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Going Back to the Fundamentals: The 2013 India Rebalance

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Both the Indian equity market[1] and the Indian rupee have experienced strong bouts of volatility[2] in recent years and especially this year. Amid the noise of recent central bank activity, WisdomTree rebalanced its India Earnings Index on September 20—the same day the new governor of the Reserve Bank of India (RBI) held his first policy meeting and two days after the U.S. Federal Reserve (Fed) announced its monetary policy decision. The timing of this Index rebalance and the RBI meeting was a coincidence—the Index rebalance occurs the same time every September.

With the volatility of the markets, many have questions about what is happening in the Indian economy. We set out to discuss related broad economic issues as well as details about the specific performance drivers of the Indian equity markets and the changes that took place in our Index at this latest rebalance.

INDIA ECONOMIC OUTLOOK AND REVIEW

India's demographics—its massive 1.237 billion[3] population with a median[4] age of just 26—are one of its great fundamental strengths. On a long-term basis, we believe there is great potential for Indian incomes to converge with those of the developed world. But the path for this catch-up will clearly not be a straight, ever-increasing line. This year, markets have focused on India's challenges in terms of productivity and income.

+ **Main Challenges:** India's struggles are often discussed—high inflation, lack of basic infrastructure, overly complex regulation and the "twin deficits"[5]. We explore these in greater detail below.
+ **Potential Catalyst for Change:** We believe the recent change of leadership at the RBI may provide an important inflection point for sentiment, at least based on very initial indications.

[1] As measured by the MSCI India Index.
[2] Volatility: A measure of the dispersion of actual returns around a particular average level.
[3] Source: World Bank data for 2012.
[4] Median: The value within a dataset at which 50% of all observations occur above and 50% occur below.
[5] Twin deficits: Refers to current account balance and government budget balance.

INDIA EARNINGS INDEX REBALANCE

+ **Having a Disciplined Focus on Profitability and Valuation[6]:** The WisdomTree India Earnings Index (WTIND) adheres to a rules-based annual rebalancing discipline. The rebalance process takes stock of company fundamentals[7], evaluates what is being reflected in stock prices, and makes shifts in allocations based on changes in relative value[8].
+ **Changes in Index Exposures:** At this year's rebalance, financials saw the greatest increase in weight as these stocks saw some of the largest price declines. Technology stocks saw the greatest reduction in weight, given their large outperformance. Much of the relative sector dispersion this year can be attributed to changes in the Indian currency, the rupee, and each sector's correlation[9] with the rupee. Our discussion on the economy thus provides important context for the Index changes that took place.

CRUCIAL ISSUE: PRODUCTIVITY BOTTLENECKS AND INFRASTRUCTURE NEEDS

India has a multitude of challenges that span from high government spending (budget deficit) and reliance on foreign financing (current account deficit) to a multitude of both regulatory burdens and government scandals that are putting a chill on investment. A basic economic issue: over half of India's working population is employed in agriculture, yet this sector only produces 15% of the country's economic output.[10] The productivity catch-up needed from this sector is emblematic of what India needs more generally.

Food inflation is high and drives approximately 50% of India's inflation gauges[11]. The government reports that as much as two-thirds of the population eat less than recommended. India needs policies to dramatically ramp up the productivity of farmers, and it needs a better system to get what is produced effectively to the market, given that currently up to 40% can be lost due to spoilage[12].

To combat this as well as other issues, serious investment in infrastructure is needed throughout the economy, and India will need foreign capital for these initiatives. India's finance minister has stated that India needs approximately $1 trillion of infrastructure investment over the coming five years.[13] Just to put this in context, the $200 billion a year is roughly equivalent to 11% of India's current economy measured in U.S. dollars as of December 31, 2012, and more than twice as much as the $425 billion cumulative—or $85 billion per year—that has been invested over the previous five years.

The widespread political corruption scandals and the difficult regulatory climate have effectively backlogged much-needed investment projects. This has weakened the country's current economic growth rates and caused much short-term pessimism. Yet there will certainly be many opportunities for locally listed firms, global firms and investors, as it is estimated that 50% of the $1 trillion infrastructure capital will need to come from investors and comprise both debt and equity opportunities.[14]

6 Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.
7 Fundamentals: Attributes related to a company's actual operations and production as opposed to changes in share price.
8 Relative value: The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.
9 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.
10 Sources: The Times of India, Indian Census Bureau, May 2013.
11 Source: UBS, "EM by the Numbers," August 2013.
12 Source: Diofasi, Anna. "Save the Waste: Food Loss in Asia and Pacific Region." Humanitas Global Development. August 29, 2013.
13 Source: Indian Finance Minister Chidambaram's Speech to the World Bank, August 2013.
14 Source: Indian Finance Minister Chidambaram's Speech to the World Bank, August 2013.

