
CHINA GROWTH TILTING FOR A VALUE MARKET

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One of the key debates going into this year has been whether the bloodletting in emerging markets and sharp downdraft in China could turn around in 2019.

WisdomTree's asset allocation committee increased exposure to emerging markets in a number of our model portfolios for 2019, recognizing that it would be difficult for emerging markets to turn around without a China trade deal, but the [valuations](#) in many markets already accounted fairly well for the risks.

Many [value](#)-sensitive investors may agree. In China, for example, the last time we have seen valuations this depressed was in early 2016 (see second chart below).

Below, we highlight this market—China—where we believe a [growth](#)-tilted approach toward large tech companies is a smart way to add exposure.

Growth for a Value Market?

Many in the U.S. have been surprised by how strong growth indexes have performed over the last decade compared with value indexes. One reason growth performed so well is because, a decade ago, relative valuation multiples became so compressed that earnings growth of growth indexes powered the returns higher over lower-multiple, value stocks.

We think the same setup is occurring in China right now.

The [WisdomTree China ex-State-Owned Enterprises Index](#) has a tilt to growth companies and is trading at a higher [price-to-earnings \(P/E\) multiple](#) than the [MSCI China Index](#). But we think that multiple is warranted.

Let's first compare the P/E ratios of [state-owned enterprises \(SOEs\)](#) and non-SOEs across time.

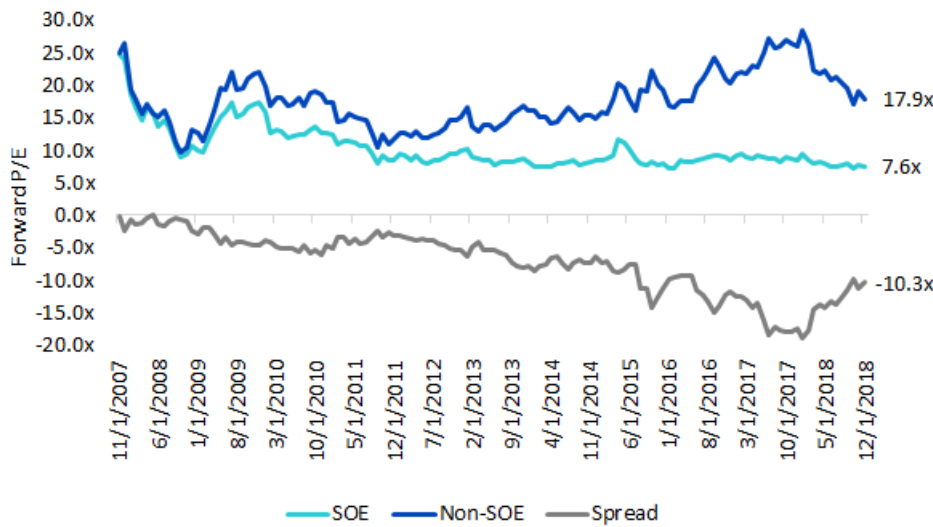
There were not that many of these newer tech giants in public markets a decade ago, so there was not much difference in the average P/E ratios across SOEs and non-SOEs.

As more tech companies went public, we can see the P/E ratio gap start to widen. Currently, the SOEs have single-digit [forward P/E ratios](#) at 7.6x, while the non-SOEs are 10 multiple points higher.

The maximum spread between SOEs and Non-SOEs was around 18x more, when SOEs were at 8.8x

and non-SOEs were 27.2x in July 2017—so there has been a lot of valuation compression in the non-SOE segment over last 18 months.

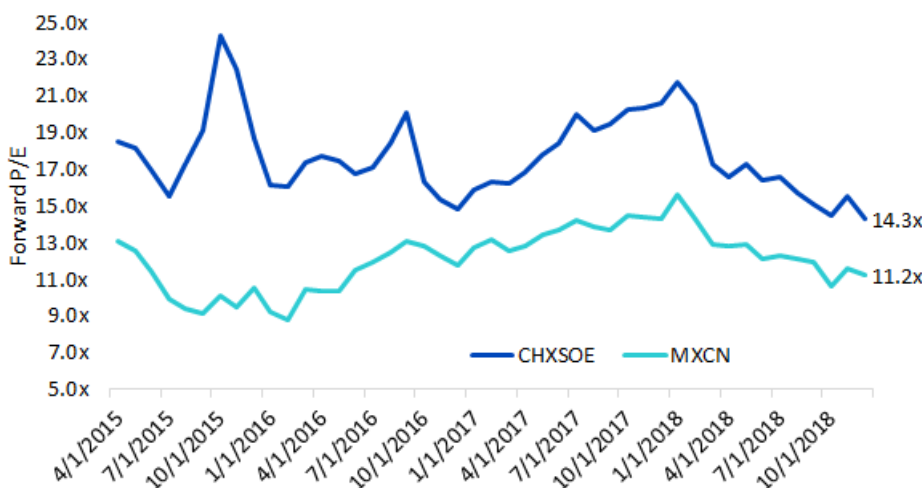
Forward P/E of MSCI China SOEs and Non-SOEs (11/30/07–12/31/18)



Sources: WisdomTree, FactSet. Data for the period 11/30/07–12/31/18. State ownership is determined at the greater than 20% of market capitalization level (higher = state-owned; lower = non-state-owned). Past performance is not indicative of future results.

When we translate these segments into the P/E ratio of our China ex-SOE Index compared with the MSCI China Index, the gap narrows to about 3 points and 11.2x for our Index versus 14.3x for the MSCI China Index. This is one of the smallest gaps in P/E ratios since we launched the Index almost four years ago.

