

# COMPARING OPPORTUNITIES WITHIN WISDOMTREE'S EMERGING MARKETS FAMILY

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In [prior blogs](#) about the current state of the emerging market equity landscape, we pointed out a number of particular findings: • The emerging markets look inexpensive, in my view, based on an analysis of historical [dividend yields](#). • Some of the lowest price-to-earnings ([P/E ratio](#)) sectors and countries within emerging markets (as represented here be the [MSCI Emerging Markets Index](#)) are also those with relatively higher [betas](#). **WisdomTree's Landscape of Broad Emerging Market Indexes** WisdomTree has a number of broadly focused emerging market equity Indexes. Below, I contrast the Indexes from the standpoints of [valuation](#) criteria (dividend yields and P/E ratios), beta ([market risk](#)) and [growth](#) factors. It is difficult for any one index to be strong on all these fronts, as there are trade-offs between valuation-focused indexes and growth-focused indexes. This blog post tries to explain attributes accentuated in current portfolios and the underlying index methodologies for the following indexes: • [MSCI Emerging Markets Index \(MSCI EM\)](#) • [WisdomTree Emerging Markets Equity Income Index \(WTEMHY\)](#) • [WisdomTree Emerging Markets Dividend Growth Index \(WTEMDG\)](#) • [WisdomTree Emerging Markets SmallCap Dividend Index \(WTEMSC\)](#) **Dividend Focus as a Foundation** Each of the WisdomTree Indexes shown here includes only dividend-paying companies. These Indexes can help position investors for the attractive dividend yields discussed in our prior blog. At its core, WisdomTree's dividend-focused, rules-based methodology allows the underlying constituent Index weights to be rebalanced back to a concept of [relative value](#)—critically outside of share price. If dividends grow faster than share prices, this typically signals an increase in weight at the rebalance; if prices grow faster than dividends, this typically signals a decrease in weight at the rebalance. An essential element of our dividend focus lies in our annual rebalance, where these weights are refreshed.

## Characteristics of WisdomTree Emerging Market Indexes Compared to MSCI EM as of 7/31/2013

	Broad Market Cap	Value	Growth	Small Cap
	MSCI EM	WTEMHY	WTEMDG	WTEMSC
Median Price-to-Earnings (P/E) Ratio <sup>1</sup>	12.3x	10.7x	15.3x	11.5x
Beta Relative to MSCI EM <sup>2</sup>	1.00	1.03	0.92	0.89
Median Long-Term Earnings Growth Expectations <sup>3</sup>	12.5%	7.4%	16.8%	13.0%
Median Dividend Yield <sup>4</sup>	2.4%	5.1%	2.1%	3.0%
Median Earnings Yield <sup>5</sup>	8.1%	9.3%	6.5%	8.7%
PEGY Ratio <sup>6</sup>	82.8x	85.4x	81.1x	71.5x
Median Dividend Yield / Median Earnings Yield <sup>7</sup>	29.5%	54.6%	32.1%	34.9%

Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index. <sup>1</sup>Median price-to-earnings (P/E) ratio: P/E ratio of index constituents where 50% of constituent values fall above and 50% fall below. <sup>2</sup>Beta relative to MSCI EM: Of the specified index, based on its 7/31/2013 constituents, relative to the MSCI Emerging Markets Index. <sup>3</sup>Median long-term earnings growth expectations: Compilation of analyst estimates of the growth in operating earnings expected to occur over the company's next full business cycle, typically three to five years.

