



Strategy Insight

WisdomTree Emerging Markets ex-State-Owned
Enterprises ESG Screened UCITS ETF (XSOE)

Governance and growth in emerging markets

October 2021

An interesting dichotomy has developed in emerging markets (EM), between government actors and independent investors in publicly traded equities. Government ownership may lead to corporate governance issues that arise from the inherent principal-agent problem and cause operational inefficiencies and weaker levels of profitability.

State-owned enterprises (SOEs)¹ typically advocate on behalf of a broad set of interests rather than focusing on maximizing shareholder value. These conflicts of interest can cause stagnation in the long-term growth potential of these companies.

There is yet another reason to remove SOEs from EM investment universes. Investors often are attracted to EM for their long-term growth potential—derived from typically themore favourable demographics and long-term consumption trends. Are SOEs representative of this growth opportunity set?

The two dominating industries among SOEs tend to be large banks and energy companies, whereas consumer and tech companies are rarely SOEs. There is a strong case that focusing on a universe of non-SOE companies best marries the EM investment opportunity set with the reason for investing in the first place: the growth potential of EM economies and future technology and consumption trends.

The Washington Consensus

The International Monetary Fund (IMF) and the World Bank have long advocated for the economic development of EM through a market-based approach, with a preference for the privatization of SOEs. The philosophy of these intergovernmental organizations (IGOs) is often referred to as the Washington Consensus.

The IMF published a paper in June assessing SOEs in central, eastern and southeastern Europe.² Their conclusion? SOEs in the region generally “generate less revenue than their private counterparts, incur heavier costs of production not least on wages, and as a consequence are significantly less profitable.” Political influences can often result in SOEs employing too many people that are paid too much.

A broader study written by the World Bank in 2014 came to a similar conclusion. It argues that SOE underperformance is in part driven by exogenous factors like lower commodity prices or other sector-specific factors. But it concludes there is “increasing recognition that poor corporate governance of SOEs is at the heart of the matter.”³

The Performance Difference

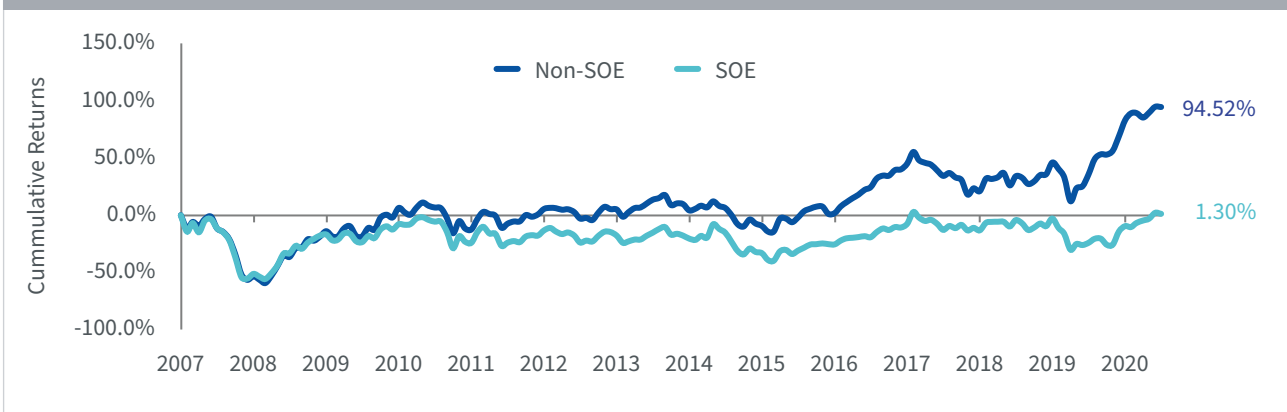
The first, and probably most critical, question to ask is whether SOEs and non-state-owned enterprises (non-SOEs) have performed differently. If the thesis that having multiple owners—shareholders and the government—significantly exacerbates what is referred to as the principal-agent problem for SOEs, it is bound to be reflected in investment performance. To show this, WisdomTree has built broad market capitalization-weighted example portfolios of SOEs and non-SOEs in EM. State ownership, as defined by WisdomTree, applies to firms that have more than 20% of their shares owned by government entities. The data in figures 1 and 2 show a consistently large performance gap in favour of non-SOEs. Some might ask if non-SOE outperformance is simply a consequence of sector tilts, or if non-SOEs have outperformed SOEs regardless. Data in figure 3 shows annualized return by sector for each of the SOE and non-SOE portfolios. We can conclude that sector tilts contributed to outperformance, as non-SOEs tend to be underweight the Energy, Materials and Industrials sectors, which have been the worst performers over the 13-year period. We can also see how the performance of non-SOEs was stronger than SOEs within the different sectors, except for the Consumer Staples, Financials and Real Estate sectors.

