Why We Think WisdomTree's India Index Is Cheap

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Stories of corruption, food inflation and anxiety over a potential oil price shock weighed heavily on India's equity markets and resulted in India experiencing one of the greatest declines of emerging markets countries during the first quarter of 2011.[1] The long-term potential for India—driven largely by its quite favorable demographic trends and the emergence of a stronger middle class and income catch up with the rest of the world—remains intact.

In this issue of *Investment Insights*, we discuss the key risk factors currently plaguing the Indian equity market and how WisdomTree can help investors access the Indian markets at cheaper prices and valuations.

MAJOR RISKS

+ Inflation

Food and energy have the greatest potential impact upon India's inflation. In fact, within the nation's Consumer Price Indexes (CPI), food and energy make up about 50% of the total value[2] of the consumption basket.[3]

In late 2010, general food inflation in India was at about 18.3%, with the subcomponent of vegetables up nearly 60%.[4] To combat rising food prices, India must increase the supply of food to the marketplace—it must address its agricultural productivity. Currently, about 50% of the Indian workforce is employed in agriculture, but agriculture contributes to less than 20% of Indian gross domestic product[5] (GDP).[6] India's agricultural industry faces significant roadblocks (namely a lack of roads) that prevent its output from being efficiently transported from farms to markets. About one-third of produce grown in India rots before it can reach the end customer.[7] The combination of inefficient production, inefficient storage and inefficient transportation significantly contribute to supply-related issues.

In the course of history, human creativity has resulted in greater production and supply of agricultural commodities over time, which dampened prices. For example, agriculture's share of the Indian labor force is equivalent to the United States labor share around 1880, when 50% of American workers were employed in agriculture.[8] The experience of the United States, while under completely different circumstances, sheds light on a country's agricultural advancement. Substantial productivity gains by U.S. farmers, combined with dramatic improvements in transportation and infrastructure, resulted in so much additional food supply that net deflation occurred—prices declined over time. Currently the United States, with less than 2% of workers employed as farmers, produces enough food to still be a net exporter of food.

In the short-term, risks to agricultural prices are hard to predict. But over the long term we are optimistic about the potential for productivity gains in Indian agriculture and continued buildup of Indian infrastructure projects, which should boost food supplies and keep India's food inflation risk more restrained.

1 Source: MSCI
2 Kwan, Nicholas. "Asia-Inflation Illusions." Standard Chartered. February 1, 2011.
3 The consumption basket is the average amount spent by Indians on various goods; Consumer Price Indexes use those baskets to determine components of relative drivers of inflation.
4 "Will Inflation-Driven Policy Tightening Derail Asian Equities?" Pictet Asset Management. January 2011.
5 Measure of a country's total economic output.
6 Market Analysis Group. "India Crop Sector: Situation and Outlook." Agriculture and Agri-Food Canada. August 26, 2010.
7 Foley, John. "Global Food Prices in 2011 Face Perilous Rise." New York Times. December 28, 2010.
8 http://www.agclassroom.org/gan/timeline/farmers_land.htm

+ Oil

India imports over 95% of its oil needs.[9] Studies indicate that a $5 dollar increase in the price per barrel of oil could roughly be associated with a .2% reduction in GDP for Asian oil importers, a group in which India is included.[10]

Turmoil breeds risk, and investors fear a possible spike in the price of oil due to current political issues in the Middle East impacting the oil markets. Morgan Stanley's India strategist Ridham Desai published a note discussing the relationship between oil, India's economy and equity markets. Desai's research showed that oil price changes had little explanatory power on either the absolute performance of the Indian equity markets or their relative performance versus the broader emerging markets. Desai concluded:

> *Of course, oil is crucial to India's macro [outlook] and can produce negative short-term implications for the economy. A sharp rise in oil is always a tail risk for India, but given equity valuations, we think it is a good time for stock picking with a 12-month view.*

+ Corruption

When governments have the power to facilitate the creation of vast amounts of wealth for private citizens, some inevitably look to exploit the system to their individual advantage. One former Indian government official referenced corruption as a low-risk, high-reward activity.[11] By making the cases of corruption very public, India has the opportunity to learn from its mistakes and develop better investor safeguards that foster fair competition. Though it takes time to work through these cases and appropriately punish those responsible, Manmohan Singh, along with his United Progress Alliance government, appear committed to cracking down on the current scandals.[12]

The most powerful longer-term influence against corruption could very well be India's own people. Citizens have drafted a bill, known as the Lokpal Bill, designed to be a more robust anti-graft law; they have also organized marches as part of the "India Against Corruption" movement.[13] We believe it is important for investors in the Indian equity markets to have realistic expectations that the fight against corruption will be a long-term battle.