CURRENT ACCOUNT, FINANCING THE DEFICIT

India's financing deficit requires importing capital from abroad—and thus India has been impacted by the rise in interest rates in the United States that caused portfolio shifts away from emerging markets.

India's current account deficit[15], at 5% of gross domestic product (GDP), is among the largest in EM economies, and it is driven primarily by its trade deficit.[16] India is one of the most sensitive emerging market economies to the current account dynamic and thus has been fairly sensitive to changes in U.S. interest rates this year.

India is taking steps to remedy its current account deficit. The currency decline could help exports, especially if key trading partners such as Europe return to more positive growth. The European Union and North America together comprise almost 30% of India's exports,[17] so improved growth in these regions combined with currency depreciation has the potential to be helpful to exports.

But imports are a central concern. India's largest imports are oil and gold, which account for approximately 34% and 11%, respectively, of total imports.[18] India imports four-fifths of its oil needs and heavily subsidizes these prices.[19] Geopolitical fears, such as those surrounding Syria, become a negative for India as they raise the specter of higher oil prices and further deterioration of the government and current account deficits.

Anil Sharma of Nomura estimates that a drop in the exchange rate of one rupee against the dollar adds an extra $1.26 billion to the subsidy bill. As the rupee has dropped from 55 rupees per dollar to a low of over 68 rupees per dollar in August of 2013, the government deficit and associated subsidy payments worsened, as did the import bill (creating more selling pressure on the rupee to pay for the oil in dollars). Of course, while the rupee has certainly had its weaker points in 2013, the picture could be slightly improved as the rupee appreciated by approximately 10% during the month of September 2013, and is now around a level of 61 per 1 U.S. dollar as of October 10, 2013.

India is trying to curb gold imports by placing additional tax levies on them. Based on official reports, the measures seem effective, as gold imports have collapsed since the levies have been put in place. But some worry that this just creates a parallel black market where Indians are smuggling in gold. The gold imports, as one currency strategist told us, are just a symptom of capital flight from India. Indians are a creative bunch and can find other ways to find protection from the declining value of the rupee.

