
TAKING SOE RISKS OFF THE TABLE

Alejandro Saltiel – Head of Indexes, U.S.
11/23/2020

The belief that [state-owned enterprises \(SOEs\)](#) are safer investments than ex-state-owned companies (ex-SOEs) because they have government backing is anything but certain.

We sometimes hear this safety argument from clients. The thesis is compelling—because SOEs have implicit (or explicit) government support, they have a lifeline when times get tough and they need easy access to credit.

While we do not disagree with this argument per se, there is a powerful counterargument to this “government lifeline” thesis.

State-owned enterprises typically have an inherent conflict of interest as they often look to (or are forced to) promote the government’s objectives at the expense of creating value for other shareholders. This is often referred to as a “national service” requirement of SOEs.

Taking SOE Risks Off the Table

WisdomTree’s ex-State-Owned Enterprises Indexes—[EMXSOE](#) and [CHXSOE](#)—seek to give investors broad exposures to the emerging markets and Chinese markets, respectively, favoring non-SOEs and reducing the exposure to those companies that can be subject to these conflicts of interest.

WisdomTree conducted the annual reconstitution of these ex-State-Owned Enterprises Indexes in October.

The most notable update is that one of the largest holdings in both EMXSOE and CHXSOE is the Hong Kong-listed share of Alibaba Group, switching from the previously held ADR. As noted before¹, [potential delisting of Chinese ADRs isn’t a material risk to these Indexes](#), as Hong Kong listings for these are becoming more [liquid](#) and will provide an alternative if needed.

Here’s a recent example of controversy surrounding SOEs and highlights from the most recent reconstitution of EMXSOE and CHXSOE.

NPLs Rising in China

A good example of SOEs not seeking to maximize shareholder value can be seen in China’s four largest banks: Bank of China, Industrial and Commercial Bank of China (ICBC), China Construction Bank and Agricultural Bank of China.

It is well known that these banks service national obligations and are charged with distributing loans to keep employment and GDP growing within the government’s objectives.

The chart below, shared by Bloomberg anchor David Ingles, shows how implementing the government’s objectives can translate into operating complications for these financial institutions.

Non-performing loans (NPLs), loans in which the borrower has defaulted on its obligations, have increased at an alarming rate in each of these bank’s loan books. We can see how economic difficulties experienced by Chinese businesses during 2020 have translated into NPLs reaching almost 1 trillion yuan—this can be a looming problem if the economy does not improve quickly.

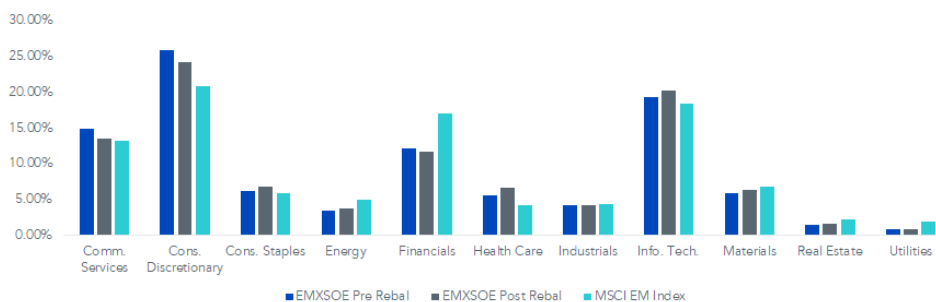


Source: Bloomberg, @DavidIngles. Data as of 9/30/20.