ANALYSIS OF INDIA'S MARKET PRICES

India's growth expectations should drive its equity prices. To that end, analysts estimate that potential long-term profit growth for Indian companies could be double that of U.S.-based companies over the next three to five years.[14] However, it is also true that emerging market countries such as India have higher levels of risk, which often keeps valuation[15] levels more restrained.

[9] CIA World Factbook (https://www.cia.gov/library/publications/the-world-factbook/geos/in.html)
[10] http://www.imf.org/external/pubs/ft/oil/2000/#table1
[11] Raghavan, RK. "The Losing Battle Against Corruption." The Hindu. January 17, 2011.
[12] Yardley, Jim. "Indian Premier Vows to Fight Corruption." New York Times. February 16, 2011.
[13] Garg, Abhinav. "Delhi Acts Against Corruption." The Times of India. January 31, 2011.
[14] Based on Bloomberg consensus analyst estimates of companies in the WisdomTree India Earnings Index and the BSE Sensex 30 Index.
[15] The valuation of an index relates the prices of the securities to a measure of fundamental value such as earnings or sales. Valuation indicators are used to determine if markets are relatively cheap (attractive to buy) or expensive (less upside potential).

As a result of its drop during late 2010 and early 2011, India's equity market (as measured by the WisdomTree India Earnings Index) is currently selling at relatively cheap prices (given the higher growth expectation) compared to other global benchmarks:

PRICE-TO-EARNINGS RATIOS[16] [as of March 31, 2011]

WisdomTree India Earnings Index	14.5
BSE Sensex 30 Index	17.3
MSCI ACWI Index	14.7
MSCI Emerging Markets Index	13.5
S&P 500 Index	15.5

LOWERING THE PRICE-TO-EARNINGS RATIO OF INDIA

By design, the WisdomTree India Index methodology can help lower the price-to-earnings ratio (P/E ratio) for India through the combination of two factors:

+ **Selection: Only companies with positive net income over the trailing year are included in the index.**
+ **Weighting: Weighting constituents by net income (earnings per share times shares outstanding) instead of market capitalization (price times shares outstanding).**

This selection and weighting methodology typically shifts weight toward lower-P/E companies and away from higher-P/E companies when compared to a market cap-weighted benchmark such as the MSCI India Index or the BSE Sensex 30 Index.

Fast-growing countries often command higher or premium valuations relative to the market. But as discussed above, that is not currently the case with the WisdomTree India Earnings Index. A critically important component to long-term investment performance is how much of future growth expectations are already factored into the market by the higher prices. Given the recent sell-off in India, we have become more optimistic about the longer-term prospects for India, given its price levels compared to other global markets.

ACCESS INDIA WITH WISDOMTREE

WisdomTree India Earnings Fund, EPI, seeks investment results that correspond to the price and yield performance, before fees and expenses, of the WisdomTree India Earnings Index. View the EPI Fund details to learn more.

[16] The price-to-earnings ratio is a measure of the aggregate market value of an index or set of stocks divided by its aggregate earnings. The price-to-earnings ratio gives investors an idea of how much they are paying for an index's earnings power. One way to think of the price-to-earnings ratio is how many years it would take for an index to earn its price (market value), assuming no future growth in earnings. A lower price-to-earnings ratio thus is considered a positive feature of an index, assuming future growth of that index is equal to that of a competing index.

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Index Definitions: WisdomTree India Earnings Index: A fundamentally weighted Index that measures performance of companies in India that are profitable and eligible to be purchased by foreign investors. Weighting is by earnings, measured in the year prior to the Index measurement date. MSCI ACWI Index: A market cap-weighted index that is designed to measure the equity market performance of developed and emerging markets. 45 country indexes are included. The 24 developed country indexes are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The 21 emerging market Indexes are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey. BSE Sensex 30 Index: A value-weighted index that tracks the performance of the 30 largest stocks on the Bombay Stock Exchange. MSCI Emerging Markets Index: A market cap-weighted index designed to measure the equity market performance of emerging markets. The 21 constituent countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey. S&P 500 Index:The S&P 500 Index is 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 India Index: The MSCI India Index is a market cap-weighted index that is designed to measure the performance of the Indian equity market.

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 to view or download a prospectus online. 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. This Fund focuses its investments in India, thereby increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in emerging, offshore or frontier markets such as India are generally less liquid and less efficient than developed markets and are subject to additional risks, such as of adverse governmental regulation and intervention or political developments. As this Fund has a high concentration in some sectors, the Fund can be adversely affected by changes in those sectors. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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