
RALLYING BEHIND THE LATEST MOVES IN EMERGING MARKETS

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[Emerging market \(EM\)](#) equities cooked up a massive rally at the end of 2020, gaining 55% over the last nine months of the year and beating the [S&P 500 Index](#) by nearly 8%¹.

Much of the market narrative throughout the year was about the growing dominance of U.S. large-cap tech-secular champions whose businesses are the rare beneficiaries of a work-from-home environment. But, although it got little fanfare, [ex-state-owned enterprises](#) in emerging markets (EM) managed to outmuscle even the formidable [NASDAQ 100](#) following the market's rock bottom in March.

WisdomTree's Model Portfolio Investment Committee entered 2021 with a positive outlook on EM equities. Despite the impressive rally thus far, we have reasons to believe EM can be a strong place for allocators to turn to again in 2021. A few reasons:

- **A sinking U.S. dollar:** The dollar has continued on the slide that started when global [risk](#) appetite rose from the grave in March. EM equities have a strong negative relationship with the dollar, and additional [fiscal stimulus](#) measures from Congress may have the effect of further dollar weakness in a reflationary environment.
- **Resurgent positive sentiment:** EM experienced nearly \$48 billion in outflows in the first eight months of 2020. By the end of December, EM had experienced net inflows in every week of the final four months and finished back in net inflow territory for the year²—a stunner of a positive turn in investor sentiment and positioning.
- **Rising earnings growth expectations:** Earnings expectations troughed in October and have soared in recent months. Consensus 2021 and 2022 earnings growth expectations are now at 34% and 16%, respectively³.
- **Relatively attractive valuations:** While not screamingly cheap, EM stocks trade at a 31% discount to the S&P 500 and a 26% discount to the MSCI World Index⁴. Discounts of this magnitude have historically been predictive of forward outperformance of EM relative to developed markets.

Within many WisdomTree ETF Model Portfolios, the anchor position that captures this positive sentiment about EM is a core allocation to the [WisdomTree Emerging Market ex-State-Owned Enterprises Fund \(XSOE\)](#).

Why Avoiding the State Makes Sense

A big outstanding question mark about the asset class is the political tension between China and the U.S. while the Biden administration is likely to be more predictable in its dealings with foreign leaders, there is bipartisan support for a tough stance with China in the aftermath of the COVID-19 pandemic and the growing number of restrictions on Hong Kong.

While these political tensions are hard to predict, taking a non-state-owned approach

can help mitigate this risk. On November 12, 2020, outgoing President Donald Trump announced Executive Order (EO) 13959, banning U.S. investors from investing in securities identified by the Department of Defense as Communist Chinese military companies (CCMCs).

XSOE did not hold any of the initial 35 CCMCs or their subsidiaries listed in the scope of this EO, as they were previously identified as state-owned enterprises and screened out.

Market benchmarks like the [MSCI EM Index](#) and the [FTSE Emerging Index](#) were forced to drop close to 20 CCMCs representing around 1.1% of their [market cap weights](#). Indexes tracking the Chinese market like the [MSCI China](#) and the [FTSE China 50](#) were the most affected by EO 13959 as they were forced to drop CCMCs nearing 3% and 8% of their respective weights.

The Bottom Line on Performance

Investors love hearing stories and narratives to craft an investment thesis, but ultimately the proof is in the performance. And while these newly sanctioned companies may now represent a business liability, these and other state-owned stocks have been laggards for quite some time.

SOEs have been dead money since 2007, remarkably still underwater from that level and having lost 1.2% per year. On the flipside, non-SOEs have outperformed their state-run counterparts by 5% per year⁵.

Having harnessed this structural governance advantage, XSOE has a performance pedigree worth bragging about.

