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Interview series: Investment Factors that drive ETF performance

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In this latest piece focused on factors we ask Jeremy Schwartz, Director of Research at WisdomTree about what factors should investors look to when they are addressing the currency question. We believe that having access to a currency hedge can be a constructive tool and are encouraged by the innovation in the ETF industry, but only if it is in the hands of a user who appreciates the factors that drive the decision making process.

Dan Weiskopf: What factors should we be monitoring to know whether we want to be hedged on the Korean won?

JEREMY SCHWARTZ: Certainly the currency volatility is one important factor. You saw this where the Korean won was trading versus the dollar, it bottomed out in 2014, around 1009. It was getting close to the 1000 level and it started making the Koreans more uncomfortable. They started talking about it more in the rhetoric, saying the strengthening won was hurting them. Now they're at 1143. You have seen almost an 11% depreciation just in the last 12 months. So you're starting to see that currency start to weaken.

When I look at what the factors are when you think about hedging, the cost to hedge is certainly an important factor. And the cost to hedge is based on interest rate differentials, which is coming down, as the Koreans are cutting interest rates. Today, their sort of Fed fund type rate is at 1.25%, down from 1.5% after a recent cut. Thinking about this in the context of our potential rise in interest rates makes me think that the interest rate differential versus the US will just get wider and more interesting. As we raise rates and as they lower rates, that cost can converge towards zero, which means that investors could possibly get paid for the hedged over the next 12 to 18 months. Now that would be a big deal.

But the Koreans are not just worried about the dollar. They're increasingly focused on the won versus the yen. It used to be essentially 7 won to the yen, and now it's 11. A 50% depreciation versus the yen, which makes Japan a lot more competitive. If the yen keeps depreciating, I would expect the Koreans to take more action to weaken their currency.

Dan Weiskopf: You mention in your white paper that equities in South Korea are trading at 2009 levels. What factors have led to this discount, and what catalysts should we be looking to that might lead to a narrowing of this discount?

JEREMY SCHWARTZ: I think the valuation that we say is at 2009 levels is the price-to-sales ratio, which is at .6. There are very few countries trading at that low multiple. Even Russia is selling at a .8 price-to-sales ratio. I think the factor that is hurting South Korea is the profitability of its companies, which again is clearly helped by a weaker currency given that their economy is so export driven. We wrote a piece recently that showed a chart that essentially compared the profitability of the consumer discretionary companies in South Korea versus Japan, and the relative profit differential there was dramatic.

When you even look at a PE ratio, 10 to 11 times earnings for South Korea, when you look at the broad developed market index, 15, 16 times earnings and the US is at 17 to 18 times earnings, it's actually relatively on the lower price range of developed or emerging market, you know, it is borderline developed/emerging markets upgrade it. But even for the standard price-to-earnings ratio, which includes that lower profitability, you see Korea as a relatively low priced country there.

And so, I think that with a weaker Won the profitability of the companies exporting would become more profitable which itself would make the market cheaper and arguably provide more of a reason to narrow the valuation gap.

Dan Weiskopf: Your index is about equally balanced at 25% between materials, technology, consumer, cyclicals and industrials. As a result, the index is underweight Samsung versus the MSCI index and technology overall, and a bit more exposed to midcaps and other indexes. Why is that? Was the index constructed with a broad slant toward exporters?

JEREMY SCHWARTZ: If you look at the broad MSCI, indexes Samsung definitely tends to get around 20% sort of a very large outlier. We wanted to put more restrictions in our top holdings with a cap of 10%and similar to our Japanese hedged ETF we're tilting the weight away from just local economy stocks.

We're underweight financials. We're underweight technology because we capped out our top holding at 10%. And it's not as capped out in that broad market index. So we have some more diversification. You don't have one stock driving the majority of returns that are less than the majority of returns. And then we also do tilt toward those companies uniquely positioned for a weaker won, but financials are underweight because there are no financials that are broad globally based or exporter based.

Dan Weiskopf: What sectors might we be looking towards for earnings growth in 2016?

JEREMY SCHWARTZ: Again, as an export driven economy one of the factors will be China. You could say if China's economy has a hard landing, that will not be good for South Korea. China recently reported a strong GDP number so if they do manage through their situation well it could be one positive support for the export companies.

Dan Weiskopf: There is a lot of debate about whether South Korea should be classified as a developed or emerging market as a classification. As head of research at WisdomTree, where do you stand on that question?

JEREMY SCHWARTZ: Their GDP and per capita income is definitely very close to developed market status. However, we tend to be more closely aligned with MSCI, meaning emerging markets because the won is broadly not a free-floating type currency—one of the major characteristic of developed markets.It's really some of these operational market access questions.

Dan Weiskopf: Dividend payouts in South Korea are starting to increase. Can you speak about this trend and how this as a factor might be a predicative indicator?

JEREMY SCHWARTZ: Very importantly, when you look at their tail ratio, this is one of the reasons why WisdomTree uses an earnings-related model to lead South Korea—it has one of the lowest tail ratios, in really, the world. It was just up 15%. Now what's interesting is government basically started instituting a tax, that if you don't– you can get around the tax if you do more capital spending, you pay your employees more, or if you pay dividends. And you saw in our basket,over 40% in our Korean asset index. So your companies respond that one way they can lower their underlying taxes is to pay dividends. You get a tax credit essentially. That's going to encourage companies to pay dividends, and we think that's going to continue to be the case over the coming year.

When we do a broad earnings weighted metric, you tend to have high levels of retained earnings, which is one of the factors that all the different discount models that return equity times essentially your retained earnings of what needs to be stable over time. The earnings tend to give you those higher levels of retained earnings. So we think that could be, Korea, because it's right now at a 15% ratio and even just the broad LSDI[?] versus over 30. And the US is at 30, and it's at historical low levels just at 30. We think that ratios are likely to rise for a lot of reasons like that over the coming few years. And you could see it at that historical number, or that broad number for emerging markets closer to 30, or even higher now that they're actually incentivizing.

Dan Weiskopf: Thank you Jeremy. As a macro investor, I appreicate having the additional tools available to me that firms like yours provide. A global investment world deserves truly global solutions.