Value reflects the point where 50% of values are above and 50% are below. <sup>4</sup>Median dividend yield: Value of the trailing 12-month dividend yield for a given index for which 50% of values are above and 50% are below. <sup>5</sup>Median earnings yield: Earnings per share divided by share price. Value reflects the point where 50% of values are above and 50% are below. <sup>6</sup>PEGY ratio: Ratio of the median price-to-earnings (P/E) ratio divided by the sum of the median long-term earnings growth expectations and the median dividend yield. Lower numbers indicate lower prices relative to the median long-term earnings growth expectations and median dividend yield of the underlying stocks. <sup>7</sup>Median dividend yield/median earnings yield: Meant to calculate the median payout ratio, which is the median dividend per share divided by the median earnings per share. • **WTEMSC for Small Caps—A Unique Option with the Lowest Beta of the Indexes Shown:** It is counterintuitive that the lowest beta Index shown—the only one below .9—is focused entirely on small-cap stocks. WTEMSC also has a P/E ratio below that of the MSCI EM and long-term earnings growth expectations in double-digit territory. We believe that WTEMSC's lower beta is largely due to the fact that its exposures steer it away from Russia and China and toward Taiwan, its largest absolute weight, and also gives a nearly 10% weight to Malaysia, an equity market with a beta of below .7 as of July 31, 2013. It is also worth noting that WTEMSC has the lowest PEGY ratio of all the indexes shown, indicating that the median long-term growth expectations and median dividend yield are particularly high relative to the current median P/E ratio. • **WTEMHY for Value:** WTEMHY has the lowest median P/E ratio and the highest median dividend yield, but to be fair, it also has the lowest long-term earnings growth expectations, in part due to a median payout ratio of nearly 55%, nearly twice as high as that of the other indexes shown. When indexes have higher payout ratios, constituents are reinvesting a lower percentage of their earnings to fund future growth opportunities. WTEMHY's underlying focus on valuations—by sorting the market by dividend yield and selecting the highest dividend yield stocks as part of its selection process—drives this result. The best valuations are currently found in Russia and China on the country side, and in Energy on the sector side, so it makes sense that WTEMHY's beta is above 1.00, given what I detailed in the prior blog post about how these countries and this sector all have betas above 1.00. • **WTEMDG for Growth:** WTEMDG has the highest median P/E ratio and the lowest current median dividend yield, but its higher [long-term earnings growth expectations](#) compared to the other indexes shown is also important. This illustrates a potential trade-off in the financial markets: high current yield (WTEMHY) or future growth potential (WTEMDG). Quantitatively, this can be shown through the lower PEGY ratio for WTEMDG compared to both the MSCI EM and WTEMHY, meaning that if one accounts for the higher median long-term growth expectations and median dividend yield, price levels for WTEMDG are actually lower. Relative to WTEMHY, WTEMDG has less exposure to Russia and Energy stocks and more exposure to Indonesia, Mexico and Consumer Staples. WTEMDG basket trades at a higher median P/E ratio but has a lower expected beta. WTEMDG includes historical three-year average [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#) as part of its selection criteria—and these stocks often sell at higher multiples and deserve the premium multiples<sup>1</sup>. The ROE/ROA focus of the WTEMDG methodology reminds me of the famous quote from Charlie Munger: *"We've really made the money out of high quality businesses . . . If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result."* – Charlie Munger at USC Business School in 1994 **Conclusion** With the plethora of emerging market equity indexes that have come into existence, there are more options for fine-tuning the type of emerging market exposure desired. Each individual has his or her own goals, and it is important to focus on the indexes with exposure characteristics most closely aligned with those goals. Read the full research paper [here](#). <sup>1</sup>The terms "higher multiples" and "premium multiples" refer to the P/E ratio.

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You cannot invest directly in an index.

## **DEFINITIONS**

**Dividend yield** : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

**MSCI Emerging Markets Index** : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as “emerging markets” by MSCI.

**Beta** : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

**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.

**Risk** : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**WisdomTree Emerging Markets Equity Income Index** : A subset of the WisdomTree Emerging Markets Dividend Index measuring the performance of the higher-yielding stocks as measured by trailing 12-month dividend yields, weighted by cash dividends.

**WisdomTree Emerging Markets Dividend Growth Index** : A fundamentally weighted index designed to track the performance of dividend-paying emerging market companies that WisdomTree believes have the potential to increase their dividends due to certain factors, which include estimated earnings growth, return on equity and return on assets. Weighting is by trailing 12-month cash dividends.

**WisdomTree Emerging Markets SmallCap Dividend Index** : A subset of the WisdomTree Emerging Markets Dividend Index measuring the performance of the smallest firms by market capitalization weighted by cash dividends.

**Relative value** : The relationship between a particular attribute, e.g., a dividend, and the firm’s share price compared to that of another firm.

**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.