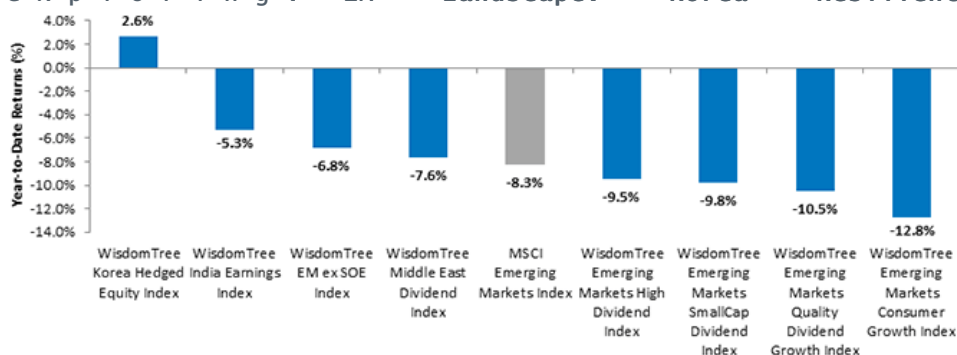


SOUTH KOREA: A STANDOUT PERFORMER IN EMERGING MARKETS

10/15/2015

Thus far in 2015, equity returns in emerging markets (EM) have lagged those of Europe, Japan, the U.S. and the broader developed world.¹ As EM equities battle their largest outflows, rivaling that of 2008,² the trinity of excessive pessimism, attractive fundamentals and supportive macroeconomics may present unique opportunities in the region. Not all emerging markets are built alike; below we highlight a few areas worth exploring. EM Landscape: Korea Resilient Amid Sell-off



Sources: WisdomTree, Bloomberg, 12/31/14–10/9/15. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of

indexes in the chart, visit our [glossary](#). **Theme 1: Resilient Korean-Hedged Index:** In spite of the broad EM sell-off in 2015, Korea is in a class of its own, having returned 2.6% on a [currency-hedged](#) basis, while the broad [MSCI EM Index](#) contracted 8.3%. • As recently as mid-September, Standard & Poor's (S&P) upgraded Korea's [credit rating](#) to AA-, the highest level in nearly 18 years. It said Korea is likely to maintain economic growth higher than most developed economies over the next three to five years. S&P is further encouraged by the decline in external debt owed by Korean banks and reduced short-term borrowing in total [external debt](#). • Many fear that EM will falter when the [Federal Reserve \(Fed\)](#) raises interest rates and investors are forced to reassess EM's yield advantage. Interestingly, Korea is on better footing, considering its total debt owed to foreigners is relatively low at 38% of [gross domestic product \(GDP\)](#).³ • Lower commodity prices have also benefited importers such as Korea by helping reduce their import bills. It comes as no surprise that Korea has seen vast improvements in its [current account](#) dynamics. It most recently recorded a surplus of 7.3%, the highest since 1999.⁴ **Theme 2: Blame It on EM Currencies:** EM has been caught in a storm of disappointing performance largely attributable to currencies. In a prior blog post, [we argued that EM currencies could offer good value](#) and support the [valuation](#) case for already depressed equity price multiples in the region. Meanwhile, given the steep cost to hedge many EM currencies, investors are forced to contend with shorter-term EM currency volatility. • Currencies account for between 75% and 90% of the negative returns experienced by the broad indexes listed above.⁵ • EM currencies are a tale of two economies—commodity importers and exporters. The commodity-exporter currencies, such as the Brazilian real, Turkish lira, Malaysian ringgit and South African rand, are the

main underperformers this year, having depreciated anywhere between 13% and 30%.⁶ while not immune to the sell-off, commodity-importing currencies such as the Taiwanese dollar and Indian rupee have held up better, having only depreciated between 2% and 3%.⁷ • The [WisdomTree Korea Hedged Equity Index](#) seeks to include profitable Korean companies while neutralizing currency exposure at an annualized cost of 1.2%. In comparison, currency hedging in the broader EM complex is far more costly, with currencies in MSCI EM costing almost 4.5% annually to hedge.⁸

- The Korean currency was down 4.7% this year, but the hedged nature of the Korea Hedged Equity Index can neutralize this decline.

Theme 3: Quantifying Equity Valuations: EM equities are currently trading at fairly low valuation multiples, with some countries testing the single-digit [price-to-earnings \(P/E\) ratio](#) territory-like China and Russia. Contrasting a country's [earnings yield](#) to its equivalent 10-year local [government bond](#) yield further helps evaluate equities compared to the alternative fixed income vehicle. • Equities in China, Taiwan and Korea have the highest earnings yield compared to their local [10-year government bond yields](#). Incidentally, these are also commodity-importing nations. The yield differential between equities and bonds ranges from 6.9% to 7.1%, helping make a stronger case for equities in these regions. • Russia comes in at a close fourth, with an earnings yield of 16.95%, the highest in the EM block, and a nominal 10-year bond yield of 11%. This implies an equity yield advantage of 5.9%.⁹ While the EM region remains a tricky landscape to navigate, we believe it is important to be able to concentrate on areas in EM where both cyclical and structural factors align to support equities and currencies. Korea makes for an interesting market that stands out for its performance in 2015, relative low cost to hedge against currency weakness and fairly wide spreads for earnings yields compared to bond yields.

¹Source: Bloomberg. Refers to the 12/31/14 to 10/9/15 performance of the MSCI Europe, MSCI Japan, S&P 500 and MSCI EAFE Indexes, respectively. ²Source: Deutsche Bank, EPFR data as of 10/9/15.

³Source: Bloomberg, total external debt to GDP as of 6/30/15. ⁴Source: Bank of Korea, Bloomberg, as of 6/30/15. ⁵Source: WisdomTree, Bloomberg, as of 8/31/15. Refers to [WisdomTree Emerging Markets High Dividend Index](#), [WisdomTree Emerging Markets SmallCap Dividend Index](#), [WisdomTree Emerging Markets Quality Dividend Growth Index](#), [WisdomTree Emerging Markets Consumer Growth Index](#) and [WisdomTree EM ex-SOE Index](#). ⁶Source: Bloomberg, as of 10/9/15. ⁷Source: Bloomberg as of 10/9/2015. ⁸Source: Bloomberg, as of 9/30/15. ⁹Source: Bloomberg, as of 10/9/2015.

Important Risks Related to this Article

Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments.

Investments focused in South Korea increase the impact of events and developments associated with the region, which can adversely affect performance.

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but can hurt when the foreign currency appreciates against the U.S. dollar.

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DEFINITIONS

Currency hedging: Strategies designed to mitigate the impact of currency performance on investment returns.

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.

Credit ratings: An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor’s, Moody’s or Fitch.

External Debt: total public and private debt owed to nonresidents.

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

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

Current account: The difference between a nation’s total exports of goods, services and transfers, and its total imports of them.

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.

Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Earnings yield: The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

10-year government bond: a debt instrument backed by a government guarantee with an original maturity of 10 years.

10-year government bond yield: Yields on the 10 year government debt security.