STRONG BUY SIGNAL: EM VALUATION GAP VS. S&P 500

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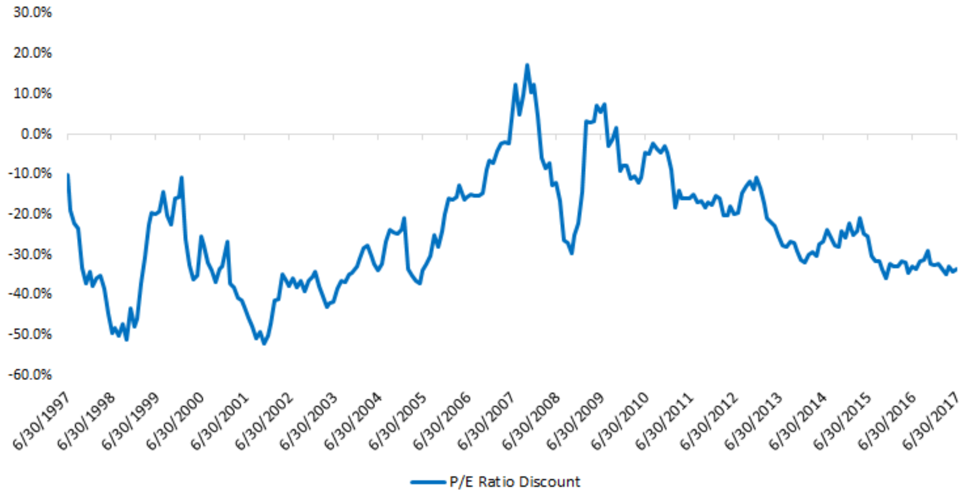
Given several years of diverging returns between U.S. and emerging market (EM) equities, it should come as no surprise that EM equities currently trade at a discount to U.S. equities. The size of that discount, however, is something that we feel is not being fully appreciated by many investors.

As of June 30, the MSCI Emerging Markets Index traded at a 14.6x price-to-earnings (P/E) ratio, while the S&P 500 Index was at 21.9x earnings—a 33.5% discount.[1] This is one of the largest valuation gaps between the two gauges since 2005.

MSCI EM Index P/E Ratio Discount to S&P 500



Sources: WisdomTree, FactSet, as of 6/30/17. You cannot invest directly in an index. Past performance is not indicative of future results.

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.

Remember the Last Time This Happened?

Investors who allocated to EM in 2005 likely recall those days fondly. Starting in 2005, the MSCI EM Index began a three-year stretch of returning at least 32% per year—significantly higher than the 28.2% *cumulative* return provided by the S&P 500 over that same time.[2]

Surely hindsight is 20/20, but if investors had known then what they know now, odds are they would have taken advantage of the valuation opportunity presented to them by backing up the truck and buying EM in droves.

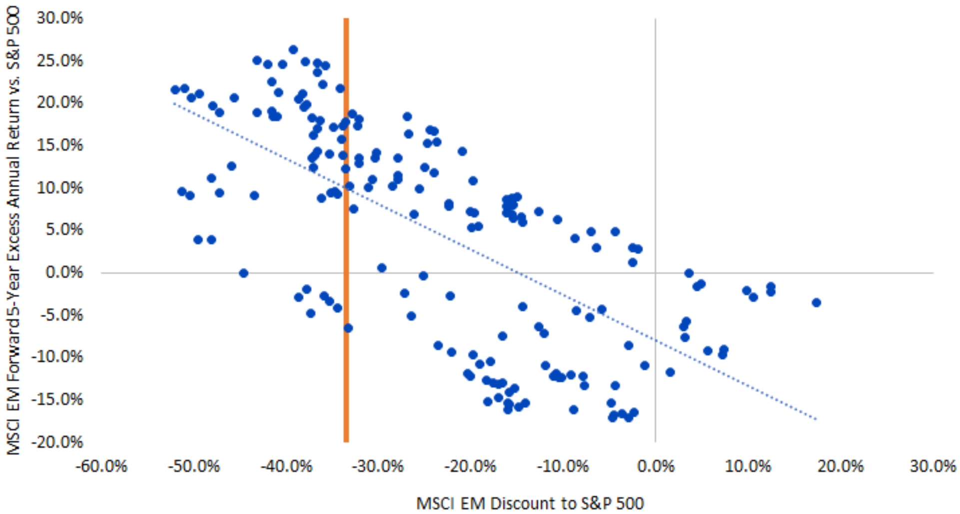
Fortunately for investors who missed the opportunity in 2005, they may be in luck right now.

