SEPARATING GOOD FROM BAD EMERGING MARKET EXPOSURE

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As pioneers of Modern Alpha™ strategies and currency hedging, WisdomTree has been at the forefront of providing smarter exposure to investors. Our head of Research, Jeremy Schwartz, recently wrote about managing currency risk in our newly launched Emerging Market (EM) multifactor strategy. This comes at a time when EM currencies have been under immense pressure due to trade concerns, sanctions and a host of other global macro-related issues.

Should all EM exposures be painted with the same brush—and if not, what is the right way to separate good EM exposure from bad in the current environment?

Separating EM into Its Components

Most investors have treated EM like a monolith—a single asset class. However, individual countries do have a positive beta to the asset class, just like in any other region. In the European Union, for example, there are fundamental differences between the German and Italian economies. Similarly, there are fundamental differences between the Indian and Brazilian economies.

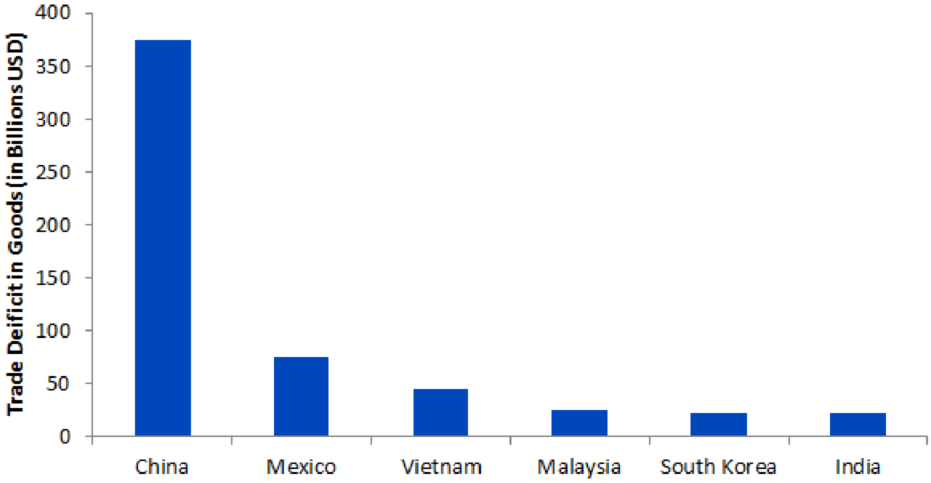
This is why, when it comes to the single biggest threat facing EM stocks right now—trade and geopolitics—we hear of certain countries like China and Turkey much more often than countries like India and South Korea.

When Washington looks into individual trade surpluses, they start with the chart below.

At a Chinese trade surplus of over $375 billion, Washington realizes that closing 10% of the total gap with China would be a much bigger victory than closing 100% of the gap with Malaysia, South Korea or especially India individually.[1]

Here I would clarify that not all Chinese equities face the brunt of a trade war, but investors should focus on sectors and companies that tap into China's stellar internal growth, such as Information Technology, which is increasingly the focus of the new China economy, while staying away from traditional manufacturing and industrial companies.

2017 Trade Deficit of the U.S. for Goods Traded with Large EM Trading Partners



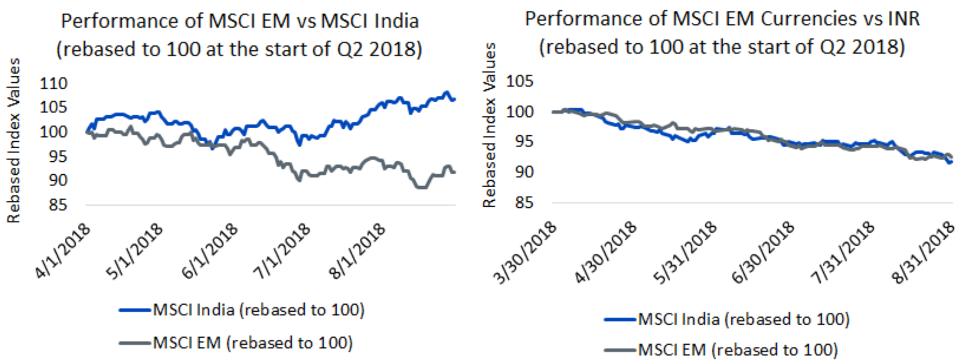
Source: U.S. Census Bureau. As of 06/30/2018.

Currency Is Important

Whenever there is any negative sentiment about broad EM, currencies, which are almost entirely driven by global appetite (and macro factors such as inflation and rates), are the first to be impacted due to knee-jerk reactions from investors. In contrast, equities, which are in part driven by global risk appetite and in part by earnings and economic growth, can continue to do well.

Thus, EM currencies tend to move in a flock, driven by global risk appetite, while stocks can continue to be differentiated from currencies and can offer positive returns.