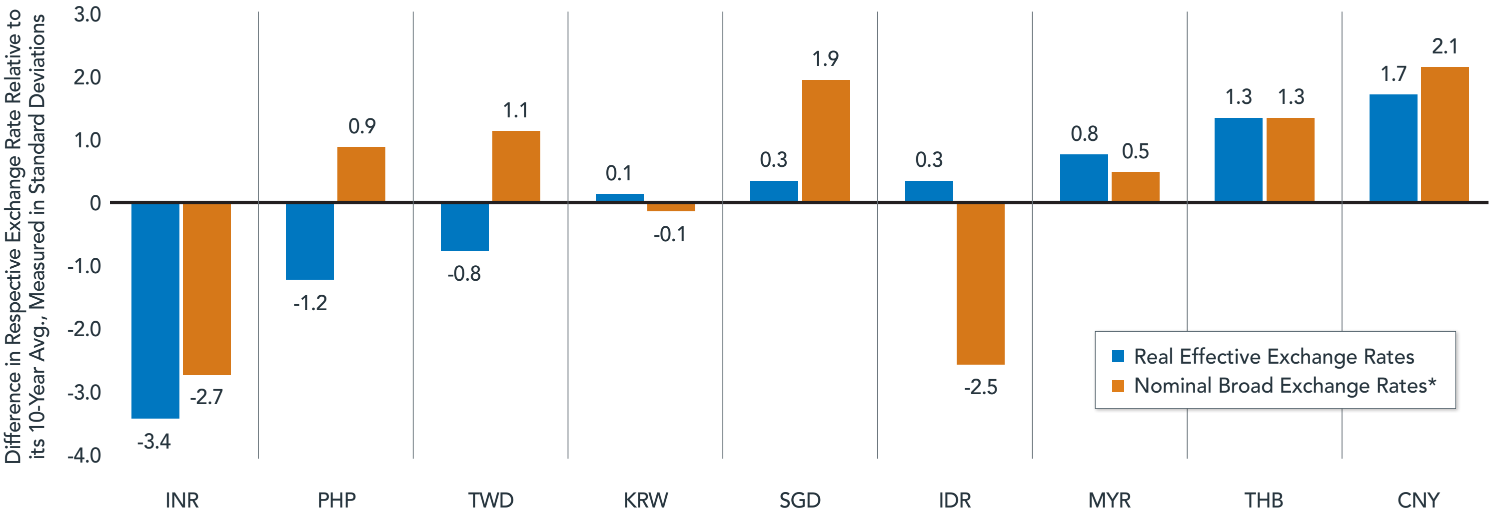
RELATIVE VALUE IN THE RUPEE GIVEN LARGE DECLINES

The rupee has depreciated about 36% against the dollar since early 2008, the worst performance of any Asian currency.[20] To contrast this with one of its prime competitors, the Chinese currency, the rupee has depreciated 47% against the Chinese yuan over this period, making India's products and exports more competitive in global trade, especially compared to China. Of course, China's currency does not exactly freely-float[21] in value against the U.S. dollar, but the fact remains that such depreciation of the rupee does make India's goods and service exports cheaper compared to China's.

One broad gauge of the currency's move is to look at the real effective exchange rate[22]. The broad real effective exchange rate is comprehensive and takes into account the measure of a currency's performance versus its major trading partners after adjusting for inflation.

[15] Source: Indian Finance Minister Chidambaram's Speech to the World Bank, August 2013.
[16] Source: Indian Finance Minister Chidambaram's Speech to the World Bank, August 2013.
[17] Source: Morgan Stanley Research, August 31, 2013.
[18] Sources: CEIC, Morgan Stanley as of December 2012.
[19] Source: Abheek Bhattacharya, "Rupee Throws Oil on India's Subsidy Problem," The Wall Street Journal, Aug 31, 2013.
[20] Source: Bloomberg, as of August 31, 2013.
[21] Freely-float: A currency that has its value completely determined by buyers and sellers within the market and is not influenced by government interactions and attempts to impact this value.
[22] Real effective exchange rate: The weighted average of a country's currency relative to an index or basket of other major currencies, adjusted for the effects of inflation.

FIGURE 1: EXCHANGE RATE HISTORICALLY CHEAP COMPARED TO ITS TRADING PARTNERS[23] [09/30/2003 – 09/30/2013]



Sources: Bloomberg, WisdomTree. Indian rupee (INR), Taiwanese dollar (TWD), Philippine peso (PHP), Korean won (KRW), Singapore dollar (SGD), Malaysian ringgit (MYR), Thailand baht (THB), Chinese yuan (CNY). Past performance is not indicative of future results.
*Nominal Broad Exchange Rates: The unadjusted weighted average value of a country's currency relative to all major currencies, as measured by the balance of trade.

- **We evaluated the current real broad effective exchange rates (as of 9/30/2013) in the context of their history over last 10 years and show, using a measure of standard deviation[24] from its average rate over this period, how low or high the exchange rate values are compared to their own history.**
- **The real effective rupee exchange rate is approximately 3 standard deviations below its 10-year average. In other words, the INR has traded at such cheap valuations less than 0.13% of the time in the past 10 years!**
- **The broad nominal rupee[25], a measure of the currency versus its trading partners' (without taking into account inflation), is also at historically cheap levels.**
- **On both the real effective and nominal scales, the rupee has the most attractive valuations relative to its peers, as indicated by the largest negative bars in the chart above.**
- **We note over the period above that the INR has cheapened considerably compared to PHP and CNY. India competes heavily with the Philippines (second-largest destination for outsourcing)[26] for business process outsourcing (BPO) contracts, and the cheap currency will help shift competitiveness in favor of India. Additionally, the currency has cheapened considerably versus China's, and this too bodes well for India's competitiveness.**

One of the central factors that can change a currency's direction is monetary policy. And on that front, we have seen some very positive developments in September. There was a change in leadership at the Reserve Bank of India (RBI) that has coincided with a marked change in the trading of the rupee. Below we discuss the key issues facing the central bank policy makers.

