

WHY WE LIKE JAPANESE SMALL CAPS NOW

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The last decade has not been a great time to be an investor in international stocks, but [small-cap](#) stocks internationally outperformed [large-cap](#) stocks, and Japanese small-cap stocks ([WisdomTree Japan SmallCap Dividend Index](#)) on a [dividend-weighted](#) basis actually outperformed the large-cap, market capitalization-weighted index (MSCI Japan Index) by over 400 [basis points \(bps\)](#) per year over the last decade.

| Index | WisdomTree Index Inception Date | YTD | 1-year | 3-years | 5-years | 10-years | Since WisdomTree Index Inception |
|---|---------------------------------|---------------|---------------|--------------|---------------|--------------|----------------------------------|
| WisdomTree Japan SmallCap Dividend Index | 6/1/06 | 11.94% | 11.94% | 9.22% | 10.88% | 4.67% | 3.85% |
| MSCI Japan Small Cap Index | | 7.57% | 7.57% | 7.28% | 10.16% | 3.19% | 1.99% |
| MSCI Japan Index | | 2.38% | 2.38% | 2.49% | 8.17% | 0.54% | 0.80% |

Sources: WisdomTree, MSCI, as of 12/31/16. All returns above are in U.S. dollar Terms.

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.

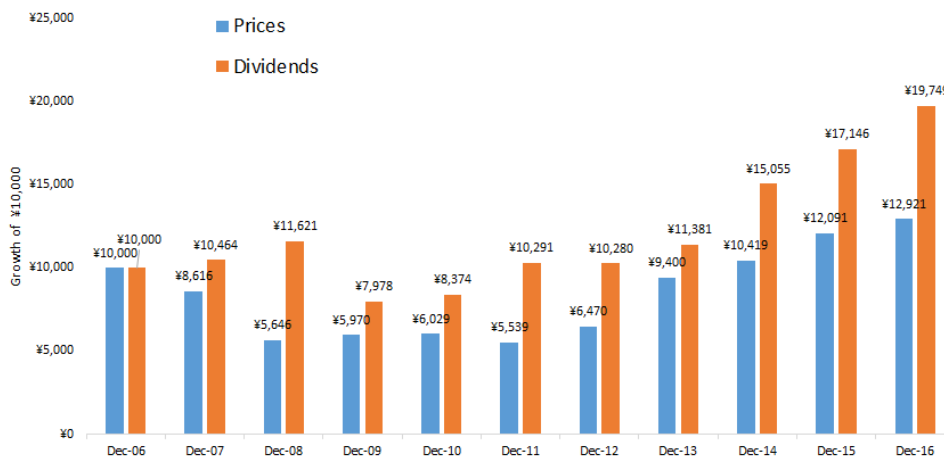
As value-oriented investors, we often believe in the theory of [mean reversion](#), or the tendency for markets to move in [cycles](#) but revert to average returns over time. One might think now is the time for Japanese large caps over small caps—given they performed so badly over last decade.

While we believe there absolutely is a case for Japanese large caps—and that ties to the yen and [growth](#) in the global economy—below we outline some of the arguments for why Japan is still attractive today, particularly its small caps.

Fundamentals: Market Became Cheaper over Last Decade

Looking at just [dividends](#) and prices, one could argue the market actually got less expensive on a [price-to-dividend](#) basis over the last decade, as dividends grew faster than prices. Over the last 10 years, dividends grew 97.5%, or 7.04% per year, which is higher than the aggregate price growth of just 29.2%, or 2.60% per year.

WisdomTree Japan SmallCap Dividend Index: Price Growth vs. Dividend Growth



Sources: WisdomTree, 12/31/06-12/31/16. Analysis done on the WisdomTree Japan SmallCap Dividend Index in local currency. Past performance is not indicative of future results. You cannot invest directly in an index.

