INDIA: A FOCUS ON EARNINGS LEADING TO LARGE GAINS

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Less than a year ago, India was considered to be part of a group of "fragile" emerging market countries that had large vulnerabilities that sent its currency into a tailspin and caused a spike in the equity volatility. During times of volatility, the focus tends to be less on individual companies' fundamentals and more on macroeconomic fears. Opportunities typically present themselves during these times of heightened volatility and fear. When emotions can get in the way of making difficult portfolio allocations, WisdomTree's rules-based process makes adjustments to portfolios based on strict readings of the underlying fundamentals. By using this rules-based fundamental indexing process at the most recent annual rebalance last September, the WisdomTree India Earnings Index (WTIND) added significant weight to companies selling at depressed relative prices, and those companies have performed very well during the market rebound. This process has added significant value to the WisdomTree India Earnings Fund (EPI), which is designed to track WTIND, by focusing on these lower-valued securities, as illustrated below. **A Focus on Earnings** WisdomTree believes fundamentals such as dividends and earnings offer more objective measures of a company's health, value and profitability than stock price alone. Because India is a low-dividend-paying country, WTIND screens and weights its constituents by earnings. While the majority of Indian indexes are market market cap-weighted—meaning they tend to give more weight to companies that sell at higher prices than those that offer stronger fundamentals—the WTIND index methodology is designed to help magnify the effect of earnings on weights and total returns. Companies with low price-to-earnings (P/E) ratios typically receive higher weights. Additionally, as I discussed here, the WTIND also strives to represent the broadest cross-section of investable and profitable companies in the marketplace. The focus on stocks with lower P/E ratios has worked particularly well since the last annual rebalance for the WTIND, as illustrated below. **P/E Quartile Performance**

P/E Ratios Quartiles (9/30/13)	Average Weights (9/30/13-5/20/14)		Performance (9/30/13-5/20/14)		Attribution (9/30/13-5/20/14)
	WTIND	MSCI India	WTIND	MSCI India	
Less Than 9.6x	31.9%	12.0%	73.8%	67.6%	10.3%
9.6x to 16.5x	31.4%	22.4%	54.8%	56.3%	2.6%
16.5x to 22.9x	23.3%	35.6%	29.9%	28.7%	0.4%
Greater Than 22.9	13.4%	26.8%	14.4%	11.5%	2.4%
Negative Earnings	0.0%	3.2%	N/A	35.2%	0.0%
Index Total	100.0%	100.0%	46.1%	30.4%	15.7%

Sources: WisdomTree, Bloomberg, 9/30/13–5/20/14. Because WTIND's annual rebalance is in September, 9/30/13 was chosen as a start date. Returns are in U.S. dollars. Past performance is not indicative of future results. High double-digit returns are unusual and cannot be sustained. Investors should also be aware that these returns were achieved primarily during favorable market conditions. Performance, especially for very short periods, should not be the sole factor in making an investment decision. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. You cannot invest directly in an index.

• Low P/E Ratio Overweight Drove Outperformance – WTIND's overweight exposure to low P/E stocks added more than 10% of outperformance compared to the MSCI India Index. This is impressive considering it accounted for almost two-thirds of the total 15.7% outperformance during the period. **• More Weight in Lower P/E Ratios –** WTIND had over 2.5x more weight in firms with the lowest P/E ratios. Evenly impressive is the fact that WTIND had almost two-thirds of its weights in firms with a P/E ratio less than 16.5x earnings, compared to the MSCI India Index, which had more than two-thirds of its weight in firms with a P/E ratio greater than 16.5x earnings. **• Lower P/E Ratio Firms Outperformed –** Firms within the lowest quartile outperformed firms in the highest quartile by more than 55% within both WTIND and MSCI India. Although the performance differentials among quartiles for the Indexes were similar, WTIND was able to outperform over the period as a result of its overweight to stocks within the lowest P/E quartiles. When sentiment gets very negative, the market often moves more than changes in fundamentals — in this case the earnings. Rebalancing back to those fundamentals may then be rewarded when positive sentiment returns, as we have seen in last nine months. • **No Weight In Negative Earnings –** Since WTIND screens companies for inclusion based on earnings, the Index will remove all unprofitable companies at its annual reconstitution. While company earnings may fluctuate between screening dates, we think this annual screening factor helps the Index manage valuation risks. **Weighting by Earnings Focuses on Lower P/E Ratios** Given how low-priced stocks contributed to the performance, let's discuss how the Index continually focuses on this segment of the Indian market at each annual rebalance. In order to garner significant weights in the Index, the index methodology requires that a company grow its profits rather than increase its market capitalization. As a result, we can generalize the impact of the rebalance as follows: • **Typical Additions in Weight –** Firms whose share prices may have performed poorly or stayed flat but whose earnings increased. • **Typical Reductions in Weight –** Firms whose share prices may have performed quite well but whose earnings growth was negative or flat. This rebalancing process is a key differentiating element of WisdomTree's indexing approach and one that WisdomTree believes will continue to provide value over time. **Conclusion** The landslide victory by Narendra Modi and his party in the Indian prime minister election has garnered much attention and celebration in equities. A concern with such large gains in a short period is that the market may become expensive. WisdomTree's earnings-weighted approach helps to focus on lower-priced segments of the Indian market, and the Index rebalances each September to help manage the valuation risk from the big winners. For those looking for continued improvement in India, EPI — which can be considered a broad representative of the Indian market and economy, but also employs a process to manage equity valuation risk — could be an attractive way to gain exposure to India.

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DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

WisdomTree India Earnings Index : A fundamentally weighted Index that measures the performance of companies incorporated and traded in India that are profitable and that are eligible to be purchased by foreign investors. Companies are weighted in the Index based on their earnings in their fiscal year prior to the Index measurement date, adjusted for a factor that takes into account shares available to foreign investors.

Dividend : A portion of corporate profits paid out to shareholders.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

MSCI India Index : A market capitalization-weighted index designed to measure the performance of the Indian equity market.

Valuation risk : The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.