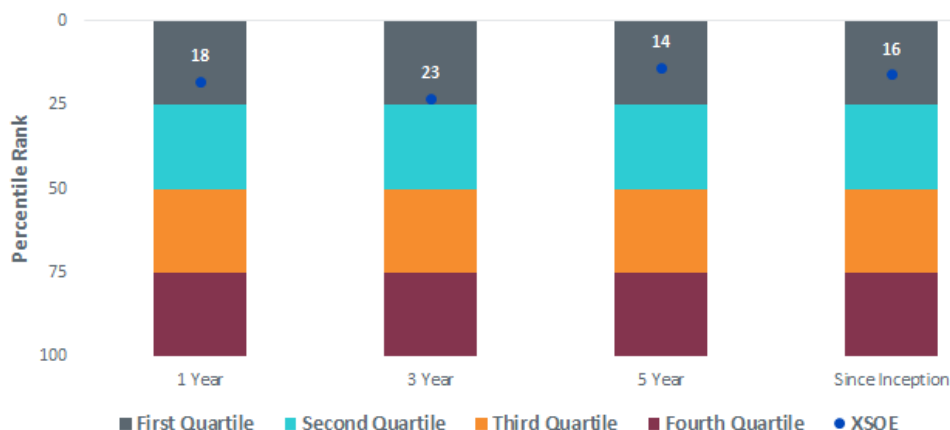
Across both universes of EM mutual funds and ETFs, XSOE ranked in the top quartile in 2020—precisely as it has done over the trailing three-year, five-year and since-inception time periods.

Performance of SOEs vs. Non-SOEs



Sources: WisdomTree, FactSet, Bloomberg. 12/31/07–12/31/20 corresponds with earliest date of available data. Universe of securities is MSCI Emerging Markets Index. Returns in U.S. dollars. Past performance is not indicative of future results. You cannot invest directly in an index.

XSOE Peer Ranking among Diversified Emerging Markets ETFs and Mutual Funds



Source: Morningstar Direct, as of 12/31/20. Number of funds in category: 797 (1-year), 697 (3-year), 597 (5-year), 524 (since inception). The rankings show in the chart are total return. Morningstar, Inc., 2019. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers is responsible for any damages or losses arising from any use of this information. Past performance, rankings and ratings are no guarantee of future results.

Know the Role that EM Plays in a Portfolio

Investors have started taking notice to XSOE’s eye-catching numbers.

Of the entire universe of EM ETFs, only one fund took in more than XSOE’s \$2.1 billion in 2020.

That said, XSOE may be the people’s champion. The only fund that saw more inflows than XSOE achieved more than half of its entire year’s flows in just five trading days, implying a small number of buyers were responsible for much of the fund’s popularity. XSOE, on the other hand, was a consistent investor favorite throughout the year, with 78 days of inflows and zero days of outflows⁶.

The Fund’s widespread appeal to advisors, institutions and retail investors alike is a major reason that it was WisdomTree’s top flow gatherer in 2020.

Coming into 2021, investors have no shortage of potential ideas fighting for capital within a portfolio. For those who wish to be aligned with the thought leaders at WisdomTree, XSOE should be a strong contender to act as the anchor of any EM allocation.

¹Bloomberg, as of 12/31/20. EM performance represented by MSCI Emerging Markets Index.

²Morgan Stanley, Asia EM Equity Strategy, 1/4/21.

³Morgan Stanley, Asia EM Equity Strategy, 1/10/21.

⁴WisdomTree, FactSet, as of 12/31/20.

⁵WisdomTree, FactSet, Bloomberg, 12/31/07–12/31/20.

⁶Bloomberg, as of 12/31/20.

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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.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Ex-SOEs: ex-state owned enterprises or companies that are neither wholly or partially owned and operated by a government.

Nasdaq 100 Index: Includes 100 of the largest domestic and international non-financial companies listed on The Nasdaq Stock Market based on market capitalization. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies, including investment companies.

Risk: Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

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.

FTSE Emerging Markets Index: A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

Market capitalization-weighting: 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.

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

FTSE China 50 Index: a market capitalization weighted index tracking the top 50 Chinese companies. Stocks are weighted by H or Red Chip share cap as appropriate.