[23] Real effective and nominal broad rupee measured by JP Morgan's REER and NEER indexes.
[24] Standard deviation: A measure of how widely an investment or investment strategy's returns move compared to its average returns for an observed period. A higher value implies more "risk," in that there is more of a chance the actual return observed is farther away from the average return.
[25] Broad nominal rupee: Measure of the rupee's performance against that of India's trading partners without adjusting for any impacts of inflation.
[26] Source: Kirtika Suneja, "Philippines, Canada Eat into India's BPO Pie," The Financial Express, July 30, 2013.

INDIA'S STICKY INFLATION COMPLICATES MONETARY POLICY

Inflation is a key challenge for the RBI. Since 2008, India has averaged an inflation rate of 10.4% on a year-over-year basis. Food, beverage and tobacco constitute 50%[28] of the inflation basket, and fuel constitutes another 10%, rendering India's inflation picture highly dependent on commodity prices. In addition, currency depreciation worsens the inflation picture, as it makes imports, particularly of food and oil, more expensive.

The elevated inflation levels complicate the monetary policy choices for the RBI. Faced with a sluggish economy, the RBI would surely like to loosen its monetary policy to support growth, but instead it has tightened monetary policy to combat inflation, which can slow down the economy even further. These are tough choices for a central bank to make.

But the RBI just had a leadership change, which brought a fresh wave of positive sentiment toward India. The new head of the central bank, Dr. Raghuram Rajan, said at his introductory press conference on September 4:

> "Some of the actions I take will not be popular. The Governorship of the central bank is not meant to win one votes or Facebook "likes." … But I hope to do the right thing, no matter what the criticism, even while looking to learn from the criticism."

MONETARY POLICY DIRECTION

Recent actions from the RBI show a shift in focus from attempting to stimulate stronger growth to becoming more focused upon external stability and managing the rupee.

During Dr. Rajan's statement at his first RBI meeting on September 20, 2013, he discussed the rationale for raising the primary interest rate (a hike of 0.25% in the repo rate[29]). He elaborated that:

> "recognizing that inflationary pressures are mounting and determined to establish a nominal anchor which will allow us to preserve the internal value of the rupee, we have raised the repo rate by 25 basis points[30]."[31]

A focus on the rupee's level is clearly important, but the rupee started trading better even from his first press conference on September 4, when Dr. Rajan took over the leadership role. Some of the key directives he outlined that are most encouraging for the markets:

+ **Plans to Speed Up Approvals of New Bank Branches:** The RBI intends to make it easier for commercial banks to open new bank branches. No longer will a well-run domestic commercial bank have to approach the RBI for permission to open a branch. Regulations are often thought of as one of India's challenges. The RBI's cutting back red tape could prove a useful model for the government in other sectors.

[27] Source: Bloomberg, as of December 2012.
[28] Sources: CEIC, UBS, as of August 2013.
[29] Repo rate: is the rate at which the central bank of a country (Reserve Bank of India in case of India) lends money to commercial banks in the event of any shortfall of funds. Repo rate is used by monetary authorities to control inflation.
[30] Basis point: 1/100th of 1 percent.
[31] Dr. Raghuram Rajan, RBI Governor, RBI Policy Statement, September 20, 2013.

+ **Encouraging Foreign Banks to Enter Market:** The RBI wants to encourage foreign banks to participate in India's growth but in exchange would like more regulatory and supervisory control. Raising long-term foreign capital is key for the rupee's future, and additional support for allowing those who receive rupees to reinvest them in India could also be very supportive of financing needs.
+ **Providing Discounted Loans to Banks:** The RBI is providing discounted rates for banks to borrow from the RBI, which can help alleviate the interest rate pressures the banks were facing.

The markets reacted extremely positively to these initial announcements. It is great to see deliberate actions to cut down red tape, as regulations are often cited as a primary concern for India.

Furthermore, Dr. Rajan last year advocated for a new wave of privatization of state-owned enterprises, which control about three-quarters of the banking sector but also substantial parts of other sectors, including natural resources and energy. He stated, "State ownership in many areas no longer serves the public interest, and the only reason it continues is because it serves the many vested interests that benefit from the status quo … public sector workers who have cushy undemanding safe jobs ... the occasional corrupt executive who rakes in bribes, and the minister who enjoys the patronage."

These are serious thoughts and exactly what India needs. We have been living in a world dominated by central bank activity in recent years, with the U.S. Federal Reserve, bold new policies from the Bank of Japan, the European Central Bank, which will do "whatever it takes" to preserve the euro,[32] and Mark Carney taking the helm at the Bank of England.

