

All Emerging Markets Are Not Created Equal

Published April 8, 2013

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As investors in emerging market fixed income, we believe that a country's economic fundamentals matter. As an actively managed Fund, the [WisdomTree Emerging Markets Local Debt Fund \(ELD\)](#) uses a quantitative and rules-based process¹ to select countries for inclusion and allocate exposures across tiers. The Fund's Strategy Committee incorporates a variety of market-based and economic factors into its structured investment process. This fundamentals-based approach is supported by diligent risk-monitoring that can reduce or eliminate positions, should conditions in a country or their outlook materially change. By biasing the portfolio toward more credit-worthy issuers, the Fund has been able to provide comparable levels of [performance](#) with significantly lower levels of volatility.²

Hungary Case Study Hungary serves as a good example of the Fund's investment process at work, given that it is ELD's largest underweight relative to its performance benchmark (4.9% weight in the index vs. a 0% allocation in ELD as of March 31, 2013). Recently, the ratings agency Standard & Poor's announced that it was joining Moody's in lowering the outlook for Hungary's sovereign credit rating.³ ELD's portfolio management team has excluded Hungary from the portfolio ever since the Fund's inception for many of the same reasons discussed in the S&P report. Principally, we are concerned about the uncertainty of future action by government policy makers. After a breakdown in negotiations with the International Monetary Fund (IMF) disappointed markets last year, we remain skeptical about the path of governmental reform we believe is required to help improve Hungary's economy. Currently, Hungary is rated BB (two notches below investment grade) by S&P, on par with borrowers such as Portugal and Guatemala. S&P notes that the government's predictability and credibility has continued to weaken in the past year. Questions about central bank independence, a large percentage of debt held by foreign investors, and a banking system with large foreign liabilities pose significant risks, in our opinion.

Hungarian Forint: Historically High Volatility From a risk/reward perspective, Hungary currently trades at modestly higher yields than many other emerging market countries, but when combined with a historically volatile currency like the forint, it can be particularly problematic for fixed income investors.⁴ For example, between ELD's inception in August 2010 and March 2013, Hungarian forint-denominated debt has been the most volatile constituent in the index (over 25.5% annualized volatility versus 12.7% for the index).⁵ After Hungary's poor performance in 2011, the largely risk-on markets of 2012 resulted in its debt being one of the best-performing bond markets of the year. In the first quarter of 2013, Hungary has been among the worst once again. In our view, this boom–bust cycle of investing appears contrary to prudent risk management. Ultimately, we believe that focusing on economic fundamentals can add value over time. While certain countries may outperform over the short run, we believe that maintaining a bias toward countries living within their means has the potential to lead to superior performance in the long run.

¹The locally denominated debt Funds follow a "structured investment process" whereby the Funds' Strategy Committee examines a variety of

economic and fundamental factors when selecting countries for and tiering of the portfolio. 2Compared to the Fund's performance benchmark, JPMorgan Government Bond Index – Emerging Markets (GBI-EM) Global Diversified. 3Standard & Poor's, March 21, 2013. 4As measured by the standard deviation of the JPMorgan GBI-EM Global Diversified Hungary Index. Sources: Zephyr StyleADVISOR, WisdomTree, 3/31/2013. 5Proxied by the JPMorgan GBI-EM Global Diversified Hungary sub-Index and the JPMorgan GBI-EM Global Diversified Index. Sources: Zephyr StyleADVISOR, Bloomberg, 2012.

Important Risks Related to this Article

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 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 and intervention or political developments. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. Unlike typical exchange-traded funds, there is no index that the Fund attempts to track or replicate. Thus, the ability of the Fund to achieve its objective will depend on the effectiveness of the portfolio manager. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile. S&P ratings assist investors by evaluating the credit worthiness of many bond issues. AAA to BBB ratings are typically issued to those securities considered investment grade. The rating is not a recommendation to buy or sell a particular bond. For information on the rating agency's methodology, go to: <http://www.standardandpoors.com/home/en/us>