

# Building an Index for Exposure to Emerging Market Consumer Growth

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One of the major themes that we believe will drive much of the global economy over the coming years is the rise in potential growth from emerging market (EM) consumers. Given EM's youthful demographics and the potential for their low per capita incomes to catch up with those of the developed world, the potential ramifications of this trend could be quite large. Despite the importance of this major shift, the options that could reflect and measure the performance of equities that benefit from it are quite limited. Yes, there are plenty of broad-based emerging market indexes and even a few sector-specific indexes. But the rise of the middle class in the emerging markets is more than a "sector" idea. Companies from a wide cross-section of the economy and markets—such as insurance companies and health care companies—could have as much potential to benefit from a growing emerging market middle class as your typical car company (Consumer Discretionary) or food company (Consumer Staples). WisdomTree thus set out to create an Index that broadly reflects the growth in purchasing power of consumers within these local economies by including a broad cross-section of EM companies that we believe are positioned to benefit from the growth in emerging market consumption. **Introducing the WisdomTree Emerging Markets Consumer Growth Index (WTEMCG)—Selection Criteria and Rationale** Stocks from the two Consumer sectors—Staples and Discretionary—are certainly an important part of creating a broadly diversified Index that reflects a growing middle class and a rise in local economic consumption, but they are not the only sectors that benefit from growing emerging market economies. For example:

- **Financials:** These firms may benefit from an increased demand for credit, loans and other services as middle-class consumers earn greater amounts of money.
- **Health Care:** These firms may benefit from growing populations requiring greater services and innovations.
- **Telecommunication Services:** These firms may benefit from the ability of consumers to pay for greater data and coverage services as being connected to the global economy becomes ever more important.
- **Utilities:** These firms may benefit from the fact that consumers will likely need more power and basic services as their incomes grow.

**Building a Universe for Selection** A key feature of our Index is the inclusion of a **geographic revenue filter** to guide stock selection. Companies that meet our inclusion rules must derive a majority of their revenue from the emerging markets and cannot have undue concentration of their revenues coming from any of the major developed markets. Specifically, more than 60% of their revenue must come from emerging markets, and no more than 25% can come from any one of the following regions: Europe, Japan or the United States. Moreover, the sectors that are more globally sensitive and less direct beneficiaries of emerging market local consumption growth—such as Energy and Materials (commodity sectors)—are not eligible for inclusion. Some of the traditional emerging market indexes have heavy exposures to these commodity sectors, so removing these sectors also provides a

contrast in exposure compared to other benchmarks. Another important exclusion would be banks with more than \$10 billion in market capitalization as of the annual screening date, as we think that these would have the potential to be much more globally sensitive. **Final Selection Rules** For firms meeting the above criteria, the final screens select 250 companies: 150 from Consumer sectors (specifically Staples and Discretionary) and 100 from the non-Consumer sectors with the best combined rank of growth, quality and valuation factors. • **Growth Ranking:** One-third weighted based on the rank of long-term earnings growth expectations. • **Quality Ranking:** One-third weighted based on the rank of historical three-year average return on equity (ROE) and historical three-year average return on assets (ROA). • **Valuation Ranking:** One-third weighted based on the rank of the earnings yield. Companies that have a combined ranking in the top 150 from the two Consumer sectors and the top 100 companies from the eligible sectors outside Consumer Discretionary and Consumer Staples will be selected for inclusion in the Index. **Weighting Rules** The initial weight of a company in the Index at the annual reconstitution is based on net income over the last four quarters. This earnings-weighted approach is further subject to the following constraints<sup>1</sup>: • 5% cap to any individual securities at each annual rebalance. • 25% cap to any individual countries at each annual rebalance. • Weighting allocation adjustment of 60% will be applied to the two Consumer sectors and 40% to all the other sectors as of the annual screening date. **Conclusion** Many recognize the potential from the growth in emerging market consumption, but a central concern is that much of this is already reflected in prices, and valuations can become extended given the high expectations for growth. Our Index methodology strives to incorporate a rigorous, rules-based rebalancing program back to the *Earnings Stream* to address concerns about valuations. We will write more about this methodology in coming posts, as this looks to us to be one of most important drivers of the global economy over the coming years. <sup>1</sup>Between annual rebalances, the individual security weights may fluctuate above 5%, individual country weights may fluctuate above 25%, and the weighting allocation adjusted to the two Consumer sectors versus all the other sectors may not hold in the exact 60:40 proportion due to market movement.

## Important Risks Related to this Article

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. You cannot invest directly in an index.