Dr. Rajan has the potential to enter the discussions as one of the most influential global central bankers. When a market is faced with the spectrum of difficulties of India, the real question is what might catalyze a change or inflection point. Dr. Raghuram Rajan may just be the inflection point for India.

WISDOMTREE'S INDIA EARNINGS INDEX: ANNUAL REBALANCE SCREENING

Each year, WisdomTree monitors the *Earnings Stream*[33] of India's equity market to find the firms that have generated positive cumulative profits. Qualifying companies are then weighted by their proportionate contribution to the earnings stream, meaning that typically:

+ **Firms whose price levels have declined but whose earnings have either remained constant or grown would tend to see increases in their weights.**
+ **Firms whose price levels have increased but whose earnings have either remained constant or decreased would tend to see decreases in their weights.**

[32] Mario Draghi Press Conference, European Central Bank (ECB), July 26, 2012.
[33] *Earnings Stream:* Defined as cumulative earnings over the prior four fiscal quarters for each component in the Index, using S&P's "Core Earnings" concept.

It is in this way that WisdomTree, by way of earnings and price changes, applies a disciplined focus to firm fundamentals and relative value within India, as opposed to having the potential to be swayed by sentiment.

MONITORING THE *EARNINGS STREAM*

WisdomTree India Earnings Index Earnings Stream [Shown Annually as of Each Screening Date, in $ billions]						
	8/29/2008	8/31/2009	8/31/2010	8/31/2011	8/31/2012	8/31/2013
WidomTree India Earnings Index Earnings Stream (USD)	$51	$45	$61	$81	$77	$67
% Annual Growth (USD terms)	N/A	-11.76%	35.56%	32.79%	-4.95%	-13.51%
% Cumulative Growth (in USD, 8/29/2008 through specified date)	N/A	-11.76%	19.61%	58.82%	52.18%	30.59%
% Annual Growth (in rupee terms)	N/A	-1.95%	30.69%	30.02%	14.50%	2.35%
% Cumulative Growth (in rupee terms, 8/29/2008 through specified date)	N/A	-1.95%	28.15%	66.61%	90.77%	95.25%
% Annual Change in India's Currency vs. U.S. dollar	N/A	-10.0%	3.7%	2.1%	-17.0%	-15.5%
% Cumulative Change in India's Currency vs. U.S. dollar (8/29/2008 through specified date)	N/A	-10.0%	-6.7%	-4.7%	-20.9%	-33.1%

Sources: WisdomTree, Standard & Poor's, Bloomberg. Past performance is not indicative of future results.

One of the most interesting parts of each year's rebalancing process regards the behavior of the *Earnings Stream*. We typically report the *Earnings Stream* measured in U.S. dollars to compare aggregate earnings in India to other markets. Since the rupee tends to exhibit significant movement (especially of late), a consequence could be the appearance of negative *Earnings Stream* growth even if the firms themselves have grown their earnings over the period, when measured in Indian rupees.

Since the performance of our Index is also unhedged, it is further worth noting that the rupee has depreciated on a cumulative basis since the first annual rebalance in 2008. When it has been positive over individual periods, for example from August 31, 2009, to August 31, 2010, and from August 31, 2010, to August 31, 2011, it has appreciated only slightly. The *Earnings Stream* growth (as well as the Index performance) has faced a significant headwind, especially over trailing 12-months.

SECTOR WEIGHT CHANGES AND MEASURES OF POTENTIAL RUPEE SENSITIVITY

One of the most closely watched details of the annual rebalance is what the changes in the Earnings Stream mean in terms of stock and sector allocations. In other words, which sectors are seeing added weight, and which are seeing subtracted weight based on their changes in relative value?