¹ State-owned enterprises are defined as firms that have more than 20% of their shares owned by government entities.

² “Reassessing the Role of State-Owned Enterprises in Central, Eastern, and Southeastern Europe,” International Monetary Fund, 6/18/19, pp 15–23.

³ “Corporate Governance of State-Owned Enterprises,” World Bank, 2014, pp 11-12

Figure 1: Cumulative Returns of SOEs vs. Non-SOEs in the MSCI Emerging Markets Index



Sources: FactSet, WisdomTree, 31 December 2007 – 30 June 2021. SOEs are defined as firms that have more than 20% of their shares owned by government entities. Non-SOEs are defined as firms that have less than 20% of their shares owned by government entities. Universe of securities is the MSCI Emerging Markets Index. Returns are calculated in U.S. dollars. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

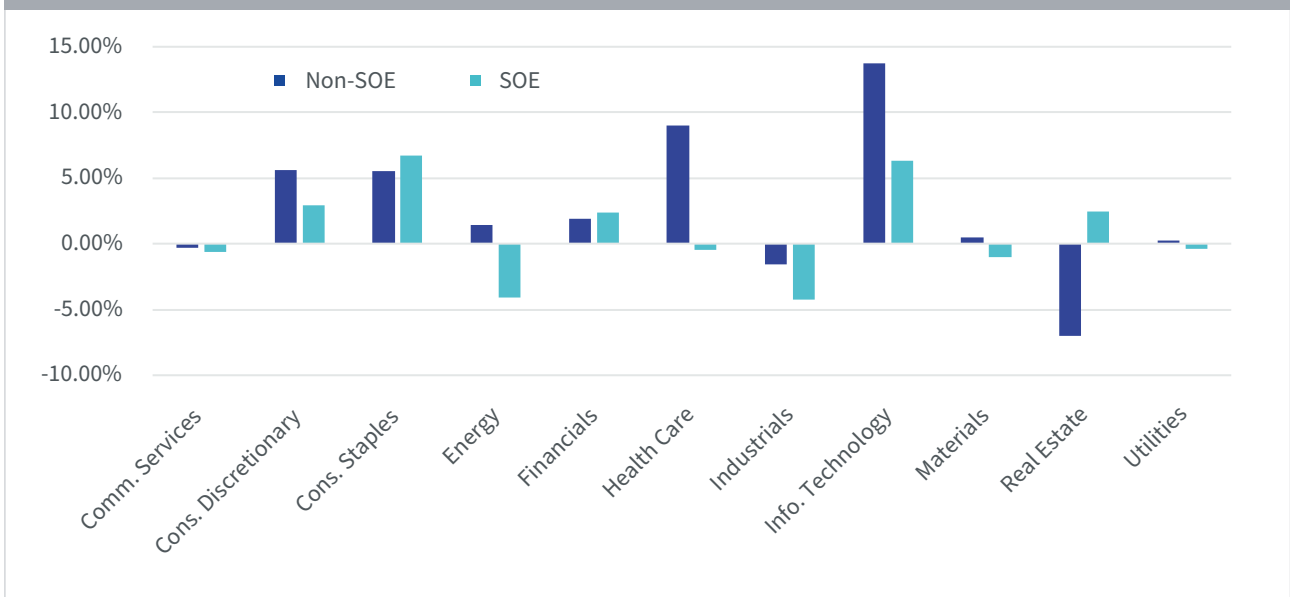
Figure 2: Standardised Calendar Year, Annual Returns & Standard Deviation (as of 30 June 2020)

Average Annual Returns						Standard Deviation					
	1 Yr	3 Yr	5 Yr	10 Yr	Since 2007		1 Yr	3 Yr	5 Yr	10 Yr	Since 2007
Non-SOE	43.42%	13.14%	14.70%	6.19%	5.05%	Non-SOE	13.42%	19.38%	16.68%	17.29%	21.79%
SOE	33.35%	5.08%	7.94%	0.70%	0.10%	SOE	17.62%	19.63%	16.95%	19.39%	22.64%

Calendar Year Performance														
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Non-SOE	-53.42%	84.52%	23.69%	-17.77%	20.62%	-0.48%	-0.81%	-13.01%	12.35%	42.57%	-16.63%	20.75%	25.35%	6.28%
SOE	-51.20%	70.63%	10.80%	-17.62%	14.33%	-5.35%	-3.20%	-15.92%	11.42%	24.17%	-6.18%	11.87%	-6.84%	11.86%

Source: WisdomTree, as of 30 June 2021. Universe of securities is the MSCI Emerging Markets Index. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. **Historical performance is not an indication of future performance and any investments may go down in value.**

Figure 3: Annualised Sector Performance for SOEs & non-SOEs



Source: WisdomTree, 31 December 2007 – 30 June 2021. Universe of securities is the MSCI Emerging Markets Index. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. **Historical performance is not an indication of future performance and any investments may go down in value.**

How to access non-state-owned enterprises?

The WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened UCITS ETF (XSOE) provides exposure to the broad EM universe, investing in companies in which the local government owns less than 20% of shares, making it the only fund of its kind. We believe exposure to non-SOEs is a more efficient way to approach EM equity markets for investors that want to mitigate the risks inherent in investing in companies that don't have complete control over their own operations.

Since 18 September 2014, the underlying index of XSOE has outperformed prominent competitors within EM such as the Vanguard, Fidelity, UBS and HSBC. Owing to the limited live history for WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened UCITS ETF (**XSOE**), the performance of XSOE is based on the performance of WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened Index TR net of 0.32% fees. The performance of Vanguard FTSE Emerging Markets ETF (**VDEM**) is based on the performance of the FTSE Emerging Net Tax Index TR USD net of 0.22% fees. The performance of Fidelity Emerging Markets Quality Income ETF (**FEMI**) is based on the performance of the Fidelity Emerging Markets Quality Income Index NTR net of 0.50% fees. The performance of UBS (Lux) Fund Solutions – MSCI Emerging Markets UCITS ETF (**EMMUSA**) is based on the performance of the MSCI Emerging Net Total Return USD Index net of 0.23% fees. The performance of HSBC Emerging Market Sustainable Equity UCITS ETF (HSEM) is based on the performance of the FTSE Emerging ESG Low Carbon Select Net Tax Index net of 0.18% fees.

Figure 4: Simulated cumulative performance comparison



Source: Factset, WisdomTree as of 31 August 2021. Please note – WisdomTree is represented by WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened Index TR net of 0.32% fees. Vanguard is represented by the FTSE Emerging Net Tax Index TR USD net of 0.22% fees. Fidelity is represented by the Fidelity Emerging Markets Quality Income Index NTR net of 0.50% fees. UBS is represented by the MSCI Emerging Net Total Return USD Index net of 0.23% fees. HSBC is represented by the FTSE Emerging ESG Low Carbon Select Net Tax Index net of 0.18% fees. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

Methodology

The proprietary index that XSOE tracks starts with a broad universe of approximately 800 EM companies, which are analyzed to identify significant government ownership. After going through filings and regulatory documents, WisdomTree identified 220 companies in which the local government owns more than 20% of shares—state-owned enterprises. Looking at the breakdown of the SOEs that are removed from the universe we can see that close to half of them are Chinese and that most are concentrated in the Financials, Energy and Materials sectors.

