

# JAPANESE SMALL CAPS: THE LOCAL OPPORTUNITY

Christopher Gannatti — Head of Research, Europe  
06/25/2014

For the first five months of 2014, Japanese equities<sup>1</sup> didn't deliver compelling performance, yet economic conditions in Japan, thanks to [Abenomics](#), are looking better and better. We notice that many of Japan's largest, most globally oriented firms don't trade strictly on what's going on in Japan, though, and their share prices are heavily influenced by developments around the world. We believe that small-cap Japanese stocks may offer greater sensitivity to the local economy. And the evidence is encouraging: small caps are currently outperforming their more global brethren in the large-cap space. Thus, we believe that fears about Japan's consumption tax hike derailing Japan's local economy are misplaced, since small caps are much more heavily dependent on actual Japanese consumption. WisdomTree has an array of Indexes focused on different parts of Japanese equity markets. **Performance in 2014 through May 31, 2014** • [WisdomTree Japan SmallCap Dividend Index](#) (Japan SmallCaps [Unhedged](#)): 0.72%. [Click here](#) for full Index performance. • [WisdomTree Japan Hedged SmallCap Equity Index](#) (Japan SmallCaps [Hedged](#)): -3.21%. [Click here](#) for full Index performance. • [WisdomTree Japan Hedged Equity Index](#) (Japan Global Exporters Hedged): -5.34%. [Click here](#) for full Index performance. While past performance does not guarantee future results, it's important to note that, over this period, the Japanese yen has appreciated approximately 3.5% versus the U.S. dollar, explaining the majority of the performance difference between Japan SmallCaps Unhedged, which benefits from an appreciating yen—and Japan SmallCaps Hedged, which does not. Even so, both of these Indexes have provided some mitigation of negative performance compared to Japan Global Exporters Hedged—the most globally sensitive of the three Indexes shown. **Japan Small Caps Since 2006** One five-month period is not enough to serve as the foundation for too many conclusions, but one Index on this list—Japan SmallCaps Unhedged—has been around since 2006, giving us the ability to look at nearly eight years of performance and to include the impact of the 2008–09 global financial crisis. **Evolution of Sector Exposures** Japan SmallCaps Unhedged is focused on dividend payers. Unlike U.S. small caps<sup>2</sup>, where only roughly half of broad-based small-cap indexes paid at least one dividend over the prior 12 months, in Japan the figure was nearly 96% (as of 5/31/14). Going back to 2006, the Consumer Discretionary and Industrials sectors have tended to garner the largest weights—each over 20% on average. While intuition may suggest that a dividend-focused approach would tilt heavily toward defensive sectors, what we've seen in this particular segment of the market is that the strategy has tended to largely avoid Utilities and Telecom, have less than 5% weight in Health Care and have approximately 11.3% exposure, on average, in Consumer Staples.<sup>3</sup> **The Japanese Consumer vs. the Global Consumer** In Japan, a differentiator of small-cap exposure is local-revenue sensitivity. In Japan SmallCaps Unhedged, for example, weighted average revenue from within Japan for constituents in the Consumer Discretionary sector was more than 80%.<sup>4</sup> This is very different from the picture painted by Japan Global Exporters Hedged, which saw 34%.<sup>5</sup> The conclusion: While both Indexes have significant exposure to Consumer Discretionary stocks, one is a play on the Japanese consumer, whereas the other is more of a play on the global consumer. As Abenomics is transmitted to local Japanese consumers, the constituents in Japan SmallCaps Unhedged might be directly sensitive to the changing landscape of increased aggregate demand in Japan. **Significant Performance Difference—Not a Fluke!**

Average Annual Returns as of 3/31/2014						
Index	WT Index Inception	YTD	1-Yr.	3-Yr.	5-Yr.	Since WT Index Inception
WisdomTree Japan SmallCap Dividend Index	6/1/2006	-0.10%	7.52%	8.59%	13.44%	1.73%
MSCI Japan Small Cap Index		-2.25%	6.53%	7.72%	12.80%	0.31%
MSCI Japan Index		-5.61%	7.53%	5.38%	10.35%	-0.60%

Sources: WisdomTree, Bloomberg, with data as of 3/31/2014. Past performance is not indicative of future results. You cannot invest directly in an index.

*For definition of indexes in*

*the chart, please visit our [glossary](#).* • **Small Caps Have Long-Term Edge:** While the short-term performance has been encouraging for Japan SmallCaps, it's not unique to 2014. Going back over longer periods such as three and five years, Japanese small caps outperformed the [MSCI Japan Index](#) by over 3 percentage points per year. • **What about Drawdowns and 2008?** Many look at 2008 performance as a test of how a strategy performs in a difficult market. Japan SmallCaps Unhedged was down 17.4%, whereas MSCI Japan was down 29.21%. For context, the [S&P 500 Index](#) was down 37% during the same period. **Conclusion: Local Japanese Small Caps vs. Large Global Firms Based in Japan** Abenomics is geared toward improving overall economic conditions in Japan to promote long-term growth. However, Japan's economy—especially seen through many of its large-cap equities—is heavily integrated into the global economic landscape. For those looking to more purely express a view on the development of Abenomics in Japan, small caps offer an interesting option. And the outperformance of small caps over large caps in 2014 suggests that Japan's large-cap markets are being driven more by the global environment than the local economy. <sup>1</sup>Refers to the TOPIX, 12/31/13–5/31/14. <sup>2</sup>Refers to the Russell 2000 Index. <sup>3</sup>Sources for entire paragraph: WisdomTree and Bloomberg, with data from 6/1/06 to 5/31/14. <sup>4</sup>Source: Bloomberg, as of 5/31/13, using most recent completed annual geographic revenue screening for Japan. <sup>5</sup>Source: Bloomberg, as of 5/31/13, using most recent completed annual geographic revenue screening for Japan.

**Important Risks Related to this Article**

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance.

For more investing insights, check out our [Economic & Market Outlook](#)

**Abenomics** : Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

**WisdomTree Japan SmallCap Dividend Index** : Designed to provide exposure to dividend-paying small-capitalization companies in Japan.

**Unhedged** : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

**Rate-Hedged** : A bond portfolio that has offsetting positions in Treasury securities to reduce interest rate risk.

**WisdomTree Japan Hedged Equity Index** : Index designed to provide exposure to Japanese equity markets while at the same time neutralizing exposure to fluctuations of the Japanese yen movements against the U.S. dollar. Constituents are dividend-paying companies incorporated in Japan that derive less than 80% of their revenue from sources in Japan. Weighting is by cash dividends paid.

**MSCI Japan Index** : A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.

**Drawdowns** : Periods of sustained negative trends of return.

**S&P 500 Index** : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.