DIVERSIFYING EM EXPOSURE USING WISDOMTREE STRATEGIES

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Allocating to emerging markets has been a tall task recently.

Looking at the trailing 5-, 10- and 15-year periods, the broad MSCI Emerging Markets Index (MSCI EM) lagged the S&P 500 by more than 11%, 10% and 9% annually, respectively.[1]

But there have been pockets of companies within emerging markets that have experienced solid performance over these periods—usually driven by idiosyncratic considerations such as country, sector and factor exposures.

We believe in the long-term benefits of diversification and encourage investors to allocate across regions and asset classes.

Below, we lay out a capital-efficient way to allocate to emerging markets using WisdomTree's Indexes.

WisdomTree Large-Cap Emerging Market Exposures

WisdomTree has two Indexes providing exposure to emerging market[2] companies: the WisdomTree Emerging Markets Ex-State-Owned Enterprises (EMXSOE) and the WisdomTree Emerging Markets High Dividend Index (WTEMHY).

WTEMHY was launched in 2007 and provides exposure to the highest dividend-yielding companies in emerging markets. The Index reconstitutes annually and holds the highest (top 30%) dividend-yielding companies in EM, screening out those with the highest risk according to our Composite Risk Screen measure.

After the most recent rebalance, WTEMHY over-weights in the Energy, Materials and Financials sectors and under-weights both the Consumer and Health Care sectors compared to the MSCI EM. WTEMHY over-weights Brazil and Taiwan and is under-weight in China, India and South Korea with respect to MSCI EM.

EMXSOE was launched in August 2014, and its investment thesis is to identify state-owned companies (SOEs)—defined as those with 20% or more local government ownership—and exclude them from the investable universe.

The Index, which also reconstitutes annually, weights non-state-owned enterprises using their market capitalization and aims to maintain country neutrality and sectors within +/- 3% of the starting universe prior to removing SOEs. This results in consistent over-weights in both Consumer Staples and Discretionary, Info. Tech. and Health Care and under-weights in Energy, Financials and Utilities.

Looking at each portfolio's fundamentals, it is clear how these Indexes provide different factor exposures to investors. EMXSOE tends to have high profitability metrics (ROE, ROA) and growth estimates resulting in exposure to quality and growth factors. Meanwhile, WTEMHY has a value and quality tilt with a high dividend yield, lower valuations and strong profitability metrics.

Aggregate Fundamentals (as of 6/30/23)

Fundamentals	EMXSOE	WTEMHY	MSCI EM
Dividend Yield (%)	2.25	9.94	3.25
P/E Ratio	18.14	6.15	12.70
Fwd. P/E Ratio	16.72	7.33	13.15
Return on Equity (ROE)	11.22	14.09	12.75
Return on Assets (ROA)	2.23	1.78	1.94
Wgt. Avg. Growth Estimate	16.59	3.24	13.24
P/E over Growth Estimate	1.09	1.83	0.94

Sources: WisdomTree, FactSet. Data as of 6/30/23. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the table, please visit our glossary.

Since EMXSOE's inception almost nine years ago, EMXSOE and WTEMHY have each outperformed the MSCI EM by more than 100 basis points (bps) annualized, almost doubling its risk-adjusted return.

We can see below how both Indexes achieved this with a different risk-return profile and driven by their underlying factor exposures.

EMXSOE outperformed during the years when growth companies in EM outperformed and experienced its maximum drawdown when value companies led as commodity prices rebounded in 2021 and 2022. WTEMHY experienced its highest drawdown at the start of the period, only to track closer to MSCI EM in the subsequent years and experience its stronger period of relative performance in the past 18 months, as dividend payers have outperformed.

Performance Metrics (8/29/14–6/30/23)

Metric	EMXSOE	WTEMHY	MSCI EM
Annualized Return	2.67%	2.30%	1.27%
Annualized Volatility	16.60%	15.47%	16.15%
Risk-Adjusted Return	0.16	0.15	0.08
Maximum Drawdown	-44.52%	-43.41%	-39.00%
Drawdown Period	2/17/21–10/24/22	9/3/14–1/21/16	2/17/21–10/24/22

Sources: WisdomTree, FactSet. Data from 8/29/14–6/30/23. Past performance is not indicative of future results. You cannot invest directly in an index.

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Growth of $100

Sources: WisdomTree, FactSet. Data from 8/29/14–6/30/23. Past performance is not indicative of future results. You cannot invest directly in an index.

The Power of Diversification

It can be difficult to make an investment decision by looking at the information presented above and without knowledge of how markets (and investment factors) will behave in the future.

