

Just One ETF: Taking Stock of the Emerging-Market Consumer

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Which single asset class are you most bullish/bearish about in the coming year? What ETF position would you choose to best capture that?

We are bullish on the emerging market consumer and the growing middle class within emerging markets. Currently, the best way to access this asset class, in our opinion, is through the WisdomTree Emerging Markets Small Cap Dividend Fund (DGS).

The fund (as of March 31) had 25.39% invested in consumer discretionary and consumer staples stocks. Emerging markets have been a very crowded investment as of late, but the majority is in large-cap stocks while DGS offers an exposure to emerging markets most currently do not have.

How does this ETF fit into your overall investment approach?

Ladenburg Thalmann Asset Management manages a non-dollar, internationally focused portfolio. The purpose of this portfolio is to pair high-growth equities from emerging markets, emerging-market small caps, and frontier markets with international debt and alternative assets, designed to stabilize and smooth out returns of the overall portfolio while continuing to offer non-U.S. dollar exposure. Overall, 39% of the portfolio is invested in emerging and frontier market equities.

Tell us a little more about the asset class. What makes it your top pick?

Unlike large-cap emerging market stocks, the main focus of this asset class is smaller, more localized companies, ones that do not derive the majority of their revenue from exports to the developed world. This also lowers the dependence on continued growth within the developed world, and increases the focus on the emerging-market consumer and growing middle class.

What catalysts, near-term or long-term, could move the asset class significantly?

Emerging markets overall have performed so well, and have experienced such large asset inflows, that any hiccup in growth could cause investors to take profits in this asset class and

trim their allocations. In addition, there are always political risks associated with emerging markets that are difficult to quantify.

The single largest downside risk currently involves a possible liquidity crisis stemming from issues with Greece's debt (or that of other European countries with similar debt issues). While much of the developed world is trying to de-leverage their corporate balance sheets, countries in emerging markets are gaining access to capital that was never available before. A liquidity crisis would make it difficult for some of these smaller emerging-market companies to find willing lenders.

You mentioned consumer-focused stocks; what can you tell us about the diversification of industries represented in the fund, and how might the rest of that mix (say IT or industrials) work as a catalyst for DGS?

On a sector basis, compared with the MSCI Emerging Markets Index, the WisdomTree Emerging Markets Small Cap Dividend Index (as of March 31) is overweight Consumer Discretionary, Consumer Staples, Industrials, and Information Technology; and underweight Energy, Financials, Materials and Telecommunication Services. Allocations to Utilities and Health Care are comparable between the two.

The investment not only focuses on the consumer, but also in companies whose general focus is within the local emerging market space (as is the case with IT and industrials), and not as dependent on exports to the developed world, such as is the case with many energy- and material-related companies in emerging markets. The ETF overweights companies whose revenues are largely made up from local consumer spending.

Are there any regional risks with the ETF's heavy Asia Pacific representation?

On a country basis, compared with the MSCI Emerging Markets Index, the WisdomTree Emerging Markets Small Cap Dividend Index (as of March 31) is overweight Taiwan, Thailand, Israel, Malaysia, Turkey and South Africa, and underweight the BRIC countries, as well as Mexico.

There are regional risks, but because the fund is focused on countries with lower multiples (P/E, P/B, P/S), as is the case with most dividend-weighted indexes, these risks are usually associated with lower volatility than typically found in this asset class.

Are there alternative ETFs that could be used to capture the same theme? What makes this specific ETF your first choice?

The only other broad-based emerging market small-cap ETF is the SPDR S&P Emerging Markets Small Cap ETF (EWX). The main difference between the two is EWX is weighted by market cap while DGS is weighted by dividends.

Due to the inefficiencies of emerging market small-cap stocks, the fundamentally weighted indexes (such as the one DGS tracks), for the most part, have outperformed their market cap-weighted index counterparts on a risk-adjusted basis over the past few years.

What's current sentiment like on emerging-market small caps? Does your view differ from the consensus?

After a dismal 2008, emerging markets overall - and even more so, emerging-market small caps - had extremely strong performance in 2009. Consensus is that emerging-market small caps should continue to lead the world in growth over the next few years; we agree the growth will outpace most other asset classes, but less dramatically than returns shown in 2009.

Thanks very much for sharing your views with us.

Disclosure: Ladenburg Thalmann is long DGS.