index: A subset of the Wisdom Tree 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. <u>MSCI Emerging Markets Value Index</u>: A market capitalization-weighted subset of stocks in the MSCI Emerging Markets Index that have lower share prices relative to their earnings or dividends per share. <u>MSCI Emerging Markets Growth Index</u>: A market capitalization-weighted subset of stocks in the MSCI Emerging Markets Index that have higher share prices relative to their earnings or dividends per share. FTSE Emerging All Cap ex Taiwan Diversified Capped Dividend Growth 50 Index: A capped free float market cap-weighted index that measures the stock performance of 50 emerging market companies with a high compounded annual dividend growth rate. Dow Jones Emerging Markets Select Dividend Index: A modified market capitalization approach that weights by dividend yield. Stocks are selected for fundamental strength compared to their peers, subject to various screens such as dividend quality and liquidity. S&P Emerging Markets Dividend Opportunities Index: A yield-focused approach that optimizes a list of constituents based on dividend yield, subject to constraints. There are also dividend and earnings requirements to determine constituent eligibility.

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