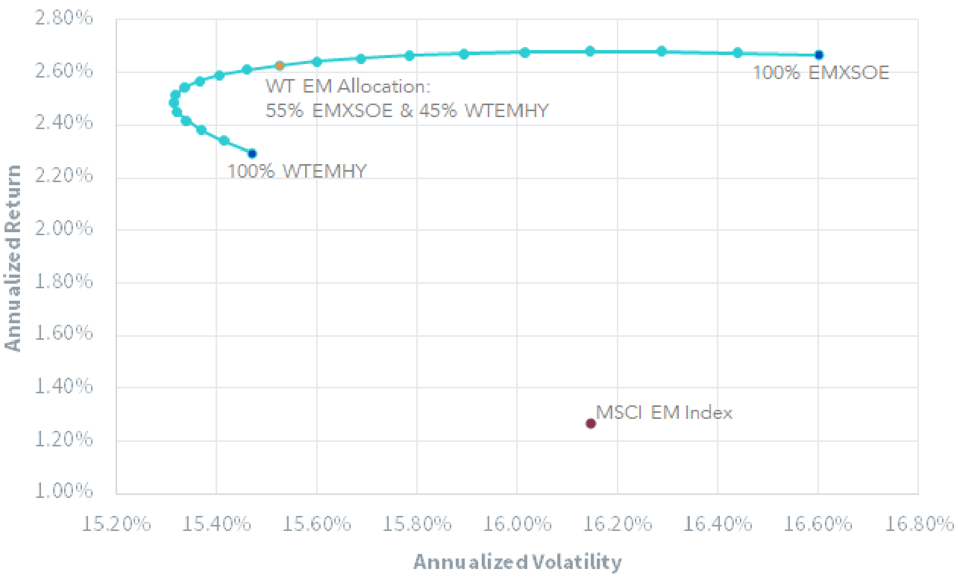
Modern Portfolio Theory (MPT)—first introduced by Nobel Prize winner Harry Markowitz in 1952—states that a portfolio's idiosyncratic risk can be reduced by investing in assets that are not perfectly correlated. Applying this theory to WisdomTree's two EM Indexes, the portfolio's idiosyncratic risk is driven mainly by the sector, country and factor exposures resulting from the Index's methodology. The chart below shows the rolling 12-month correlation between WTEMHY and EMXSOE.

Rolling Correlation: EMXSOE–WTEMHY

Sources: WisdomTree, FactSet. Data from 8/29/2014–6/30/2023.

The lower correlation between these Indexes allows investors to build a more efficient EM asset allocation. The efficient frontier below shows the annualized return and volatility of portfolios built by combining EMXSOE and WTEMHY. The data used for this chart stems from August 29, 2014, to June 30, 2023, and assumes that the allocation is rebalanced quarterly at the end of February, May, August and November. Each dot on the curve shows a 5% shift in allocation from one asset to the other.

Asset Allocation: EMXSOE vs. WTEMHY



Sources: WisdomTree, FactSet. Data from 8/29/14–6/30/23. Past performance is not indicative of future results. You cannot invest directly in an index.

As we can see, the combination of EMXSOE with WTEMHY over the period would've allowed investors to obtain comparable levels of return while reducing volatility. It is also interesting to see how most points on the curve have higher returns than the MSCI EM, with lower volatility. The highlighted allocation (WT EM Allocation), which holds 55% in EMXSOE and 45% in WTEMHY, represents the point in the curve with the greatest risk-adjusted returns. If we look at the performance metrics in the table below, we can see the power of diversification, as the WT EM Allocation portfolio has increased risk-adjusted returns and lower drawdowns than EMXSOE and WTEMHY in isolation.

Performance Metrics (8/29/14–6/30/23)

Metric	EMXSOE	WTEMHY	MSCI EM	WT EM Allocation
Annualized Return	2.67%	2.30%	1.27%	2.63%
Annualized Volatility	16.60%	15.47%	16.15%	15.52%
Risk Adjusted Return	0.16	0.15	0.08	0.17
Maximum Drawdown	-44.52%	-43.41%	-39.00%	-36.28%
Drawdown Period	2/17/21–10/24/22	9/3/14–1/21/16	2/17/21–10/24/22	9/3/14–1/21/16

Sources: WisdomTre, FactSet. Data from 8/29/14–6/30/23. Past performance is not indicative of future results. You cannot invest directly in an index.

The resulting fundamentals are also attractive compared to the broad MSCI EM in terms of valuations, dividend yield and profitability.

Aggregate Fundamentals (as of 6/30/23)

figure 7

We, therefore, believe a combination of the WisdomTree Emerging Markets ex-State-Owned Enterprises Fund (XSOE) and WisdomTree Emerging Markets High Dividend Fund (DEM), which track EMXSOE and WTEMHY, respectively, can be a good way to gain exposure to emerging markets in an investor’s portfolio.

[1]Source: FactSet. Data from 6/30/08–6/30/23.

[2]WisdomTree includes companies incorporated and listed in the following countries: Brazil, Chile, China, Czech Republic, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Saudi Arabia, South Africa, Taiwan, Thailand and Turkey.

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You cannot invest directly in an index.

DEFINITIONS

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.

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.

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

State-owned enterprise : Companies in which governments have a significant ownership stake and the potential to influence the firms’ actions over time.

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.

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.

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.

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.

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.

Drawdowns : Periods of sustained negative trends of return.

Commodity : A raw material or primary agricultural product that can be bought and sold.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

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