

Emerging Markets Rally Toolkit: Currencies, Equities & Bonds

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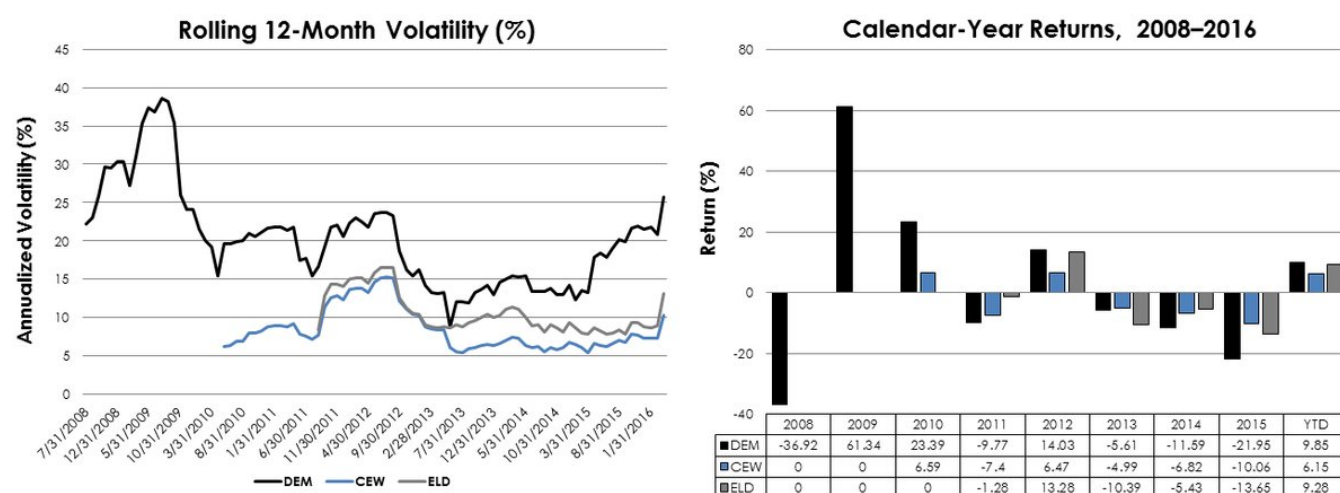
Whether investors are trading on greater stability in commodity prices or a less “hawkish” Federal Reserve (Fed), or they’re simply reallocating en masse to less expensive assets, emerging markets (EM) are soaring. But with virtually all EM assets rallying, which one makes sense for the current environment? Below, we examine the risk and return profile of three ways to position for a continued resurgence across the broader emerging markets.

Emerging Market Currencies While the last five years have seen a broad, sustained rally in the value of the U.S. dollar, 2016 has seen a fairly dramatic reversal in this trend, particularly in EM. After being beaten down to (in some instances) unprecedented levels, emerging market currencies have rallied sharply over the past two months. In our view, for investors to remain bullish on EM, they must be comfortable assuming foreign currency risk. As one alternative, the [WisdomTree Emerging Currency Strategy Fund \(CEW\)](#) offers a straightforward way to express this view. With assets peaking at more than \$700 million in August 2011, CEW currently provides exposure to 15 emerging market currencies. Given that the strategy gains exposure to EM currencies through currency forward contracts, the total returns of the Fund are determined by three components: the interest earned on the collateral (U.S. Treasury bills) of the forwards, changes in spot prices of EM currencies and the interest rate differential between EM countries and the U.S. As of April 15, CEW’s embedded income yield was 4.22%.¹ Put another way, EM currencies would need to depreciate by just over 4% in the next 12 months in order to break even on this investment. For this reason, CEW has tended to be less volatile than EM stocks or bonds. Since inception, CEW has had an average annual volatility of 8.7%.²

High-Dividend Emerging Market Equities Over market cycles, dividends have the ability to boost returns and dampen volatility normally associated with equity investing. In our view, one of the most underappreciated elements of emerging market equities is that more than 93% of all publicly traded EM companies pay dividends.³ The [WisdomTree Emerging Markets High Dividend Fund \(DEM\)](#) takes dividend-focused investing a step further by allocating to the highest-yielding 30% of the [WisdomTree Emerging Markets Dividend Index](#). After peaking at more than \$5.8 billion in May 2013, WisdomTree’s high dividend approach declined with broader markets because of its over-weight to the Financials, Energy and Materials sectors. Today, with the outlook for these industries potentially stabilizing, a [price/earnings ratio \(P/E\)](#) of 9.8x, a majority of companies trading below book value and a trailing 12-month dividend yield of 5.2%, we believe investors should consider taking a value-focused approach to emerging markets.⁴ Since inception, DEM has had an average annual volatility of 21.8%.⁵

Emerging Market Local Debt Similar to CEW, the [WisdomTree Emerging Markets Local Debt Fund \(ELD\)](#) derives its total returns from three components: changes in value of EM currencies against the U.S. dollar, income via coupon payments from bonds and changes

in bond prices due to shifts in EM interest rates. A key difference between the strategies is that CEW is investing in three-month currency forwards versus ELD's investments in longer-maturity bonds. As a result, higher income potential has generally helped dampen volatility compared to CEW. Assets peaked at more than \$2.1 billion in May 2013, and negative performance since then can largely be attributed to a strengthening U.S. dollar and negative sentiment over a majority of emerging market countries. With yields ranging from 1.7% in South Korea to 13.4% in Brazil, ELD currently boasts an embedded income yield of 6.3% (and duration of 4.89 years) by investing across 17 countries. Since inception, ELD has had an average annual volatility of 11.2%.



Source: Zephyr StyleADVISOR, as of 3/31/16 . Past performance is not indicative of future results.

Click for standardized performance of [DEM](#), [CEW](#) and [ELD](#). With a variety of options for exposure to emerging markets, how should an investor allocate in the current environment? In our view, DEM represents the deepest value strategy across WisdomTree's emerging markets suite. While dividends have historically dampened volatility compared to the MSCI Emerging Markets Index, performance will ultimately depend on continued improvement in sentiment resulting from stabilization in China and commodity prices. For investors comfortable assuming currency risk, EM local debt offers perhaps less value but higher income potential than stocks. As a result, volatility in EM fixed income will likely be lower than that of emerging market equities, but returns will likely be lower during a strong risk-on environment. Finally, while CEW will likely offer the lowest amount of volatility, the drivers of return are more straightforward: EM currencies must continue to rally against the U.S. dollar. With these factors in mind, we believe investors should strongly reconsider their current exposure to emerging market assets. ¹Source: WisdomTree. ²Compared to MSCI Emerging Markets Index volatility of 19.0%, as of 3/31/16. ³Source: MSCI, as of 3/31/16. ⁴Source: WisdomTree, as of 3/31/16. ⁵Compared to MSCI Emerging Markets Index volatility of 24.8%, as of 3/31/16.

Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Funds focus their investments in specific regions or countries, thereby increasing the impact of events and developments associated with the region or country, which can adversely affect performance. Investments in emerging 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.

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

Unlike typical exchange-traded Funds, there are no indexes that CEW and ELD attempt to track or replicate. Thus, the ability of each Fund to achieve its objectives will depend on the effectiveness of the portfolio manager.

Funds focusing on a single sector generally experience greater price volatility.

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.

As these Funds can have a high concentration in some issuers, the Funds can be adversely impacted by changes

Please read each Fund's prospectus for specific details regarding each Fund's risk profile affecting such issuers.