

Rebalancing Back to Quality in Emerging Markets

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In October, we ran what could be considered the most important differentiating factor for WisdomTree's global and emerging markets dividend Indexes compared to the market capitalization-weighted competition: our annual rebalance.

Tapping into the Classic Intuition: Relative Value

Market capitalization-weighted indexes tend to hold increasing proportions in stocks that increase in their market capitalizations. In 2006, WisdomTree flipped this concept on its head, tying constituent weights not to market capitalization, which is really dominated by share price movements, but cash dividends. At WisdomTree, we do the following:

- Companies whose share prices appreciated at a faster rate than their dividends grew would typically see a reduction in their constituent weight during the rebalancing process.
- Companies whose share prices did not appreciate or even dropped, but whose dividends were maintained or grown, would typically see an increase in their constituent weight during the rebalancing process. This has been the classic way many of WisdomTree's dividend-focused Indexes have generated outperformance of market capitalization indexes over time.¹

Quality Dividend Growth Is Different

In May 2013, WisdomTree introduced a new concept in the dividend-focused arena.

Classic approaches to dividend growth (which was widely seen as desirable) focused on historical patterns (5, 10, 20 or even 25 years of consecutive, year-over-year dividend growth). WisdomTree responded with [a forward-looking approach that could actually respond to dividend growth trends as they occur](#), as opposed to waiting an arbitrary length of time.

To get included in the [WisdomTree Emerging Markets Quality Dividend Growth Index](#):

- Companies must have dividend coverage ratios of 1.0x or greater. Issuing debt to maintain dividends is not kosher within this approach.
- Half of any company's ranking is based on long-term earnings growth estimates, which are forward-looking estimates of operating earnings growth over the coming business cycle, typically three to five years in duration.
- The other 50% of any company's ranking is based on the three-year average of return on equity (ROE) and return on assets (ROA), focusing equally on each measure in order to mitigate the risk of exposure to companies with high leverage.

How Quality Dividend Growth Works across Global Equity Markets

This approach is something WisdomTree has taken to many different corners of the global equity markets,

including emerging markets. Qualifying constituents are still weighted by cash dividends, a concept that WisdomTree developed in 2006, making sure companies distributing the largest cash dividends receive the greatest weights (and vice versa for those with the smallest cash dividends).

Emerging Market Equities in 2016

Was 2016 a major turning point in emerging market equities? While it may be too soon to know if 2016 was the start of a multiyear bull market in emerging market equities, there can be little question that there was a distinct change in trend from very negative performance and overall currency weakness versus the U.S. dollar to very positive performance and overall currency strength against the U.S. dollar. In fact, through the first three quarters of 2016, the following happened:

- Commodity Sectors:** Energy and Materials within emerging markets led the way, both up more than 26%.²

- Commodity Countries:** As we saw in sectors, the influence of commodities was very visible within the top country performers. Brazil (+62.9%) led the way, followed by Peru (+51.8%), Russia (+30.6%) and Colombia (+29.5%). Each of these markets is connected to commodities and saw their equity markets as well as currencies rebound significantly in the first three quarters of 2016.³

The Currency Story Remains Critical after the U.S. Presidential Election

One of the more important questions in emerging markets that came to light after the U.S. presidential election saw interest rates, including the U.S. 10-Year Treasury note, rise dramatically, contributing to significant short-term U.S. dollar strength, is whether currencies, such as the Brazilian real, will snap back after a short-term correction or if they will trend back toward the weakness that was seen in the years immediately preceding 2016. As of this writing, it is too soon to know for sure.

Interesting Changes in Weight in the [WisdomTree Emerging Markets Quality Dividend Growth Index](#) Sectors and Countries

Within that aforementioned context, we find it interesting to look at the top three country and sector additions in weight:

- Top Three Sectors Where Weight Was Added:** Energy (+4.4%), Materials (+3.1%) and Consumer Staples (+2.9%).

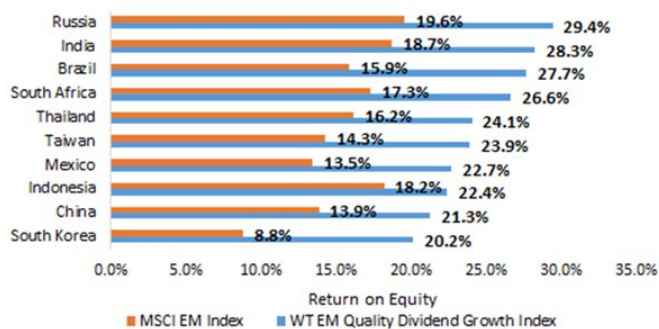
- Top Three Countries Where Weight Was Added:** Mexico (+5.1%), Russia (+4.8%) and India (+3.4%). So, weight was added to some of the top performing areas of emerging markets.