Figure 5: Country and Sector Breakdown for SOEs in a Broad EM Universe

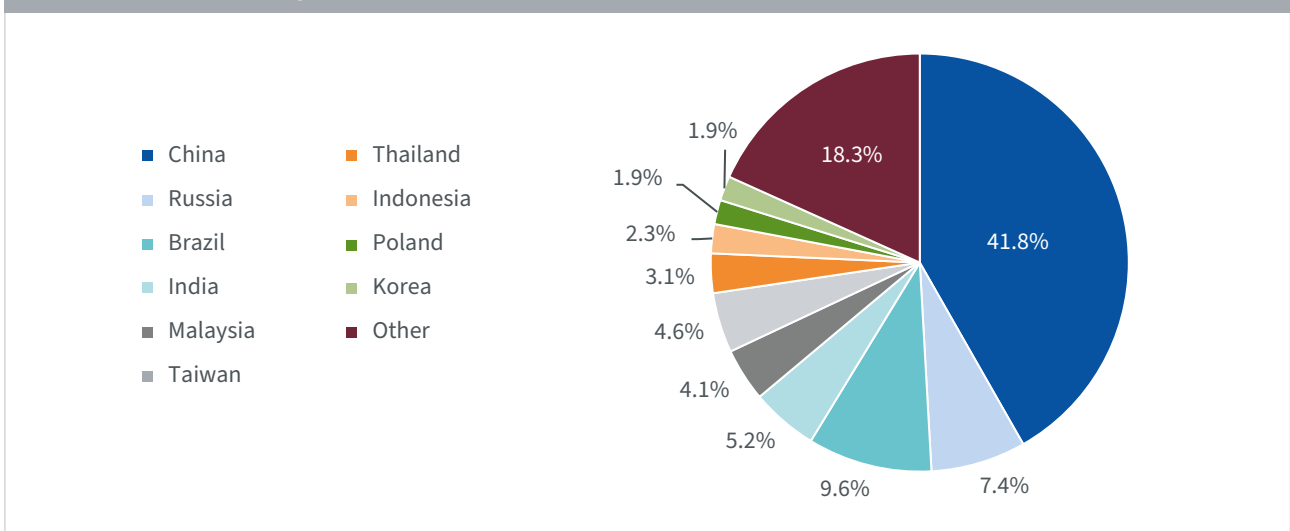
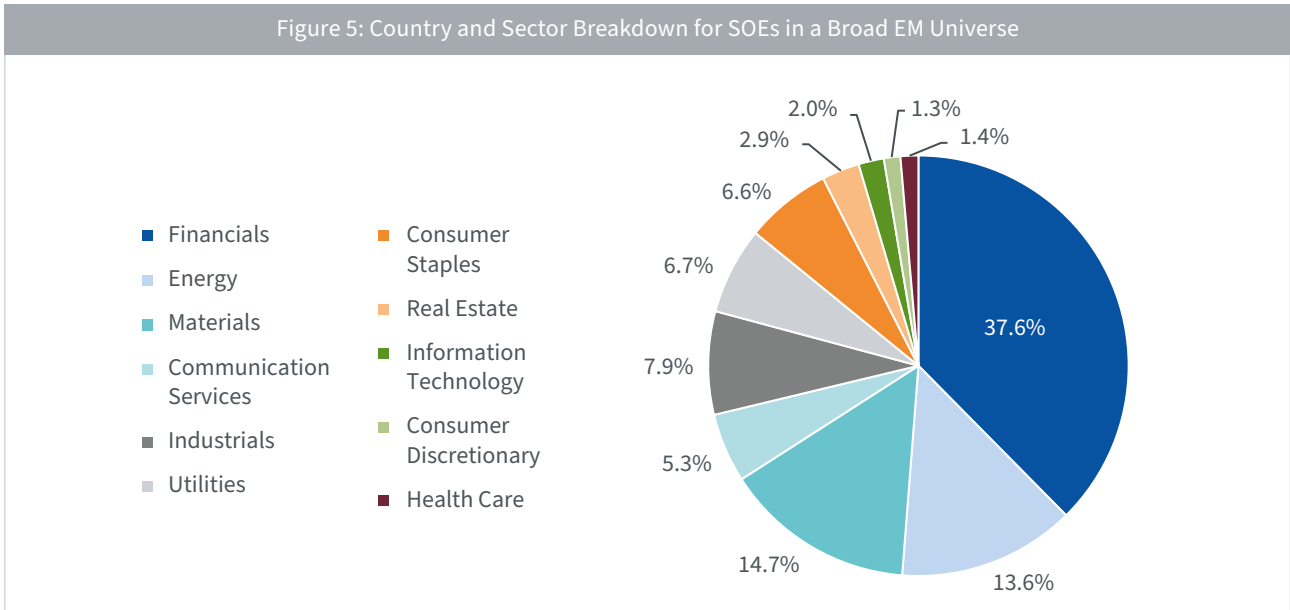


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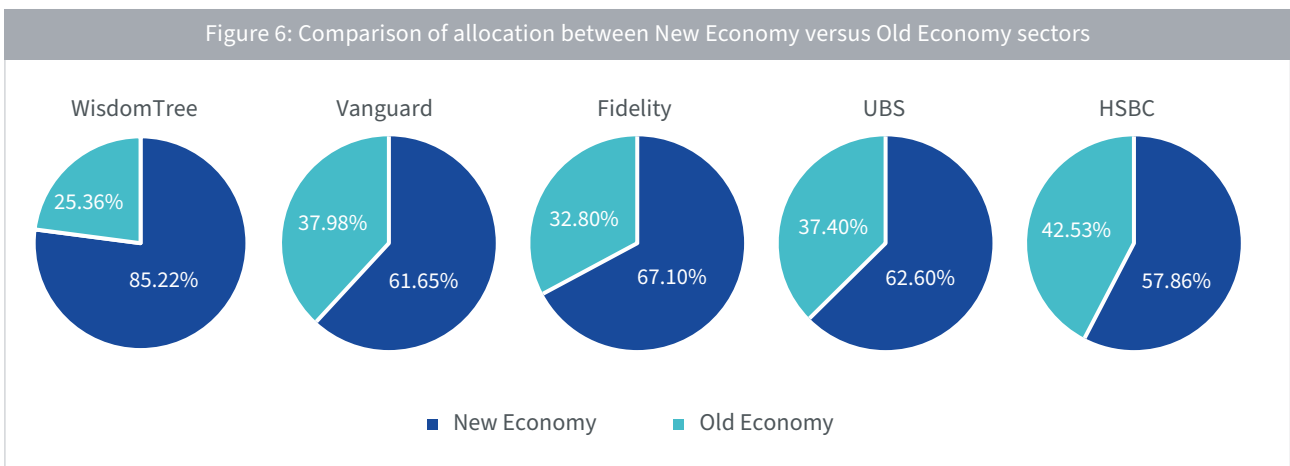
Sources: WisdomTree, FactSet, as of 30 June 2021. Holdings are subject to change.