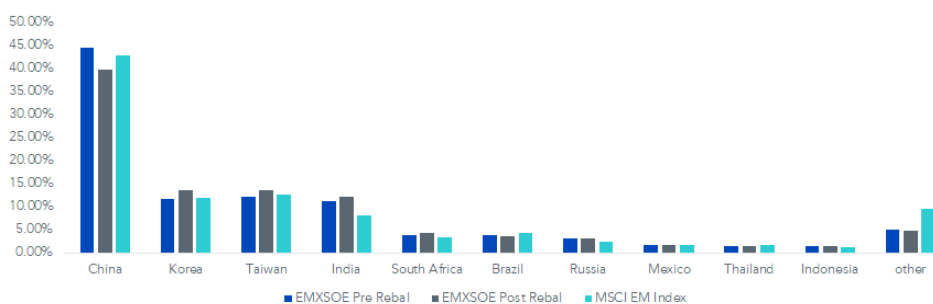
EMXSOE Rebalance Highlights

After reconstitution, EMXSOE’s country exposure was reset to match its starting universe, while its sector tilts continue to over-weight Consumer Discretionary and Information Technology and under-weight Financials and Energy.

Sector Exposure



Country Exposure



Sources: WisdomTree, FactSet, as of 10/30/20. Weights subject to change.

The reconstitution did not affect the portfolio’s fundamentals significantly. EMXSOE still has a higher implied growth rate (return on equity x earnings retention), profitability metrics and lower leverage than the [MSCI EM Index](#).

Portfolio	P/E Ratio	Fwd. P/E Ratio	ROE	ROA	Imp. Growth	PE to LTG	Leverage
EMXSOE Pre Rebal	25.06	21.57	10.99	2.04	6.43	1.45	5.40
EMXSOE Post Rebal	25.27	21.21	10.57	2.03	6.02	1.40	5.22
MSCI EM Index	18.70	17.25	10.27	1.45	5.81	1.13	7.08

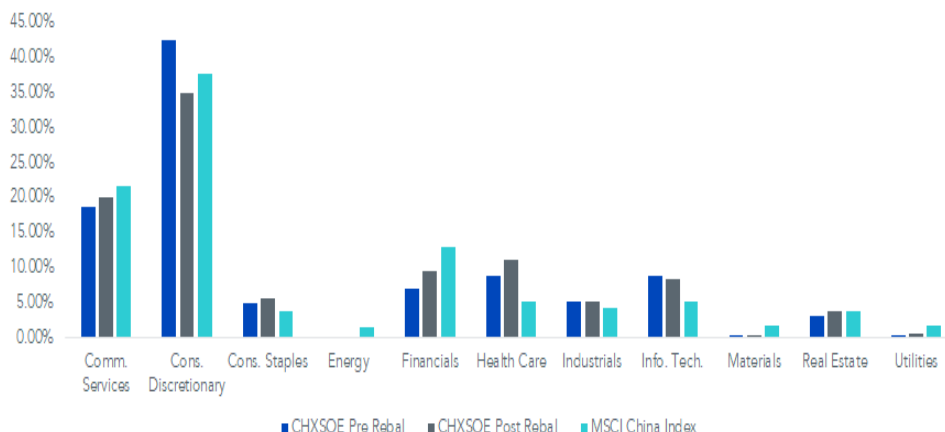
Sources: WisdomTree, FactSet, as of 10/30/20. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the chart, please visit our [glossary](#).

CHXSOE Rebalance Highlights

CHXSOE pared some of its sector tilts during reconstitution but remains over-weight in the Information Technology and Health Care sectors, while being under-weight in Energy and Financials with respect to the [MSCI China Index](#).

Sector Exposure



Sources: WisdomTree, FactSet, as of 10/30/20. Weights subject to change.

In terms of fundamental exposures, this recent reconstitution helped reduce CHXSOE’s valuation metrics while increasing its profitability and implied growth rate numbers too. Relative to MSCI China, CHXSOE shows lower leverage and significantly higher profitability and implied growth rate.

Portfolio	P/E Ratio	Fwd. P/E Ratio	ROE	ROA	Imp. Growth	PE to LTG	Leverage
CHXSOE Pre Rebal	29.57	25.83	15.12	2.23	11.41	1.33	6.79
CHXSOE Post Rebal	27.48	23.93	15.41	2.10	11.44	1.18	7.32
MSCI China Index	18.35	16.90	11.02	1.28	7.92	0.92	8.64

Sources: WisdomTree, FactSet, as of 10/30/20. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the chart, please visit our [glossary](#).

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](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only. You cannot invest directly in an index.

DEFINITIONS

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

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