EX-STATE-OWNED ENTERPRISES: A NEW WAY TO ACCESS THE QUALITY FACTOR

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One of the biggest discussions this year has been about factors and different ways in which they can be accessed and used to build portfolios. Some approaches are crystal clear, with the goal of the factor in an index's name—like quality, momentum, low volatility, value or size.

However, whether or not a strategy has a factor in its name is immaterial—every strategy that isn't owning the ENTIRE market is tilting toward some factors and away from others.

Concept of Ex-State-Owned Enterprises Aligns with Quality Variables/Sectors

In the United States, the fact that publicly traded companies are meant to operate in the best interest of shareholders is pretty much a sacred truth. Venturing into emerging markets, one sees a large number of big companies that are listed on stock exchanges but that are also majority-owned by governments.

Governments may not always have the same interests as shareholders, namely maximizing profits. The fact of the matter: ANY broad-based strategy that invests in emerging markets today without a focus on avoiding government ownership will tend to invest alongside governments, as those firms are some of the largest by market capitalization in the asset class.

Return on Equity (ROE) & Return on Assets (ROA)

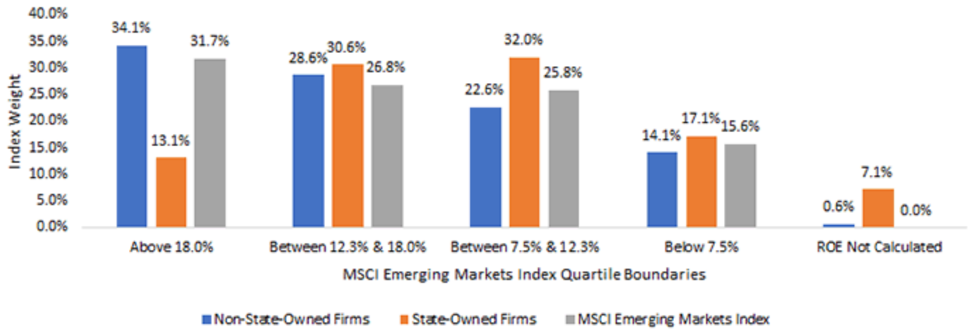
State ownership tends to come concentrated in sectors that are viewed as critical to the functioning of an economy; this can be in places like China (banks), Russia (energy firms), Brazil (energy and materials companies) and in many cases utility companies and telecom firms offering more basic services.

Where we see much less state ownership is among traditional consumer or technology companies.

What is interesting about these sector profiles is that they tilt toward higher "quality" sectors and away from "value" sectors. This also can be observed by the difference in both ROE and ROA for companies that are/are not state owned.

State-Owned Firms Exhibited Approximately One-Third the Weight in the Highest ROE Quartile

Return on Equity Quartile Distribution: Non-State-Owned-firms vs. State-Owned-firms (as of August 4, 2017)

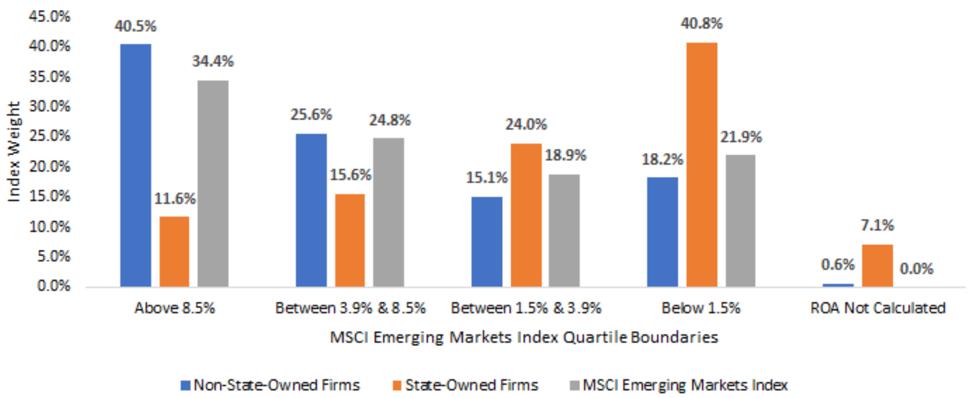


Sources: WisdomTree, FactSet, with data as of 8/4/17. You cannot invest in an index. Weighting of non-state-owned firms and state-owned firms is by float-adjusted market capitalization. Universe is from the WisdomTree Emerging Markets ex-State-Owned Enterprises Index screen, which focuses on potentially eligible constituents with greater than $1 billion in market capitalization. State ownership is determined by greater than 20% ownership by a government entity.

- **Highest-Quality Stocks:** What's most noticeable is the top ROE quartile (ROE > 18%): State-owned firms had dramatically less exposure in these most highly profitable firms.

A similar pattern can be observed in return on assets.

Return on Assets Quartile Distribution: Non-State-Owned-firms vs. State-Owned-firms (as of August 4, 2017)



Sources: WisdomTree, FactSet, with data as of 8/4/17. You cannot invest in an index. Weighting of non-state-owned firms and state-owned firms is by float-adjusted market capitalization. Universe is from the WisdomTree Emerging Markets ex-State-Owned Enterprises Index screen, which focuses on potentially eligible constituents with greater than $1 billion in market capitalization. State ownership is determined by greater than 20% ownership by a government entity.