After removing SOEs from the universes, the index weights non-SOEs using a modified float-adjusted market cap. Final weights are adjusted with the objective of staying close to the sector and country exposure of the broader starting universe. These deviations from a pure market capitalization-weighted strategy are reflected in XSOE's holdings, aggregate exposures and fundamentals.

Aggregate country and sector exposures

Removing SOEs, which tend to be concentrated in “old economy”⁴ sectors like Financials, Energy and Materials, Real Estate and Utilities results in XSOE having modest structural tilts towards “new economy” sectors like Information Technology, Consumer Discretionary and Communication Services, Health Care and Industrials.

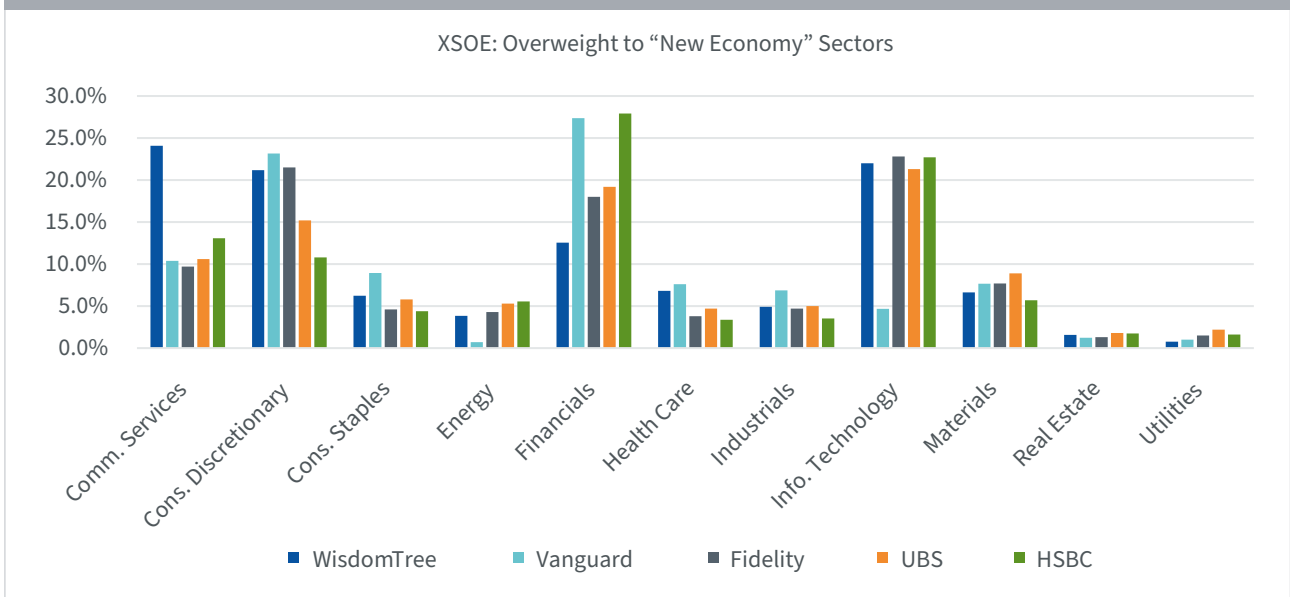
Figure 6: Comparison of allocation between New Economy versus Old Economy sectors



New economy sectors are those in EM economies that are positioned to take advantage of a growing middle class and increased domestic consumption, trends we believe will persist in the future. Meanwhile, old economy sectors rely more on capital intensive and reliant on international trade.

⁴ Old Economy describes an [economy](#) or even a group of industries that does not rely on technology or technological advancement. New Economy instead, describes aspects or sectors of an economy that are producing or intensely using innovative or new technologies.