The right-hand chart below shows how the rupee mostly has been moving in lockstep with other EM currencies over the last quarter (since trade war concerns started escalating). At the same time, Indian equities (i.e., MSCI India), shown in the left-hand chart, have demonstrated massive divergence from broad EM equities (i.e., MSCI EM) . **Note that outperformance by Indian equities is even more interesting when you consider that it is in U.S. dollar terms and includes the currency drag of rupee depreciation over that period.**



Sources: Bloomberg, MSCI. Period covered: 04/01/2018–08/31/2018. Past performance is not indicative of future results. You cannot invest directly in an index. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

So, What's the Best Way to Allocate in EM?

First, we believe a plain market cap-weighted exposure to EM does severe injustice to investor portfolios by under-weighting fast-growing countries that have a relatively small market capitalization, such as India. Here are two alternative ways to allocate to EM, while still limiting currency and country risk:

1. WisdomTree Emerging Markets Multifactor Fund (EMMF)

- Afterlaunching its multifactor approach in the U.S., WisdomTree recently launched EMMF, which dynamically hedges currency exposure to currencies showing weaker momentum. There are two aspects of this strategy that can make it appealing for investors looking for broader exposure to EM:
  - Selecting stocks with the highest composite scores on fundamental factors such as value and quality along with technical factors such as momentum and lower correlations. This model is designed to add alpha by creating a portfolio with meaningful deviations from cap weighting while also having weights derived from volatility levels to manage volatility in the current market environment.
  - Currency hedging overlay on EM currencies displaying weakening momentum. By using our dynamic approach, this strategy generally only hedges around 20% of the time, thereby keeping the cost of hedging lower compared to being hedged all the time.
  - Overall: **a multifactor exposure with a dynamic currency hedge in broad EM.**

2. WisdomTree India Earnings Fund (EPI)

- For investors looking for specific exposure to the EM universe, we believe a smart exposure to Indian equities has a lot of upside. Launched in 2007, EPI was the first exchange-traded product in the U.S. with physical access to Indian equities. However, what makes it unique is its methodology, which again focuses on smarter stock selection rather than market cap weighting. Here are a few aspects that make EPI a smarter way to access Indian stocks:
  - Selecting only profitable companies and weighting by their dollar net earnings at the time of rebalancing.
  - An earnings-driven approach provides investors with exposure to companies that are profitable. Disciplined rebalancing to overweight companies generating higher earnings ensures lower valuation multiples, which is often a concern with Indian stocks. Historically, EPI has traded at a 15%–20% discount of price-to-earnings (P/E) ratios compared to MSCI India, while still delivering exposure to profit-generating companies only.[2]
  - Overall: **exposure to profitable companies within the world's fastest-growing large economy.**

EM as an asset class often earns bad press due to its lower performance concentrated in select sectors, regions or currencies. In my opinion, investors who actively seek out good EM exposure—and avoid bad EM exposure—can capture the long-term growth rates that EM has to offer.

[1]Source: U.S. Census Bureau, as of 06/30/18.

[2]Source: WisdomTree, as of 06/30/18.

Important Risks Related to this Article

EMMF:

Investing involves risk including possible loss of principal. Investments in non-U.S. securities involve political, regulatory, and economic risks that may not be present in U.S. securities. For example, foreign securities may be subject to risk of loss due to foreign currency fluctuations, political or economic instability, or geographic events that adversely impact issuers of foreign securities. Investments in securities and instruments traded in developing or emerging markets, or that provide exposure to such securities or markets, can involve additional risks relating to political, economic, or regulatory conditions not associated with investments in U.S. securities and instruments or investments in more developed international markets.

Derivatives used by the Fund to offset exposure to foreign currencies may not perform as intended. There can be no assurance that the Fund's hedging transactions will be effective. The value of an investment in the Fund could be significantly and negatively impacted if foreign currencies appreciate at the same time that the value of the Fund's equity holdings falls. While the Fund is actively managed, the Fund's investment process is expected to be heavily dependent on quantitative models and the models may not perform as intended.

EPI:

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. This Fund focuses its investments in India, thereby increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in emerging, offshore or frontier markets such as India 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. As this Fund has a high concentration in some sectors, the Fund can be adversely affected by changes in those sectors. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of EPI please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/equity/epi

For the top 10 holdings of EMMF please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/equity/emmf

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

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You cannot invest directly in an index.

DEFINITIONS

Modern Alpha : Modern Alpha® combines the outperformance potential of active with the benefits of passive—to offer investor strategies that are built for performance.

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

Currency risk : the risk that an investment will decline in value due to a change in foreign exchange rates.

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.

Inflation : Characterized by rising price levels.

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

MSCI Emerging Market Index : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

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.

Dynamic Hedge : Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of time.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

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

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Low Correlation : Characterized by assets that have a relatively lower correlation vs the market over time. This term is also associated with the Low Correlation Factor which associates these stock characteristics with excess returns vs the market over time.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

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

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

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.