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# HOW TO AVOID BEING LIKE THE OTHER 98% OF INVESTORS

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For many [emerging markets \(EM\)](#) investors, navigating 2021 has felt like walking through a minefield. The Chinese government's rolling wave of regulations raised uncertainty, fear and even panic.

First up was Ant Financial. Ant's desires to list shares publicly accelerated [fintech](#) regulations—and it looks increasingly like Ant Financial will end up being regulated more like a traditional bank and less like a technology company—impairing the [multiples](#) on the business. There will also be [state-owned](#) firms investing in its credit rating business, which China believes is key to state interests.

[After Didi issued shares to the market](#), it was cited for consumer data violations, as China was focused on data security-related issues in their technology companies.

Tencent and other gaming companies were slammed when a state-run media outlet called online games “spiritual opium” and the government capped the amount of time that minors can play.

Luckily for them, they fared better than the private education companies, which were essentially wiped out in a rebuke of the competitiveness and affordability of tutoring. Yet what was under-reported here: China fired the education minister who took these actions without the approval of the central government. China is trying to lower the cost of educating and raising children, but the actions and fallout from a rogue education minister did not sit well.

The key for investors: what happened in the education sector that crippled the ability of firms to earn profits is not likely to be repeated.

## A Headache on Top of a Migraine

This all comes at a time when China is also seeing a growth slowdown.

The fragility of growth was perfectly epitomized by the one positive COVID-19 case that caused a forced two-week shutdown of a major terminal in the world's third-largest shipping port in China.

China further implemented environmental curbs also weighing on growth, as hard emission quotas forced some manufacturers to even shut down completely.

Now you can add a real estate slowdown to the list of headaches, with [Evergrande being the latest problem in the news](#). While Evergrande presents a myriad of problems, we don't see it as a systemic risk.

Even before the massive stock drop, Evergrande represented just 0.04% of the [MSCI EM Index](#) at the start of the year (a weight that now sits at less than 0.01%<sup>1</sup>).

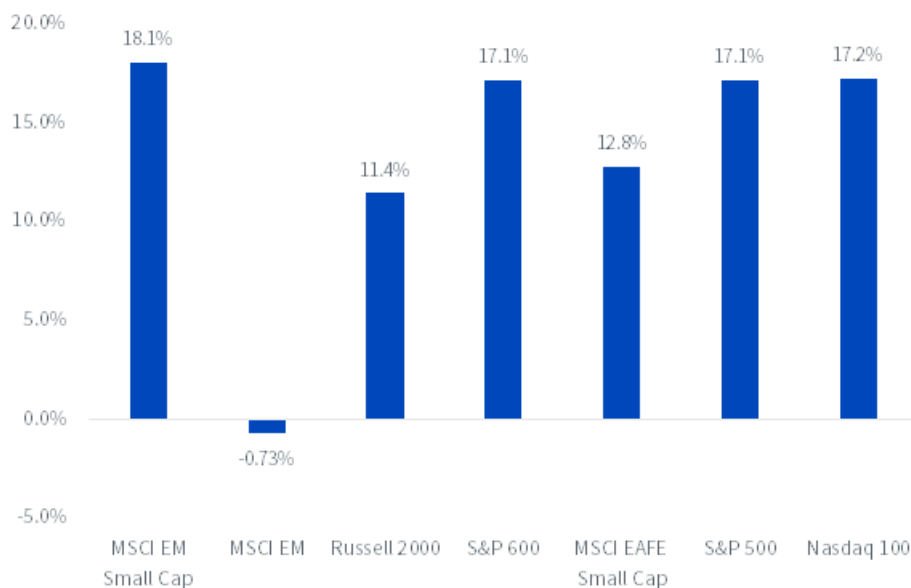
China sold off significantly with all these uncertainties—creating opportunity for those who look past the headlines into longer-run prospects and what is happening below the surface.

## A Quiet Bright Spot

We don't think the sky is falling in China or broadly in EM. And there's a significant bright spot flying under the radar—EM [small caps](#). EM small caps have outperformed the

MSCI EM Index, the U.S. and developed international small-cap indexes and even the [blue-chip](#) U.S. stock gauges in 2021.

### 2021 Index Performance (Year to Date)



Sources: WisdomTree, Bloomberg, as of 9/21/21. Past performance is not indicative of future results. You cannot invest directly in an index.