Quality Dividend Growth Is Not Solely about a Relative Value Trade

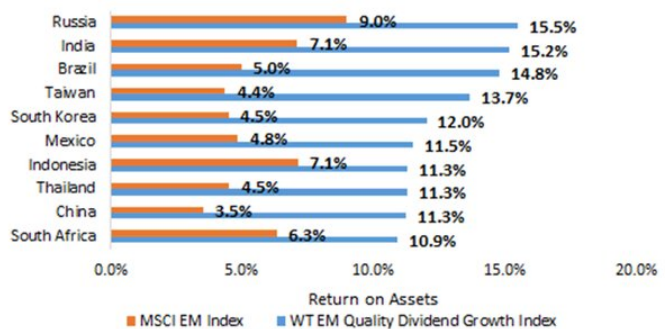
We would emphasize the high-quality nature across the board of each aspect of the WisdomTree Emerging Markets Quality Dividend Growth Index —its rebalancing process is not solely a relative value trade, but rather a reloading of sensitivity to the quality factor first, with the cash dividend weighting bringing in a secondary sensitivity to changes in relative value among constituents remaining in the Index year-over-year.

Measuring Quality: Return on Equity and Return on Assets in Top 10 Countries as Well as by Sector

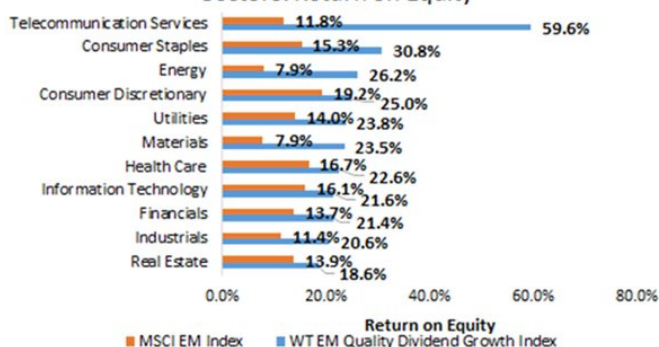
Top 10 Countries: Return on Equity



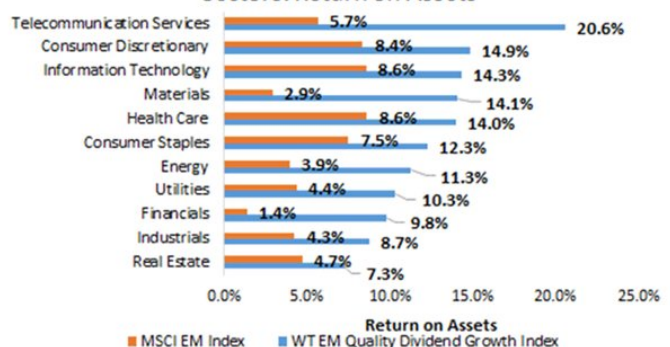
Top 10 Countries: Return on Assets



Sectors: Return on Equity



Sectors: Return on Assets



Sources: WisdomTree, Standard & Poor's, Bloomberg. "Return on Equity" and "Return on Assets" refer to three-year averages as of 10/31/16, and values represent the median of the three-year averages for each respective statistic so as not to be influenced by outliers. Past performance is not indicative of future results. You cannot invest directly in an index.

•**Russia and Brazil:** These countries were on fire during the first three quarters of 2016. What's amazing is how much higher the return on equity or return on assets figures are within the WisdomTree Emerging Markets Quality Dividend Growth Index within each of these markets compared to the exposures within the MSCI Emerging Markets Index.

•**Energy and Materials:** It isn't necessarily intuitive to think of these sectors as "high quality," but the exposures within the WisdomTree Emerging Markets Quality Dividend Growth Index were much higher than those of the market. For example, within Energy, the WisdomTree Index was at 26.2% for return on equity (ROE) and 11.3% for return on assets (compared with 7.9% and 3.9%, respectively, for the MSCI Emerging Markets Index).

For those thinking about reloading their emerging markets equity exposure with a quality focus, the most recent 2016 rebalance offers a rather interesting exploration in this direction, which will also maintain a secondary sensitivity to changes in relative value.

1Sources: WisdomTree, Bloomberg, for the period 6/1/06 to 10/31/16. The [WisdomTree Dividend Index](#) outperformed the Russell 3000 Index, the [WisdomTree MidCap Dividend Index](#) outperformed the [S&P MidCap 400 Index](#), the [WisdomTree SmallCap Dividend Index](#) outperformed the Russell 2000 Index,

the [WisdomTree High Dividend Index](#) outperformed the Russell 1000 Value Index, the [WisdomTree International Equity Index](#) outperformed the MSCI EAFE Index, the [WisdomTree International LargeCap Dividend Index](#) outperformed the MSCI EAFE Index, the [WisdomTree International MidCap Dividend Index](#) outperformed the MSCI EAFE Mid Cap Index, the WisdomTree International SmallCap Dividend Index outperformed the MSCI EAFE Small Cap Index and the [WisdomTree International High Dividend Index](#) outperformed the MSCI EAFE Value Index.

2Source: Bloomberg, for the period 12/31/15 to 9/30/16. The Energy and Materials sectors refer to constituents within those sectors from within the broader MSCI Emerging Markets Index.

3Source: MSCI, for the period 12/31/15 to 9/30/16. Brazil, Peru, Russia and Colombia were the top four performing countries within the broader MSCI Emerging Markets Index. Performance of each country refers to the universes defined by the respective MSCI Emerging Markets country indexes.

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.