

HOW ABENOMICS AFFECTS THE REVENUE GENERATION OF JAPAN'S COMPANIES

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In the start of 2016, global equity markets experienced significant [volatility](#), often accompanied by concerns of global growth prospects, especially surrounding anything related to China and emerging markets. We believe that understanding the countries where holdings are located is only part of the geographic picture. **It Is Critical to Understand Where Firms Are Generating Their Revenues** We find that understanding where the revenue of holdings comes from can be a highly complementary approach when evaluating potential investments. This is particularly prudent in Japan, where:

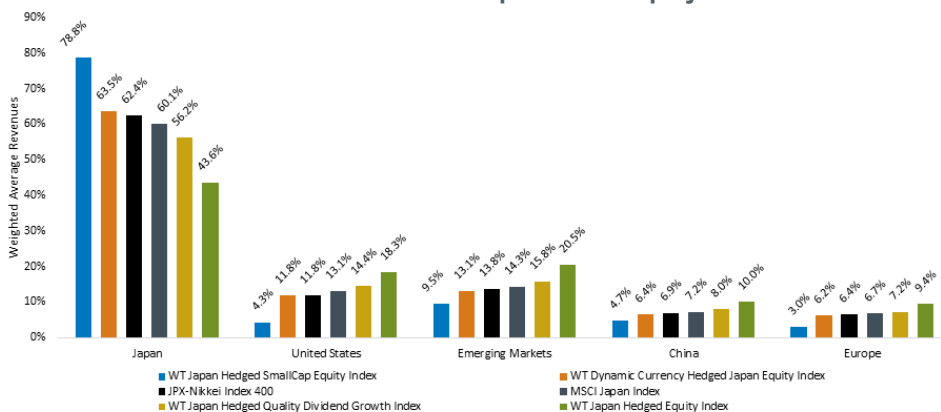
- Many small-cap companies are very sensitive to trends in the local Japanese market.
- Many larger multinational companies are very sensitive to global macroeconomic developments.

Two Layers of Abenomics We see Abenomics as a multifaceted approach meant to stimulate economic growth in Japan:

- **Weakening of the Japanese yen**, most often cited against the U.S. dollar, is one important consequence of Abenomics. The immediate impact has notably been a positive factor in the earnings performance of large multinational exporters in Japan, whose products and services become more competitive as the yen declines in value.
- **Stimulation of Japanese aggregate demand** is another consequence, as Abenomics also seeks to encourage such growth. Putting the “[deflationary](#) mindset” in the rearview mirror and encouraging companies to raise wages may increase consumption in Japan.

Bottom line: Thinking about where firms are generating their revenues can lead to a more finely tuned sensitivity to the goals of Abenomics.

Where Are Japanese Equity Indexes Generating Their Revenues?



Sources: WisdomTree, FactSet, Bloomberg as of 12/31/15.

For definitions of indexes in the chart, visit our [glossary](#). **Global Multinationals** The [WisdomTree Japan Hedged Equity Index](#) (“Japanese exporters”) gained attention as the Bank of Japan (BOJ) and economic factors caused the yen to fall nearly 32% against the U.S. dollar from the start of Abenomics through February 29, 2016.¹ The companies in this Index are selected based on their global revenue base and have less than 80% of their revenue coming from inside Japan. The logic for this strategy is simple: Focus on companies that will benefit from a weaker local currency (exporters) while reducing that currency’s impact on the returns of the U.S.-based investor. As the currency weakens, the exports of countries that trade in that currency will likely become more attractive. Those firms that derive more revenue from abroad should then outperform with a boost in exports. The consequence, however, is a large degree of global macroeconomic sensitivity.

The Marriage of [Quality](#) and [Growth](#) with [Currency-Hedge](#) Wrapper Another strategy that has gained attention in

the current market volatility is the [WisdomTree Japan Hedged Quality Dividend Growth Index](#). With a Japanese revenue exposure of 56% as of December 31, 2015, it offers a step back from the export tilt of the Japanese exporters. This methodology aims to seek out quality firms that are often better positioned in volatile market environments. The growth factor ranking is based on [long-term earnings growth expectations](#), while the quality factor ranking is based on three-year historical averages for [return on equity](#) and [return on assets](#). The companies are then weighted on cash [dividends](#) paid. Combining these quality and growth screens with a currency hedge, we believe, can be a helpful strategy in the face of market uncertainty. **Unlocking Small-Cap Potential While Mitigating Currency Risk** Small-cap equities are often cited for their “local focus,” and if we look at the 79% Japanese geographic revenue exposure of the [WisdomTree Japan Hedged SmallCap Equity Index](#) as of December 31, 2015, we find that this holds true with almost twice the revenue from Japan as the Japanese exporters. It also has half the exposure as Japanese exporters to the emerging markets and only 5% directly tied to China. This Index also applies a currency hedge to the yen and has a dividend-weighting process for constituents. Also note that while the WisdomTree Japan Hedged SmallCap Equity Index has appreciated 32.0% since its inception, its [price-to-earnings \(P/E\) ratio](#) has actually fallen from 19.0x to 13.8x.² **A Dynamic Yen Hedge, More Balanced Revenue Exposure** WisdomTree more recently created a Japanese equity Index, in partnership with Record Currency Management, that applies a [dynamic currency hedge](#) to the yen based on three underlying currency signals: [interest rate differentials](#), [momentum](#) and [value](#). The [hedge ratio](#) is adjusted once a month, and the current hedge ratio in place for February was set to be 50.0%.³ The underlying equity strategy for this Index is a broad dividend-weighted allocation to stocks trading in yen, and this Index, without a revenue filter, has a more balanced exposure to Japanese revenue than the Japanese exporters discussed above. ¹Refers to the period 11/30/12–2/29/16. ²Sources: WisdomTree, Bloomberg, from the inception of the WisdomTree Japan Hedged SmallCap Equity Index on 5/1/13 to 2/29/16. ³Sources: WisdomTree, Record Currency Management, with data as of 2/1/16.

Important Risks Related to this Article

Investments focused in Japan increase the impact of events and developments associated with the region, which can adversely affect performance.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.

Investments focusing on certain sectors and/or smaller companies may be more vulnerable to any single economic or regulatory development.

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You cannot invest directly in an index.

DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

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.

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

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

Long-Term Earnings Growth Expectations : Compilation of analyst estimates of the growth in operating earnings expected to occur over the next full business cycle, typically 3 to 5 years, sourced from Bloomberg.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

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

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Dynamic Hedge : Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of time.

Interest Rate Differentials : The Difference between the 2 Year interest rate swaps of the United Kingdom vs. the United States.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Hedge Ratio : The specified percentage of currency exposure being hedged, with 0% indicating that none of the currency exposure is being hedged and 100% indicating that all of the currency exposure is being hedged.