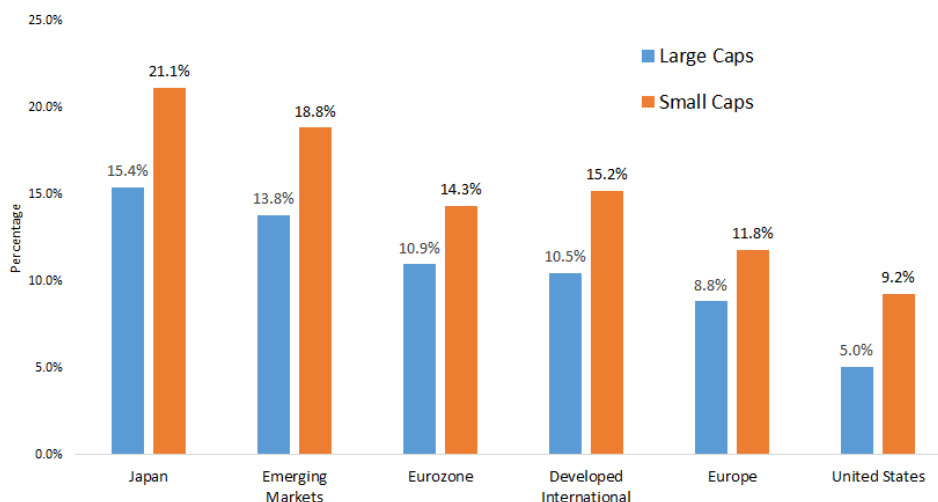
We expect that, with ample cash on their balance sheets and a focus on investor stewardship reforms, Japanese companies will continue to increase both dividends and [buybacks](#) over the next few years—a trend very supportive for the markets.

Sources of Future Cash Distributions

There has been a lot of talk about all the cash on U.S. companies' balance sheets that will be paid as dividends and buybacks with different repatriation policies. Here's what is interesting in terms of how these cash levels can impact [valuations](#) and also the potential for distribution growth: Japanese large-cap companies have three times the relative cash compared to [market cap](#) than U.S. large-cap companies (15% cash to market cap versus 5%).

Japanese small-cap companies have even more cash than large caps—at 21% cash to market cap. These are the highest levels compared to all other regions. This also means that when we look at valuation levels that compare, say, total market cap to total earnings, Japanese companies have an even greater discount because they have cash levels that make them 15% to 20% cheaper than their absolute levels.

Cash as a Percentage of Market Cap (ex-Financials)



Sources: WisdomTree, MSCI, as of 12/31/16. Each region/country is represented by MSCI market cap-weighted index.

Finally, the investment case for Japanese small caps is based on our [bullish](#) view on the Japanese domestic economy: After decades of [deflation](#), [deleveraging](#) and demand contraction, Japan's domestic demand has entered a structural up-cycle driven by two fundamental forces:

1. Demographic sweet spot: a structural shortage of labor is forcing improvements in both the quality of employment and the incomes earned from employment.
2. Policy switch to fiscal dominance: Instead of relying on [monetary policy](#) to support the economy, in August 2016, the Japanese cabinet approved a multiyear supplementary spending program of ¥28 trillion, approximately 5.5% of GDP.¹ This should support growth in Japan over the coming years.

The primary question an investor might have about implementing Japanese small caps is whether to hedge currency exposure or not. In this market insight, we discussed the [negative correlations between the yen and equity markets suggest that a weak yen is still an important consideration and could be a further motivation for investing in Japan](#)—if an investor thought the yen was going to weaken.

We would suggest a minimum of a 50% yen-[hedged](#) approach, with an argument that a full hedge would help mitigate the risk of the yen being a structurally weak currency over time.

¹Source: Abe administration press release announcing program 8/1/16.

Important Risks Related to this Article

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You cannot invest directly in an index.

DEFINITIONS

Small caps : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Dividend weighted : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

Basis point : 1/100th of 1 percent.

Mean reversion : The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Dividend : A portion of corporate profits paid out to shareholders.

Price-to-dividend ratio : Refers to the index price divided by the trailing 12-month dividends.

Buyback : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Bullish : a position that benefits when asset prices rise.

Deflation : The opposite of inflation, characterized by falling price levels.

Deleverage : Bring down levels of debt.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.