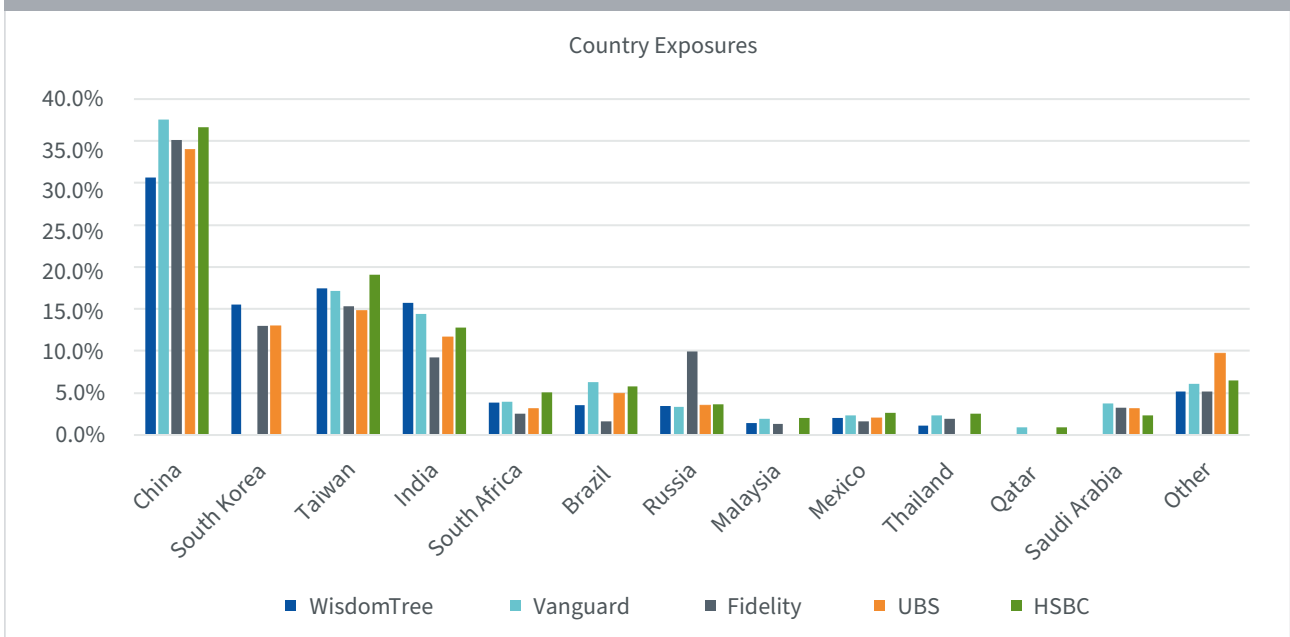
Figure 7: Comparison of WisdomTree's sector tilts relative to its peers



Source: WisdomTree, Bloomberg as of 31 August 2021. Please Note: WisdomTree is represented by WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened UCITS ETF (XSOE), Vanguard is represented by Vanguard FTSE Emerging Markets ETF (Bloomberg Ticker: VDEM LN), Fidelity is represented by Fidelity Emerging Markets Quality Income ETF (Bloomberg Ticker: FEMI LN), UBS is represented by UBS (Lux) Fund Solutions – MSCI Emerging Markets UCITS ETF (Bloomberg Ticker: EMMUSA SW), HSBC is represented by HSBC Emerging Market Sustainable Equity UCITS ETF (Bloomberg Ticker: HSEM LN). Holdings are subject to change.

In terms of country exposures, XSOE stays relatively close to its starting universe as well as to its peers. Because of the concentration of many SOEs in a handful of countries, the index methodology had to ensure that XSOE's final portfolio was not overly biased—either for or against—any individual country.

Figure 8: Comparison of WisdomTree's country tilts relative to its peers



Source: WisdomTree, Bloomberg as of 31 August 2021. Please Note: WisdomTree is represented by WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened UCITS ETF (Bloomberg Ticker: XSOE LN), Vanguard is represented by FTSE Emerging Markets ETF (Bloomberg Ticker: VDEM LN), Fidelity is represented by Fidelity Emerging Markets Quality Income ETF (Bloomberg Ticker: FEMI LN), UBS is represented by UBS (Lux) Fund Solutions – MSCI Emerging Markets UCITS ETF (Bloomberg Ticker: EMMUSA SW), HSBC is represented by HSBC Emerging Market Sustainable Equity UCITS ETF (Bloomberg Ticker: HSEM LN). Holdings are subject to change.

Fundamentals

Comparing aggregate fundamentals for the underlying indices for each fund gives us an under-the-hood look and helps us understand where some of their differences come from. We can see that by removing SOEs from its universe, historically XSOE achieves higher profitability and earnings growth estimates than its peers.

Profitability metrics such as ROE⁵ and ROA⁶ are significantly higher for XSOE, along with favourable growth metrics such as the implied growth (ROE x Earnings Retention). To us, this gets to the core of why investors may be disadvantaged by companies with significant state ownership. Better profitability and growth fundamentals both come from XSOE having interests aligned between management and shareholders, along with better corporate governance and the inherent sector tilts away from inefficient, old economy sectors into the more dynamic new economy sectors.

One of the few potential drawbacks of XSOE when looking at aggregate fundamentals is the valuation premium associated with having higher profitability and implied growth. However, looking at a growth-adjusted metric such as the PEG ratio⁷, which shows the trade-off between a portfolio's valuation (P/E ratio) and its expected growth rate, we can see that the valuation premium isn't as significant as it initially appears as it accounts for higher growth.

Historically, SOEs have been known to be less capital efficient than non-SOEs, incurring higher financial leverage. As seen below, aggregate leverage as measured by the Total Debt to Total Assets ratio, is significantly higher for the majority of XSOE's peers.

