

Xi vs. Mao: The Emerging Market Battle

Published October 8, 2018

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In the span of most of our lives, so many economic systems have turned on a dime. Look at Poland, under the Soviet thumb as recently as three decades ago, graduating this month to “developed” status in FTSE Russell Indexes. China, even after opening up upon Deng Xiaoping’s ascension to power in 1978, remained thoroughly communist for years, really engaging freer market reforms only after its Tiananmen Square fiasco in 1989. Imagine what onlookers a half century ago would have said if their crystal ball told them that 2018 would bring news that Peking University may just ban its student Marxist group.¹

Talk about a different world.

But the legacy of the old days leaves a tale of two business models:

- The state-owned variety, which typically places profits below political consideration; and
- The modern, profit-focused enterprises that, in many cases, incorporated in more recent decades

China is considered the worst offender when it comes to dominant state-controlled entities, but the intrusion of government in listed companies is endemic across the emerging world. Russia, India, Malaysia and many more are serial culprits. WisdomTree’s research of 1,000 emerging market companies found that about 300 of them had more than 20% of their equity owned by the government.²

And when you put together investment strategies that cut those companies out, what comes together is a consortium of efficiently run, low-conflict-of-interest enterprises. They are the “Xi Jinping stocks”—served up with some flaws, no doubt, and some bad habits too, but the companies of this century nonetheless. Their counterparts, if you will excuse the labored parallel, are the “Chairman Mao” stocks.

Antiquity vs. Modernity

What is a key factor for determining if a company has heavy state ownership? Its founding year. The monoliths were in most cases created when prior-era rulers, dictators, autocrats, communists created a government-run company. In contrast, many of the companies with zero state ownership never met Chairman Mao or Leonid Brezhnev.

In other words, the big state-owned companies were arms of the government for so long that many never learned how to focus on the income statement. It's not Priority No. 1. Kick them out and you have an index that naturally melts up on multiple intuitive metrics. The list is deep: projected earnings growth, profitability, propensity to grow the dividend, willingness to sack unneeded workers, promotions based on merit and so forth. You create a basket of companies that strive for excellence, not a bucket of Goliaths whose business ventures may have a long list of negative net present value political projects.

Figure 1 shows the largest over-weights in the [WisdomTree Emerging Markets ex-State-Owned Enterprises Index](#). For example, it has 6.77% in Tencent, making it 2.02% over-weight compared to its 4.75% allocation in the MSCI Emerging Markets Index.

Notice that many of WisdomTree's major over-weights were founded in the modern era—after China's 1978 opening and, of course, near or after the 1989 Berlin Wall/Tiananmen exacta.

Figure 1: Founding Year, WisdomTree Emerging Markets ex-State-Owned Enterprises Index's Top 10 Over-Weights

	Company	Domicile	WisdomTree Emerging Markets ex-State-Owned	MSCI Emerging Markets	Amt. WisdomTree Overweight	Founding Year
Largest Overweights	1 Tencent Holdings	China	6.77%	4.75%	2.02%	1998
	2 Alibaba Group	China	5.72%	3.87%	1.85%	1999
	3 Lukoil	Russia	1.80%	0.00%	1.80%	1991
	4 Ping An Insurance Group Co-A	China	1.43%	0.00%	1.43%	1988
	5 Reliance Industries	India	1.71%	0.97%	0.74%	1977
	6 Ping An Insurance Group Co-H	China	1.59%	0.99%	0.60%	1988
	7 Public Bank Berhad	Malaysia	0.92%	0.35%	0.57%	1966
	8 Baidu	China	1.77%	1.20%	0.57%	2000
	9 Novatek PJSC	Russia	0.85%	0.29%	0.56%	1994
	10 Infosys	India	0.94%	0.43%	0.51%	1981
Average Median						1988 1990

Source: WisdomTree, as of 8/31/18. Weights and holdings subject to change.

Figure 2 tells an opposite story, the story of the companies that WisdomTree's Index shuns the most compared to MSCI Emerging Markets weights. For example, its largest under-weight, China Construction Bank, is a "vintage" 1954 firm.

Boom, boom, boom, down the list, WisdomTree "kicks out" a bunch of very old companies. The 10 companies our Index shuns the most are a "Who's Who" of ancient companies, and in many cases, ancient mind-sets.