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

### Small Investors a Small, Happy Group

Investors can be forgiven for not realizing how well the asset class has done.

There is currently \$750 billion invested in U.S.-listed EM mutual funds and ETFs. Of those assets, less than 2% of all EM fund assets are in dedicated small-cap funds.<sup>2</sup>

Forget regular investors—even merely among EM allocators, nearly all of them have missed out on the best performing part of the market.

In WisdomTree's view, EM small caps offer many benefits to investor portfolios—especially when taking a fundamental tilt to the allocation like the [WisdomTree Emerging Markets SmallCap Dividend Fund \(DGS\)](#) does:

- EM small caps offer an organic way to gain access to the rise of the EM consumer theme, as most companies conduct the majority of their business within emerging markets
- EM small caps can offer an attractive income stream in today's low-yielding environment in an unexpected place (current [distribution yield](#) on DGS: 5.50%<sup>3</sup>)
- As opposed to small-cap stocks in the developed world, EM small-cap dividend payers have historically been less volatile than their large-cap peers (DGS [beta](#) since inception vs. MSCI EM Index: 0.94<sup>4</sup>)

Lastly, EM small caps are showing in today's environment exactly how great of a diversifier they can be alongside [large-cap](#) EM companies.

*Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Standardized performance and 30-day SEC yields for DGS are available [here](#).*

## How the WisdomTree Model Portfolios Allocate to EM

Most of the WisdomTree Model Portfolios take a barbell approach to their EM exposure. For example, the WisdomTree Core Equity Model Portfolio allocates 13% split across DGS at 6% and the [WisdomTree Emerging Markets ex-State-Owned Enterprises Fund \(XSOE\)](#) at 7%<sup>5</sup>.

This combination allows the models to own cutting-edge large-cap tech and growth names while also not being solely reliant on the continued dominance of those same companies.

We believe the two Funds are excellent complements to each other, as one has often zigged while the other zagged. When comparing the relative performance of each Fund against the MSCI EM Index, the [correlation](#) between them is  $-0.5^6$ . This means that when one of them outperformed, the other tended to lag, and vice versa.

This approach paid dividends this year, as Tencent, Alibaba and some of the other big names have lagged, but small caps have more than picked up the slack.

## Relative Performance vs. MSCI EM Index Strongly Uncorrelated



Sources: WisdomTree, Bloomberg, as of 9/21/21. White line is relative performance of WisdomTree EM ex-State-Owned Enterprises Index against MSCI EM Index. Yellow line is relative performance of WisdomTree EM SmallCap Dividend Index against MSCI EM Index. Past performance is not indicative of future results. You cannot invest directly in an Index.

## Be Like the 2% of Contrarians

Similar to what we've seen in the U.S., the last few years have seen a domination by tech behemoths driving EM asset class performance. While it seems likely that some of the China-based companies may be forced to scale back their ambitions in some regard, we still think they will grow at a rapid pace.

However, should the heavy-handedness of the Chinese Communist Party continue, we believe sharp investors would be wise to carve off some of their large-cap exposure to complement with small caps.

After all, who wouldn't want to try to find an edge over the other 98% of investors?

For current holdings of the Funds mentioned in this blog, please click their respective tickers: [DGS](#), [XSOE](#).

<sup>1</sup>Bloomberg, as of 9/22/21.

<sup>2</sup>Bloomberg, as of 9/22/21.

<sup>3</sup>WisdomTree, FactSet, as of 9/22/21.

<sup>4</sup>Zephyr StyleADVISOR, from 10/31/07–8/31/21.

<sup>5</sup>As of 8/31/21. Allocations subject to change over time.

<sup>6</sup>Bloomberg, from 12/31/14–9/22/21.

#### Important Risks Related to this Article

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

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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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## DEFINITIONS

**Emerging market**: Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

**Fintech**: Describes new tech that seeks to improve and automate the delivery and use of financial services

**Multiple expansion**: Term for a rising P/E ratio, meaning that share prices are rising faster than earnings are growing.

**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.

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

**Blue chip**: Stocks that have the reputation for quality, reliability and the ability to operate profitably in good times and bad.

**Distribution Yield**: Calculated by annualizing the most recent fund distribution and dividing by the fund's current NAV. The yield represents a single distribution from the fund and does not represent the total returns of the fund.

**Beta**: A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

**Large-Capitalization (Large-Cap)**: A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

**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.