ANALYSIS OF SECTOR CHANGES IN WEIGHT AND RUPEE SENSITIVITY

		Old Weight[1]	Sector Performance[2]	New Weight[3]	Change in Weight	Performance of Sector Relative to WTIND	3-Year Correlation of MSCI India Respective Sector Index to INR[4]
Underperforming Sectors	Industrials	4.59%	-34.49%	5.40%	0.80%	-21.29%	0.76
	Materials	9.90%	-28.27%	8.69%	-1.21%	-15.07%	0.62
	Utilities	4.22%	-24.93%	6.42%	2.20%	-11.73%	0.67
	Financials	22.05%	-24.34%	25.21%	3.16%	-11.14%	0.72
	Energy	20.45%	-14.03%	20.65%	0.20%	-0.83%	0.66
Outperforming Sectors	Consumer Discretionary	10.62%	-3.27%	8.78%	-1.85%	9.93%	0.58
	Information Technology	16.03%	8.91%	14.47%	-1.56%	22.11%	0.17
	Health Care	4.36%	10.99%	4.85%	0.49%	24.19%	0.40
	Consumer Staples	5.13%	13.22%	4.36%	-0.77%	26.42%	0.39
	Telecommunication Services	2.64%	25.14%	1.18%	-1.47%	38.34%	0.46

	Old Weight[1]	Average Sector Performance[2]	New Weight[3]	Change in Weight	Average of Sector Performance Relative to WTIND	Average MSCI India Sector 3-Year Correlation to INR
Sectors that Outperformed	38.79%	11.00%	33.63%	-5.16%	24.20%	0.40
Sectors that Underperformed	61.21%	-25.21%	66.37%	5.16%	-12.01%	0.69

[1] As of 9/20/2013, before rebalance weights went into effect.
[2] Performance of specified sector from 9/21/2012 to 9/20/2013.
[3] As of 9/20/2013, after rebalance weights went into effect.
[4] From 8/31/2010 to 8/31/2013.
Sources: WisdomTree, Standard & Poor's. Past performance is not indicative of future results. Subject to change.

Between annual rebalance dates, specifically from September 21, 2012, to September 20, 2013, we saw the WisdomTree India Earnings Index deliver returns of -13.20%. Given that the rupee declined 14.2% over this period, the entire decline of the Index can be explained by its currency move.

Of particular interest in the relative performance of sectors was the fact that exactly five sectors in this Index underperformed and five sectors outperformed.

+ **The Underperformers:** This group consisted of Industrials, Materials, Utilities, Financials and Energy. Their average return over the period was worse than -25%, about 12% worse than the performance of WTIND (-13%). These underperforming sectors received about 5% additional weight at this year's annual rebalance screening. The greatest two weight increases were to Financials and Utilities. Materials was the only underperforming sector to receive less weight at the rebalance.

- **The Outperformers:** This group consisted of Consumer Discretionary, Information Technology, Health Care, Consumer Staples and Telecommunication Services. Their average return over the period was approximately 11%, about 24% better than the performance of WTIND as a whole. The outperformers saw their weight reduced by 5%. The greatest reduction in weight came from the Information Technology and Consumer Discretionary sectors.
- **Correlation to the Rupee—Results:** The sectors that underperformed were the ones most correlated to the rupee. One factor causing this high correlation could be these companies' issuance of dollar-denominated debt[34]. When the local currency declines, it causes their debt levels to rise because it costs more rupees to pay off their debt.
  - **Companies that have revenue in U.S. dollars benefit from a weaker rupee:** the Technology sector is one of most prominent sectors whose companies can be said to have benefited on a revenue basis from the weakening rupee.
- **The actions taken by the RBI to provide discounted loans to financials represented a large change in sentiment and helped alleviate the pressures they faced from the declining rupee on their dollar-denominated debt—it may mark a turning point for these companies.**
- **Rebalance Results:** By shifting weight toward the Financials sector and away from the Technology sector, the correlation of the India Earnings Index to the currency change is becoming a bit more sensitive by adding more weight to a sector that is highly correlated to the rupee and taking weight away from the Tech sector, which is less correlated to the rupee.

INDIA'S EQUITY MARKETS: BROADNESS OF COVERAGE

The three widely followed indexes we will compare to WTIND will be the BSE SENSEX Index (SENSEX), the NSE S&P CNX Nifty Index (NIFTY) and the MSCI India Index (MSCI India). It is worth noting that these indexes are all weighted by market capitalization[35] and do not have ongoing profitability requirements for constituent inclusion. The ultimate question that we ask in looking at this comparison is whether certain indexes are representative of a more complete picture of India's equities as opposed to a particular size segment. We believe this could be helpful in putting subsequent valuations into better context.

