
REBALANCING EMERGING MARKETS SMALL CAPS DURING VOLATILE MARKETS

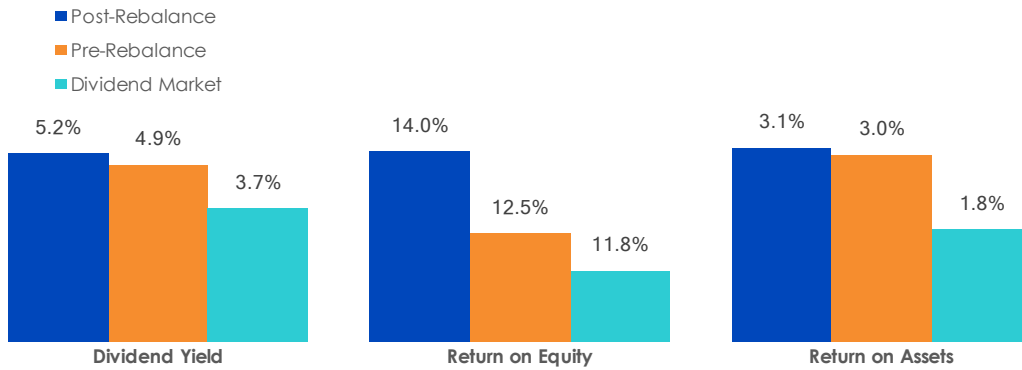
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As global trade disputes between the two largest economies continue to rise, volatility has once again become a fact of global markets with the VIX spiking to 25¹ on two occasions in October of 2018. Perhaps due to their sensitivity to trade (and concentration in China), emerging market (EM) equities have sold off considerably during this period falling by 8.7%² over the month of October alone. Despite the turmoil, we believe this bout of volatility can create long-term opportunities. At WisdomTree, we believe a key element of our index methodology is the focus on rebalancing based on fundamentals once per year. To illustrate this process, we focus on small cap dividend payers in emerging markets.

Longer trend intact – Rebalancing to stronger fundamentals with less volatility

With EM selling off, we believe this may be an opportunity for EM investors to take a step back and reassess their portfolios. Coincidentally, the timing of WisdomTree's dividend rebalances is allowing us to review and refresh the Index weights and potentially take advantage of more favorable entry points. Every year, per index rules, WisdomTree can turn over the portfolio to reallocate to potentially cheaper and undervalued constituents. This year is no exception. Most notably, the WisdomTree Emerging Market Small Cap Dividend Index rebalance increased the Index's overall dividend yield and improved the quality of its overall basket. After rebalancing, the WisdomTree Emerging Market Small Cap Dividend Index now offers a dividend yield of 5.2%, while at the same time meaningfully enhancing quality metrics of Return on Equity or Return on Assets.

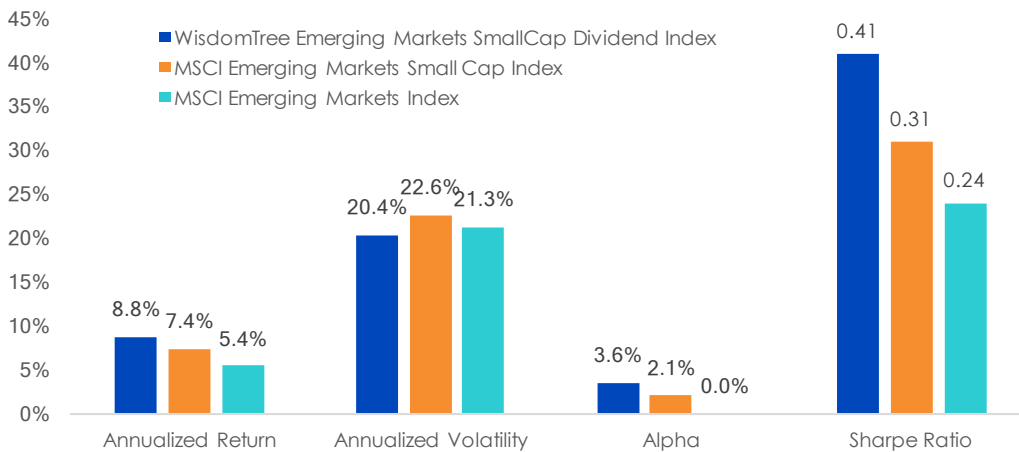
FIGURE 1: WISDOMTREE EMERGING MARKETS SMALLCAP DIVIDEND INDEX IMPACTS OF THE 2018 REBALANCE



Source: WisdomTree, Dividend Market represented by WisdomTree Emerging Market Dividend Index. Post-Rebalance and Pre-Rebalance represents the WisdomTree Emerging Market SmallCap Dividend Index pre and post rebalance as of 22 October 2018. **Historical performance is not an indication of future performance and any investments may go down in value.** You cannot invest directly in an index.

Historically, weighting emerging markets small caps by their cash dividends and rebalancing back annually to that measure has resulted in higher returns and lower volatility. To some it might be surprising that EM small caps have exhibited lower volatility than their large cap counterparts, but over the last trailing 5-year, 10-year, and common inception periods, that has been the case. Highlighting the standardized 10-year period, you can see the return advantage has been over 300 basis points (bps) a year in performance. For investors with a longer-term view, recent underperformance in the market can represent a buying opportunity.

FIGURE 2: A STUDY OF 10-YEAR RISK & RETURN METRICS



Source: WisdomTree, 30 September 2008 to 30 September 2018. **Historical performance is not an indication of future performance and any investments may go down in value.** You cannot invest directly in an index.

Longer trend intact – consumer growth is still the story

The use of dividend payers to construct the WisdomTree Emerging Market Small Cap Index has yielded a portfolio that gives investors the ability to tap into the local growth in a less volatile, higher income approach. EM small cap growth is a good way to play local economic development. Despite recent setbacks, the EM growth story remains intact. Rising populations and income levels have created a burgeoning consumer class. People in many EM countries are also moving towards urbanized regions as their economies develop and they seek to move up the value chain. One of the lasting benefits for emerging countries is their ability to adopt technology at an incredible pace. The number of internet users in emerging markets has grown to 1.8 billion since 2007 and forecast to increase even more over the next decade³. These are all positives for the growth story of EM local markets.

Large-cap names now appear much more tied to global growth than to local growth in emerging markets. By comparison, top-line growth numbers for small caps tend to be more closely tied to local economic growth factors. Specifically, small-cap dividend payers are concentrated in the information technology, consumer discretionary, and industrial sectors. These companies may be more locally focused, and many of them are bigger players in the smaller industries they are a part of.

China A-Shares inclusion

Additionally, with the inclusion of China A-shares in this year's rebalance, we are increasing the exposure to one of the largest consumer sectors of the world. WisdomTree's index added 100 Chinese domestic listed small cap companies, capping the exposure to roughly 5%, but total China exposure is around 22.4%.

In short, near term volatility may be an opportunity for investors to reassess their EM exposure. By focusing on small cap dividend payers, investors may also be able to reduce volatility relative to large cap multinationals currently being impacted by fears in global trade. In our view, the most recent rebalance continues to emphasize these trends.

¹ Source: VIX Index: Cboe SPX Volatility Index, 28 September 2018 to 31 October 2018.

² Source: MSCI Emerging Market Index, returns from 28 September 2018 to 31 October 2018.

³ Source: BCG Global Management Consulting, 22 October 2018

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