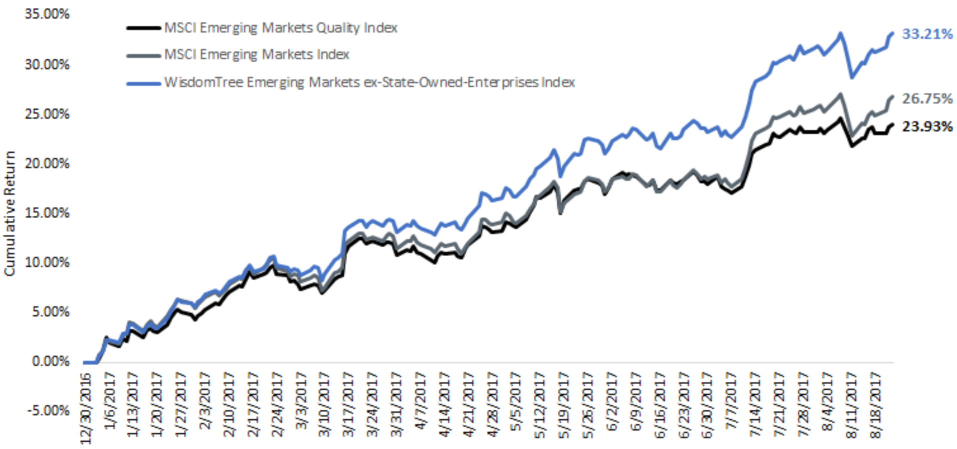
- The highest ROA quartile encompasses firms with ROA above 8.5%. Non-state-owned firms had exposure to this quartile of about 40.5%—almost 4x the exposure of state-owned firms at 11.6%.
- The lowest ROA quartile was also interesting—in this case indicating that state-owned firms had almost 40% weight to firms with ROA below 1.5%. This shows in some ways a tilt toward banks among state-owned firms.

In 2017, Ex-State Owned Outperformed While Quality Underperformed

Given these tilts, one naturally would expect the WisdomTree Emerging Markets ex-State-Owned Enterprises Index to exhibit similar performance to the MSCI Emerging Markets Quality Index.

Through the better part of the first eight months of 2017, that has not been the case at all.

Ex-State-Owned Index Outperformed While Quality Index Underperformed



Sources: WisdomTree, Bloomberg, with data from 12/30/16 (last day of live index calculation in 2016) to 8/23/17. You cannot invest directly in an index. Past performance is not indicative of future results.

If one is looking to broadly characterize what the WisdomTree Emerging Markets ex-State-Owned Enterprises Index actually does, one can say that it transitions the focal point of exposure from the "old" economy to the "new" economy.

Large energy companies are the classic manifestation of state-owned firms, and they enjoyed a great run, going from 4.4% of the MSCI Emerging Markets Index in October 1999 to almost 21% in June 2008—at the time when the price per barrel of oil hit its peak of nearly $150.[1] Since then, the relative performance of the emerging markets energy sector has been in decline, and this is the worst performing of the 11 sectors in emerging markets this year.

Information technology exhibited the opposite behavior, attaining approximately 20% weight in October 1999, dropping to approximately 10% weight in June 2008 and now chugging toward 30% weight if current trends of relative performance continue unabated.[2] The WisdomTree Emerging Markets ex-State-Owned Enterprises Index fully emphasizes (to the tune of more than 30% weight) this sector, which is the best performing in the MSCI Emerging Markets Index this year, up nearly 50%. It also fully emphasizes the ex-state-owned component in China, where WisdomTree also has a strategy that, as of this writing, was up more than 50% year-to-date.[3]

Align with the Story in Emerging Markets That Is Never Out of Favor

Do we know if the current trend of overall emerging market equity outperformance will continue? No, we do not. However, no matter how bleak the outlook or performance got in 2013, 2014 and 2015, we continued to hear that emerging markets were where the bulk of the world's population resided, and the theme of faster gross domestic product growth, increasing consumption and a rising middle class never subsided. Looking at emerging markets without the state-owned enterprises, we believe, is another way to focus on this theme and not the slower-growth, larger state-owned companies of yesterday.

[1]Sources: WisdomTree, FactSet, Bloomberg. October 1999 refers to 10/31/99. June 2008 refers to 6/30/08.

[2]Sources: WisdomTree, FactSet, Bloomberg.

[3]Sources: WisdomTree, Bloomberg, with period from 12/31/16 to 8/23/17. The WisdomTree China ex-State-Owned Enterprises Index is the strategy referenced.

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.

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You cannot invest directly in an index.

DEFINITIONS

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

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.

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.

Low Volatility : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

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.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market 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 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.

MSCI Emerging Markets Quality Index : Measure of the performance of companies from within the MSCI Emerging Markets Index that have exhibited profitability, earnings stability and low debt to equity.

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.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.