

BUILDING AN INDEX FOR EXPOSURE TO EMERGING MARKET CONSUMER GROWTH

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One of the major themes that we believe will drive much of the global economy over the coming years is the rise in potential growth from emerging market (EM) consumers. Given EM's youthful demographics and the potential for their low [per capita incomes](#) to catch up with those of the developed world, the potential ramifications of this trend could be quite large. Despite the importance of this major shift, the options that could reflect and measure the performance of equities that benefit from it are quite limited. Yes, there are plenty of broad-based emerging market indexes and even a few sector-specific indexes. But the rise of the middle class in the emerging markets is more than a "sector" idea. Companies from a wide cross-section of the economy and markets—such as insurance companies and health care companies—could have as much potential to benefit from a growing emerging market middle class as your typical car company (Consumer Discretionary) or food company (Consumer Staples). WisdomTree thus set out to create an Index that broadly reflects the growth in purchasing power of consumers within these local economies by including a broad cross-section of EM companies that we believe are positioned to benefit from the growth in emerging market consumption. **Introducing the [WisdomTree Emerging Markets Consumer Growth Index \(WTEMCG\)](#)—Selection Criteria and Rationale** Stocks from the two Consumer sectors—Staples and Discretionary—are certainly an important part of creating a broadly diversified Index that reflects a growing middle class and a rise in local economic consumption, but they are not the only sectors that benefit from growing emerging market economies. For example: • Financials: These firms may benefit from an increased demand for credit, loans and other services as middle-class consumers earn greater amounts of money. • Health Care: These firms may benefit from growing populations requiring greater services and innovations. • Telecommunication Services: These firms may benefit from the ability of consumers to pay for greater data and coverage services as being connected to the global economy becomes ever more important. • Utilities: These firms may benefit from the fact that consumers will likely need more power and basic services as their incomes grow. **Building a Universe for Selection** A key feature of our Index is the inclusion of a **geographic revenue filter** to guide stock selection. Companies that meet our inclusion rules must derive a majority of their revenue from the emerging markets and cannot have undue concentration of their revenues coming from any of the major developed markets. Specifically, more than 60% of their revenue must come from emerging markets, and no more than 25% can come from any one of the following regions: Europe, Japan or the United States. Moreover, the sectors that are more globally sensitive and less direct beneficiaries of emerging market local consumption growth—such as Energy and Materials (commodity sectors)—are not eligible for inclusion. Some of the traditional emerging market indexes have heavy exposures to these commodity sectors, so removing these sectors also provides a contrast in exposure compared to other benchmarks. Another important exclusion would be banks with more than \$10 billion in [market capitalization](#) as of the annual screening date, as we think that these would have the potential to be much more globally sensitive. **Final Selection Rules** For firms meeting the above criteria, the final screens select 250 companies: 150 from Consumer sectors (specifically Staples and Discretionary) and 100 from the non-Consumer sectors with the best combined rank of growth, quality and [valuation](#) factors. • **Growth Ranking:** One-third weighted based on the rank of [long-term earnings growth expectations](#). • **Quality Ranking:** One-third weighted based on the rank of historical three-year average [return on equity \(ROE\)](#) and historical three-year average [return on assets \(ROA\)](#). • **Valuation Ranking:** One-third weighted based on the rank of the [earnings yield](#). Companies that have a combined ranking in the top 150 from the two Consumer sectors and the top 100 companies from the eligible sectors outside Consumer Discretionary and Consumer Staples will be selected for inclusion in the Index. **Weighting Rules** The initial weight of a company in the Index at the annual reconstitution is based on [net income](#) over the last four quarters. This [earnings-weighted](#) approach is further subject to the following

constraints¹: • 5% cap to any individual securities at each annual rebalance. • 25% cap to any individual countries at each annual rebalance. • Weighting allocation adjustment of 60% will be applied to the two Consumer sectors and 40% to all the other sectors as of the annual screening date. **Conclusion** Many recognize the potential from the growth in emerging market consumption, but a central concern is that much of this is already reflected in prices, and valuations can become extended given the high expectations for growth. Our Index methodology strives to incorporate a rigorous, rules-based rebalancing program back to the [Earnings Stream](#) to address concerns about valuations. We will write more about this methodology in coming posts, as this looks to us to be one of most important drivers of the global economy over the coming years. ¹Between annual rebalances, the individual security weights may fluctuate above 5%, individual country weights may fluctuate above 25%, and the weighting allocation adjusted to the two Consumer sectors versus all the other sectors may not hold in the exact 60:40 proportion due to market movement.

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DEFINITIONS

Per capita income : The sum of the value of all goods and services produced in a particular country divided by the total population of that country. Higher values imply a higher standard of living for that country's citizens.

WisdomTree Emerging Markets Consumer Growth Index : A fundamentally weighted index designed to measure the performance of emerging market equities that have a potential heightened sensitivity to increased emerging market consumption. Weighting is by earnings.

Market Capitalization : 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.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Long-Term Earnings Growth Expectations : Compilation of analyst estimates of the growth in operating earnings expected to occur over the next full business cycle, typically 3 to 5 years, sourced from Bloomberg.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

Earnings yield : The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

Net income : A company's total earnings (or profit), which are calculated by taking revenues and adjusting for the cost of doing business, depreciation, interest, taxes and other expenses.

Earnings-weighted : Earnings for all constituents in an index are added together, and individual constituents are subsequently weighted by their proportional contribution to that total.

Earnings Stream® : Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.