Forward P/E of WisdomTree China ex-State-Owned Enterprises Index and MSCI China Index (4/30/15–12/31/18)



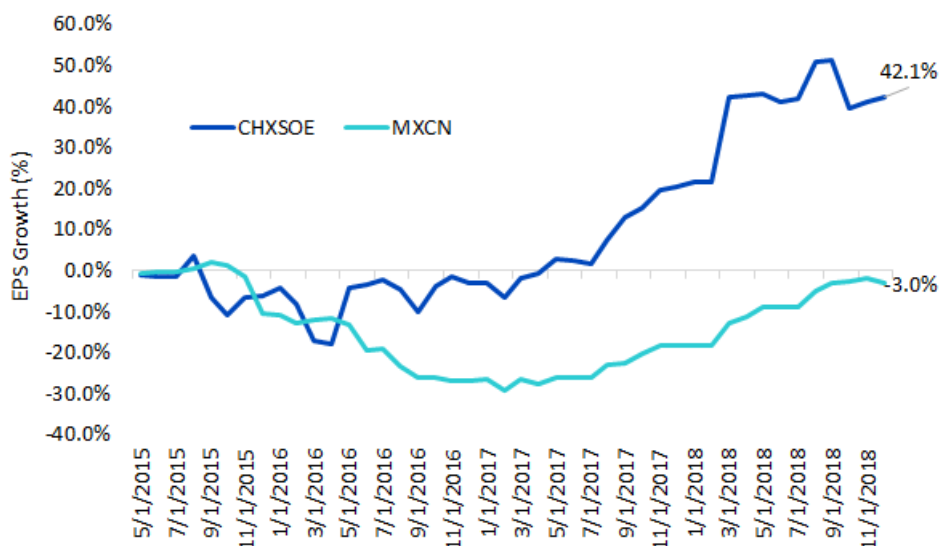
Sources: WisdomTree, FactSet. Data for the period 4/30/15–12/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

We know companies in the SOE universe are growing slower than the non-SOEs. The question

is: what is the warranted premium P/E multiple? That is a hard question to answer, but the spread may be more than warranted when looking at the relative change in earnings across the two indexes.

When you look at cumulative earnings growth of the two indexes over the last four years, the traditional MSCI China Index has shown zero earnings growth—hence its lower multiple—while our ex-SOE Index has grown earnings over 40% since its inception, based on trailing 12-month earnings figures.

Cumulative EPS Growth (%) of the WisdomTree China ex-State-Owned Enterprises Index and MSCI China Index (4/30/15–12/31/18)



Sources: WisdomTree, FactSet. Data for the period 4/30/15–12/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

SOEs are heavily made up of energy and financial companies, while the non-SOEs are more tech- and consumer-oriented. These companies tend to have significantly greater earnings growth expectations.

Now, expectations for China tech and consumer stocks may still be unreasonable, and financials that are perennial concerns may be priced right at single-digit P/E ratios and 4.5% to 6% [dividend yields](#), and they could be great value plays.

Our high-dividend value strategy owns many of these Chinese value companies.

But for a 3-point-higher P/E multiple expressed above, with the tilt to companies growing earnings at faster clips, I think a Chinese tilt to ex-state-owned enterprises reflects an interesting opportunity to capitalize on the most hated asset class of 2018.

Fundamentals Comparison Across Sectors of MSCI China: Year-End 2017 and Year-End 2018

As of 12/31/18					
Fundamentals	Consumer Discretionary	Communication Services	Energy	Financials	MSCI China
P/E Ratio	25.6x	21.6x	9.8x	6.2x	11.5x
Forward P/E Ratio	20.3x	22.9x	8.8x	6.5x	11.3x
Long-Term Earnings Growth Estimates	25.9%	18.1%	16.2%	5.6%	17.0%
PE-to-Growth (PEG) Ratio	0.99	1.19	0.61	1.11	0.67
Return on Assets	6.2%	6.2%	3.8%	1.1%	1.5%
Return on Equity	13.4%	11.7%	8.1%	13.5%	12.4%
Leverage	2.2x	1.9x	2.1x	12.5x	8.0x
Earnings Retention	88.1%	79.4%	35.4%	72.1%	71.4%
ROE x Earnings Retention	11.8%	9.3%	2.9%	9.7%	8.9%
Dividend Yield	0.5%	1.0%	6.6%	4.5%	2.5%

As of 12/29/17					
Fundamentals	Consumer Discretionary	Communication Services	Energy	Financials	MSCI China
P/E Ratio	40.7x	33.6x	14.7x	8.1x	17.1x
Forward P/E Ratio	28.2x	28.0x	12.2x	7.2x	14.3x
Long-Term Earnings Growth Estimates	28.3%	29.9%	36.6%	8.6%	24.0%
PE-to-Growth (PEG) Ratio	1.44	1.12	0.40	0.94	0.71
Return on Assets	6.8%	6.1%	2.6%	1.0%	1.4%
Return on Equity	13.8%	11.8%	5.4%	12.8%	11.2%
Leverage	2.0x	1.9x	2.1x	12.7x	8.3x
Earnings Retention	87.9%	78.7%	26.9%	72.0%	71.4%
ROE x Earnings Retention	12.1%	9.3%	1.5%	9.2%	8.0%
Dividend Yield	0.3%	0.6%	5.0%	3.4%	1.7%

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

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

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DEFINITIONS

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.

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 time.

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.

Earnings multiple: another way of saying price-to-earnings multiple.

MSCI China Index: A free float-adjusted, market capitalization-weighted equity index designed to measure the performance of the Chinese equity market.

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

Forward P/E ratio: Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

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