Figure 9: Comparison of aggregate fundamentals

Fundamentals	WisdomTree	Vanguard	Fidelity	UBS	HSBC
P/E Ratio	23.02	6.60	12.61	15.98	16.22
Return on Equity (%)	15.26	14.11	12.37	13.28	13.04
Return on Assets (%)	3.56	2.00	2.89	2.36	1.99
ROE x Earnings Retention (%)	8.18	5.67	7.27	6.50	8.15
Leverage*	19.04	21.46	15.26	19.34	17.92
PEG Ratio	1.02	1.16	1.74	2.46	1.99

Source: WisdomTree, Bloomberg as of 31 August 2021. Please Note: WisdomTree is represented by WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened UCITS ETF (XSOE), Vanguard is represented by Vanguard FTSE Emerging Markets ETF (Bloomberg Ticker: VDEM LN), Fidelity is represented by Fidelity Emerging Markets Quality Income ETF (Bloomberg Ticker: FEMI LN), UBS is represented by UBS (Lux) Fund Solutions – MSCI Emerging Markets UCITS ETF (Bloomberg Ticker: EMMUSA SW), HSBC is represented by HSBC Emerging Market Sustainable Equity UCITS ETF (Bloomberg Ticker: HSEM LN). *Leverage is calculated as Total Debt to Total Assets. PEG ratio is calculated as Price to Earnings ratio divided by growth. **Historical performance is not an indication of future performance and any investments may go down in value.**

Top holdings

Comparing the 10 largest holdings for XSOE relative to its peers, we can see the effect of the modified float-adjusted market cap-weighting after removing SOEs. The largest exclusions from the countries that dominate SOEs can give us further insight into which companies XSOE removes from its investable universe.

⁵ Return on Equity (ROE): Firm profits (after accounting for all expenses) divided by the firm's total equity.

⁶ Return on Assets (ROA): Firm profits (after accounting for all expenses) divided by the firm's total assets.

⁷ The price/earnings to growth ratio (PEG ratio) is a stock's [price-to-earnings](#) (P/E) ratio divided by the growth rate of its earnings for a specified time period. The PEG ratio is used to determine a stock's value while also factoring in the company's expected earnings growth, and it is thought to provide a more complete picture than the more standard P/E ratio.

Figure 10: Top 10 Holdings

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WisdomTree	Weight	Vanguard	Weight
Taiwan Semiconductor Manufacturing Co., Ltd.	6.72%	Taiwan Semiconductor Manufacturing Co., Ltd.	7.25%
Tencent Holdings Ltd.	5.58%	Tencent Holdings Ltd.	5.05%
Samsung Electronics Co., Ltd.	5.26%	Alibaba Group Holding Ltd.	4.12%
Alibaba Group Holdings Ltd.	4.87%	Meituan Dianping	1.70%
Reliance Industries Limited	1.83%	Reliance Industries Limited	1.31%
Meituan Dianping	1.71%	Infosys Limited	1.14%
Infosys Limited	1.34%	Vale S.A.	1.05%
JD.com, Inc.	1.16%	China Construction Bank Corporation	0.93%
Housing Development Finance Co.	1.11%	Housing Development Finance Co.	0.91%
Ping An Insurance (Group) Company of China, Ltd.	1.07%	Tata Consultancy Services Ltd.	0.73%
Fidelity	Weight	HSBC	Weight
Samsung Electronics Co., Ltd.	5.17%	Taiwan Semiconductor Manufacturing Co., Ltd.	11.73%
Tencent Holdings Ltd.	4.58%	Tencent Holdings Ltd.	7.35%
Li Ning Co Ltd.	2.68%	Infosys Limited	3.61%
Bosideng International Holding	2.39%	China Construction Bank Corporation	2.32%
MSCI Emerging Market Dec 21	1.78%	Alibaba Group Holdings Ltd.	2.15%
Housing Development Finance Co.	1.75%	Meituan Dianping	1.88%
ANTA Sports Products Ltd.	1.53%	Itau Unibanco Holding SA	1.66%
China Meidong Auto Holdings Ltd.	1.52%	Industrial & Commercial Bank of China	1.29%
Globalwafers Co Ltd.	1.51%	Reliance Industries Ltd.	1.29%
Zhongsheng Group Holding	1.49%	MSCI Emerging Market Dec 21	1.09%

Source: Bloomberg, WisdomTree as of 31 August 2021. Please Note: WisdomTree is represented by WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened UCITS ETF (XSOE), Vanguard is represented by Vanguard FTSE Emerging Markets ETF (Bloomberg Ticker: VDEM LN), Fidelity is represented by Fidelity Emerging Markets Quality Income ETF (Bloomberg Ticker: FEMI LN), HSBC is represented by HSBC Emerging Market Sustainable Equity UCITS ETF (Bloomberg Ticker: HSEM LN). Holdings subject to change.