Figure 2: Founding Year, WisdomTree Emerging Markets ex-State-Owned Enterprises Index's Top 10 Under-Weights

		Domicile	WisdomTree Emerging Markets ex- State-Owned Enterprises Index	MSCI Emerging Markets	Amt. WisdomTree Underweight	Founding Year
Largest Underweights	1	China Construction Bank	China	0.00%	-1.66%	1954
	2	China Mobile	China	0.00%	-1.14%	1997
	3	Ind & Comm Bank of China	China	0.00%	-1.00%	1984
	4	Housing Development Finance	India	0.00%	-0.84%	1977
	5	Vale SA	Brazil	0.00%	-0.79%	1942
	6	Bank of China	China	0.00%	-0.70%	1912
	7	Itaú Unibanco	Brazil	0.00%	-0.64%	2008*
	8	CNOOC	China	0.00%	-0.61%	1982
	9	Samsung Electronics	South Korea	0.00%	-0.59%	1938
	10	Taiwan Semiconductor	Taiwan	3.48%	-0.58%	1987
Average						1968
Median						1980
Average Using Predecessor Companies for #7 (1945 for Itaú & 1924 for Unibanco)						1961
Median Using Predecessor Companies for #7 (1945 for Itaú & 1924 for Unibanco)						1966

Source: WisdomTree, as of 8/31/18. Weights and holdings subject to change.

Considerations

WisdomTree has seven broad emerging market ETFs and two that are China-specific. For investors who are keen to focus on the future of the developing world, the WisdomTree Emerging Markets ex-State-Owned Enterprises Index, tracked by the [WisdomTree Emerging Markets ex-State-Owned Enterprises Fund \(XSOE\)](#), is trading for 13.9x forward earnings and has a dividend yield of 2.2%.³ In contrast, perhaps our deepest value emerging market ETF, the [WisdomTree Emerging Markets High Dividend Fund \(DEM\)](#), tracks the [WisdomTree Emerging Markets High Dividend Index](#). That Index is down to 9.0x forward earnings and has a 5.3% dividend. Being deep value, a trade-off for having single-digit price-to-earnings (P/E) ratios, is a natural inclusion of state-owned firms.

There is something else that investors may want to think about: the so-called “global trade war.” Although we have expressed skepticism with respect to its severity in recent blog posts and reports, investors with strong opinions either way can use XSOE and DEM, depending on which side their outlook lies. To the extent that Chinese state-run banks and industrials are more China-focused, they may be more insulated from a deep trade rift with the U.S. That favors DEM. For investors on the other side of sentiment, who anticipate trade resolution or who simply see emerging equities as a contrarian buy opportunity, the non-state-run companies could be the angle. That favors XSOE, which has been pummeled 17.5% since January 26, 2018.⁴

For dedicated China ETFs, a parallel to these concepts is the battle between the [S&P China 500 Index](#) and the [WisdomTree China ex-State-Owned Enterprises Index](#). Their respective WisdomTree ETFs are the [WisdomTree ICBCCS S&P China 500 Fund \(WCHN\)](#) and the [WisdomTree China ex-State-Owned Enterprises Fund \(CXSE\)](#).

1Source: Financial Times, "Peking University Threatens to Close Down Marxism Society," 9/23/18.

2Sources: WisdomTree, FactSet, Standard & Poor's, as of 9/30/17 index screening. Initial companies in index screens are those that pass minimum listing, market cap and liquidity requirements for inclusion.

3Source: WisdomTree, data as of 9/27/18 for this and all indexes herein.

4Through 9/27/18.

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. Some of these Funds focus their investments in China, including A-shares, which include risk of the RQFII regime and Stock Connect program, thereby increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in emerging or offshore 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. The Funds' exposure to certain sectors may increase their vulnerability to any single economic or regulatory development related to such sector. As these Funds can have a high concentration in some issuers, the Funds can be adversely impacted by changes affecting those issuers. These Funds will be required to include cash as part of their redemption proceeds, which introduces additional risks, particularly due to the potential volatility in the Chinese market and market closures. The Funds invest in the securities included in, or representative of, their Indexes regardless of their investment merit, and the Funds do not attempt to outperform their Indexes or take defensive positions in declining markets. Due to the investment strategy of these 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.