COMPARISON OF MARKET CAPITALIZATION SIZE SEGMENTS, AS OF 8/31/2013 REBALANCE SCREENING FOR WTIND

	Total Index				Large Cap (>$10 billion)				Mid Cap ($2 billion to $10 billion)				Small Cap (<$2 billion)			
	WTIND	MSCI India	SENSEX	NIFTY	WTIND	MSCI India	SENSEX	NIFTY	WTIND	MSCI India	SENSEX	NIFTY	WTIND	MSCI India	SENSEX	NIFTY
Weight	100.0%	100.0%	100.0%	100.0%	53.7%	66.8%	85.0%	72.5%	33.7%	29.7%	15.0%	26.5%	12.6%	3.5%	0.0%	1.1%
Market Capitalization ($ billions)	$859.5	$621.2	$467.0	$548.7	$468.4	$416.5	$403.3	$398.4	$304.2	$191.1	$63.7	$146.0	$86.9	$13.6	$0.0	$4.3
# of Firms	187	71	30	50	18	18	17	17	65	44	13	30	104	9	0	3
P/E Ratio	9.4x	13.3x	12.7x	12.2x	11.6x	14.1x	13.1x	13.0x	8.9x	12.8x	11.4x	11.0x	6.4x	9.4x	N/A	9.0x

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

[34] Dollar-denominated debt: Debt that is issued in U.S. dollars and must be paid in U.S. dollars. If the issuer's local currency depreciates against the U.S. dollar, it becomes more expensive for the issuer to pay off the debt; if the issuer's local currency appreciates against the U.S. dollar, the debt obligation becomes less expensive.
[35] Market capitalization: Market cap = share price x number of shares outstanding.

- **WTIND—The Broadest Option:** The total market capitalization of an index is one way to indicate the broadness of its market coverage, and WTIND's market cap far exceeds those of the other three indexes shown. A primary reason for this resides simply in the number of included constituents—187 for WTIND, and 71, 30, and 50, respectively, for MSCI India, SENSEX and NIFTY. What's interesting is that each index includes roughly the same number of large-cap companies (those over $10 billion in market cap), but WTIND has much more exposure to mid-cap firms and also many more small-cap firms.
- **Small Caps Largely Ignored:** By virtue of the methodologies employed by MSCI India, SENSEX and NIFTY, the small-cap segment of India's equity market is largely ignored by these indexes. We believe that when people think of India as a potential opportunity in emerging markets, a big attraction lies in India's entrepreneurial potential. There is better potential for that characteristic to express itself through India's small-cap stocks than its large-cap stocks. While we certainly agree that WTIND's greater-than-12% exposure to small caps could lead to volatility, especially in risk-off environments, we would remind readers that each constituent needs to demonstrate positive profits prior to gaining Index inclusion, so these firms are not completely without any record of past business success.
- **The Nature of India's Valuation Opportunity:** WTIND is an earnings-weighted index, so while market capitalization-weighted indexes place the greatest weights in firms with the largest market caps, WTIND places the greatest weights in firms that have generated the greatest earnings. Compared to market capitalization-weighting, earnings-weighted indexes may have a natural bias toward lower price-to-earnings (P/E) ratios[36], so it is not surprising that WTIND's P/E ratio is the lowest of the indexes shown. However, we would also point out that across the indexes, the large-cap stocks are the most expensive and the small-cap stocks are the least expensive. If people are thinking about where the potential valuation opportunity in India may reside, the P/E ratios seen among India's small-cap equities, at least within these indexes, could be difficult to ignore.

[36] Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

CONCLUSION

When we consider India's equity markets today, we believe it is important to be sensitive to the various concerns circling around India's economic landscape. However, with such uncertainty, at times, comes potential opportunity, and we believe that when conditions are at their least certain could be the most important time to maintain the focus of a disciplined approach.

WisdomTree India Earnings Index: A fundamentally weighted index that measures the performance of companies incorporated and traded in India that are profitable and that are eligible to be purchased by foreign investors. Companies are weighted in the Index based on their earnings in their fiscal year prior to the Index measurement date, adjusted for a factor that takes into account shares available to foreign investors. BSE SENSEX Index: Popularly cited, market cap-weighted Index of India's equity market, constructed through exposure to 30 of the largest and most heavily traded firms listed on India's Bombay Stock Exchange. NSE S&P CNX Nifty Index: Popularly cited, market cap-weighted index of India's equity market, constructed through exposure to 50 of the largest and most heavily traded firms listed on India's National Stock Exchange. MSCI India Index: A market capitalization-weighted index designed to measure the performance of the large- and mid-cap segments of the Indian equity market.

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