

With Recent Volatility, Is It Time for Active Management in the Emerging Markets?

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A number of concerns have recently flared up for the emerging markets, creating volatility both in the equity markets and the currency markets. Concerns started emerging when the Federal Reserve began talk of tapering its asset purchase program, which many feel will reduce liquidity flows to emerging markets. Moreover, a rebalancing in China from investment-led growth toward domestic consumption has put pressure on commodity prices, with ripple effects through many emerging markets that are sensitive to commodity prices. Also there is concern about a banking crisis in China based on the rapid credit expansion that has occurred over the last five years. Many are also pointing to the underperformance of emerging markets over the last three years as being characterized by high volatility. So is now the time for active managers to pick the best opportunities? In short, my research suggests active managers have a tough time beating traditional index-based benchmarks over longer periods, and I think this particular environment should be no different. **There Are Many Ways to Invest** As emerging markets have become more accessible, there are an increasing number of ways to invest in them, but the decision usually starts with whether to invest in active mutual funds or passive exchange-traded funds (ETFs) . Recently, some have argued that active managers are best suited to outperform in today's environment, so I want to take a hard look at the numbers. In the table below, I compare how some emerging market indexes have performed against U.S. ETFs and open-end mutual funds within Morningstar's Diversified Emerging Markets category¹. **Active Managers vs. Indexes**

	Trailing 10-Yr	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
MSCI Emerging Markets Index Return	11.17%	-2.60%	18.22%	-18.42%	18.88%	78.51%	-53.33%	39.39%	32.17%	34.00%	25.55%
Did Active Managers Outperform MSCI EM Index??	No	Yes	Yes	No	No	No	No	No	Yes	No	No
Percent of Active Managers Beaten by the Specified Index (12/31/2003-12/31/2013)											
MSCI Emerging Markets Index	73.0%	42.1%	40.7%	63.2%	54.3%	74.4%	57.6%	66.7%	44.6%	54.3%	58.9%
MSCI Emerging Markets Small Cap Index	86.8%	70.8%	81.2%	3.9%	93.4%	98.6%	17.4%	83.0%	47.3%	33.6%	51.1%
WisdomTree Emerging Markets Equity Income Index	N/A	27.1%	24.9%	97.8%	85.2%	17.1%	100.0%	N/A	N/A	N/A	N/A
WisdomTree Emerging Markets SmallCap Dividend Index	N/A	49.3%	86.3%	44.8%	97.6%	88.0%	86.9%	N/A	N/A	N/A	N/A
Number of Managers	224	642	604	494	445	427	340	311	281	261	244

Sources: WisdomTree, Zephyr StyleADVISOR, Morningstar, 12/31/2003–12/31/2013. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, please visit our [Glossary](#). • **Most Active Managers Underperform**

– Over the most recent 10-year period the MSCI Emerging Markets Index (MSCI EM) has outperformed 73.0% of funds in the Morningstar Diversified Emerging Markets category. MSCI EM also outperformed more than 50% of the Morningstar category in seven out of the past 10 calendar years. It is also important to note that the MSCI Emerging Markets Small Cap Index has outperformed 86.8% of the Morningstar category over the past 10 years. • **WisdomTree Emerging Markets Equity Income Index (WTEMHY)** – Since its inception, WTEMHY has outperformed close to 98% of the Morningstar category². I find it impressive that during two of the worst calendar year returns for emerging markets, 2011 and 2008, the Index was able to outperform almost 98% and 100% of the Morningstar category, respectively. •

WisdomTree Emerging Markets SmallCap Dividend Index (WTEMSC) – Since its inception, WTEMSC has outperformed over 94% of the Morningstar category³. On a calendar year basis, WTEMSC was also able to outperform over 85% of the Morningstar category in four out of the past six years, or two-thirds of the time. **Why Emerging Market Indexes?** Mutual fund managers, like all investors, are susceptible to behavioral biases that can negatively affect their investment decisions. This is exhibited through the table above, which shows that the majority of active managers in the Morningstar Diversified Emerging Markets category actually underperformed MSCI EM over the most recent 10-year period and during seven of the last 10 calendar years. For believers of active management, I think these results are even more alarming given the fact that MSCI EM is a market cap-weighted index. Market cap-weighted indexes typically give the greatest weight to the stocks with the highest prices, without regard to any measure of fundamental value. As a result, market capitalization-weighted indexes tend to over-weight more expensive equities,

sectors and countries, and under-weight those that may be relatively less expensive. **Why Smart Beta?** I believe it is especially important now to have a disciplined focus on the valuation opportunities present in the emerging markets, specifically cash flow and dividends. WisdomTree Indexes use a rules-based methodology to weight companies by their underlying fundamentals, such as dividends or earnings, because we believe that stock markets are not always efficient. Furthermore, WisdomTree rebalances its Indexes annually to adjust for relative value. While stock prices may deviate from the underlying fundamental value for a number of reasons, one is sentiment, which can result in “herding” behavior. Currently, I feel this is one reason for emerging markets’ recent underperformance, but I am confident the market will eventually revert back to its underlying fundamentals. As a result, investors shouldn’t abandon the space, but instead have a rules-based strategy that focuses on fundamentals and is not susceptible to psychological biases. 1The U.S. OE Diversified Emerging Markets category encompasses all the open-ended mutual funds and ETFs that Morningstar categorizes as “Diversified Emerging Markets” funds. 2Sources: Zephyr StyleADVISOR, Morningstar; Index inception: 06/01/2007. 3Sources: Zephyr StyleADVISOR, Morningstar; Index inception: 08/01/2007.

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. Funds focusing on a single sector and/or smaller companies generally experience greater price volatility. 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, intervention and political developments. Due to the investment strategy of the Funds, they may make higher capital gain distributions than other ETFs. Please read each Fund's prospectus for specific details regarding the Fund's risk profile. Investments focused in China are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance. 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.