Historical Precedent of Outperformance

On a monthly basis over the last 20 years, there have been 61 instances where the valuation gap between the MSCI EM Index and the S&P 500 has been as large as it currently stands. Following these instances, the next several years have tended to provide stellar returns for EM investors:

- 89% of the time, the MSCI EM Index outperformed the S&P 500 over the next five years (54 of 61 instances)
- Average five-year annual return for the MSCI EM Index was 18.7%
- Average five-year annual return for S&P 500 was 3.9%

MSCI EM Index P/E Discount to S&P 500 and Forward 5-Year Excess Annual Return vs. S&P 500



Sources: WisdomTree, FactSet, Bloomberg, as of 6/30/17. Blue dots represent forward five-year excess return of the MSCI EM Index relative to the S&P 500 Index. The orange line represents current discount of the MSCI EM Index to the S&P 500 Index.

Don't Forget the Other Part of P/E

Granted, valuation alone is not a catalyst, but a significant one is just picking up steam. Corporate earnings in EM collapsed starting in 2011, bottomed out at the start of 2016 and finally turned positive at the start of 2017. Given the long-awaited delivery of earnings growth (and with forward earnings expectations rapidly rising[3]), we believe that this could help keep EM valuations relatively low, even if stock prices continue to rally.

The EM rally that began in 2016 is still getting its legs underneath it, and investors worrying that they missed the opportunity should fear not. We believe that strategic investors with longer investment horizons should be taking advantage of any opportunity to add to their EM allocations.

Smart Beta ETFs to Access the Rally

With a strong case for the asset class behind us, the next step is how to implement. WisdomTree has two of the largest exchange-traded funds (ETFs) in the industry in the WisdomTree Emerging Markets SmallCap Dividend Fund (DGS) and the WisdomTree Emerging Markets High Dividend Fund (DEM). Both of these ETFs have strong track records over the nine-plus years of their history: DGS, which is the largest small-cap EM ETF in the industry and launched in October 2007, and DEM, a value-oriented fund that just passed its 10-year anniversary. In addition to these, we wanted to bring attention to two lesser-known core smart beta offerings.

One of the best-performing broad-based EM ETFs in the first half of 2017 was the WisdomTree Emerging Markets ex-State-Owned Enterprises Fund (XSOE), finishing up 22.8% against the MSCI EM Index's 18.4%.[4] The Fund's methodology enables it to reduce exposure to state-owned companies, and as a result tends to be over-weight in the "new" EM sectors such as Technology and Consumer Discretionary. The Fund's positions in these two growth sectors have provided momentum-style excess returns for the Fund in 2017 and since its inception in 2014.

On the flip side, the WisdomTree Emerging Markets Dividend Fund (DVEM) tends to be more of a value-oriented strategy. DVEM includes all dividend-paying stocks in the EM universe and weights them by their contribution to the *Dividend Stream®*. This methodology typically means that the Fund will trade at a discount to, and have less volatility than, the overall market. While value has been out of favor across the globe in 2017, we believe that the value factor certainly exists in EM and may see a return to prominence in the near future.

Conclusion

Smart beta adoption has taken ahold of U.S. markets and has started to bleed into international developed markets. With a historical valuation opportunity facing investors today in EM, we think there's a valid case to be made for smart beta offerings there as well. Momentum-focused investors can see that XSOE has added value since its inception, and those of a value mindset will find DVEM at an even more attractive relative valuation than an already attractive EM index. Depending on which particular factor an investor believes has the best potential to outperform, WisdomTree can provide a core solution.

[1]FactSet, as of 6/30/17.

[2]Bloomberg, as of 6/30/17.

[3]Bloomberg, as of 6/30/17.

[4]Morningstar Direct, as of 6/30/17.

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DEFINITIONS

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.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

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.

Average Annual Returns : Mean of annual yearly returns for the historical period

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Momentum Factor : 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.

Dividend Stream : Refers to the regular dividends per share multiplied by the number of shares outstanding.

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