Figure 11 : XSOE's Largest Exclusions

WisdomTree Emerging Markets ESG Screened Ex-State Owned Index's largest Exclusions % Weight			
Company	% Weight	Country	Sector
Tata Consultancy Services Limited	0.66	India	Information Technology
Grupo Mexico S.A.B. de C.V. Class B	0.19	Mexico	Materials
SK Holdings Co., Ltd	0.14	Korea	Industrials
KT & G Corporation	0.13	Korea	Consumer Staples
Adani Ports & Special Economic Zone	0.08	India	Industrials
Hindalco Industries Limited	0.08	India	Materials
Klabin SA	0.07	Brazil	Materials
Exxaro Resources Limited	0.04	South Africa	Energy
Haci Omer Sabanci Holding A.S.	0.04	Turkey	Financials
Tata Power Company Limited	0.04	India	Utilities
PT Adaro Energy Tbk	0.03	Indonesia	Energy
Adani Enterprises Limited	0.03	India	Industrials
PT Gudang Garam Tbk	0.03	Indonesia	Consumer Staples
Hanwha Corp	0.02	Korea	Industrials
Total	1.57	-	-

Source: Bloomberg, WisdomTree as of 30 June 2021. Holdings subject to change.

Performance attribution

By construction, XSOE will have 100% of its weight invested in non-SOEs, while competitors will likely have a combination of both SOEs and non-SOEs. As shown in figures 1 and 2, non-SOEs have consistently outperformed SOEs over the last 13 years, so being overweight non-SOEs and underweight SOEs has positively contributed to XSOE's outperformance since inception.

Figure 10 illustrates how WisdomTree's average weight to SOEs and non-SOEs along with their contribution to total return for each group over the past 1, 3 and 5 years. Compared to the benchmark MSCI Emerging Market Index, WisdomTree has managed to generate annualised excess returns of 0.92%, 3.83% and 3.68% respectively owing to its higher allocation to non-SOEs. The benchmark's exposure to SOEs has not been beneficial as the relative contribution to returns from this exposure is significantly smaller than its average weight to the category.

Given how the numbers have historically backed up a sound investment thesis, we believe in the potential for this trend to continue in the future.

Figure 12: Performance attribution



Source: Factset, WisdomTree as of 31 July 2021. Please Note: WisdomTree is represented by WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened Index (Bloomberg Ticker: EMXSOEUT Index); Benchmark is represented by the MSCI Emerging Markets Index (Ticker: MXEF Index). **Historical performance is not an indication of future performance and any investments may go down in value. Weights are subject to change.**

Figure 13 : Simulated risk-adjusted performance comparison

Name and currency	Aug	YTD	1Y			3Y			5Y			SCH		
	Return	Return	Return	Std. dev	SR	Ann. Return	Std. dev	SR	Ann. Return	Std. dev	SR	Ann. Return	Std. dev	SR
WisdomTree USD	1.49%	0.37%	19.36%	16.76%	1.14	13.01%	18.90%	0.62	13.34%	16.51%	0.72	8.21%	16.23%	0.44
Vanguard USD	3.31%	4.14%	19.97%	14.97%	1.32	10.13%	17.39%	0.50	9.88%	15.39%	0.55	5.27%	15.84%	0.26
Fidelity USD	1.58%	10.02%	35.83%	14.42%	2.47	12.27%	17.83%	0.61	11.12%	15.68%	0.62	6.96%	15.68%	0.37
UBS USD	2.60%	2.69%	20.85%	15.29%	1.35	9.61%	17.85%	0.46	10.15%	15.77%	0.55	5.32%	15.93%	0.26
HSBC USD	4.15%	4.58%	22.05%	15.15%	1.44	9.61%	17.20%	0.48	10.39%	15.22%	0.59	6.28%	15.70%	0.33

Source: WisdomTree, Bloomberg. As of 31 August 2021. Calculations are based on returns in USD and include backtested/backcast data. WisdomTree is represented by the WisdomTree Emerging Markets ex-State-Owned Enterprises ESG Screened Index TR net of 0.32% fees. Vanguard is represented by the FTSE Emerging Net Tax Index TR USD net of 0.22% fees. Fidelity is represented by the Fidelity Emerging Markets Quality Income Index NTR net of 0.50% fees. UBS is represented by the MSCI Emerging Net Total Return USD Index net of 0.23% fees. HSBC is represented by the FTSE Emerging ESG Low Carbon Select Net Tax Index net of 0.18% fees. The Index started its live calculation on 23 August 2021. Standard deviation estimates based on daily returns. Sharpe Ratio is not reported, when return in excess of the risk-free rate is negative. SCH is since common history and corresponds to 19 September 2014. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

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