

# ON JAPANESE CENTRAL BANK ACTION, JAPAN QUALITY FACTOR IN FOCUS

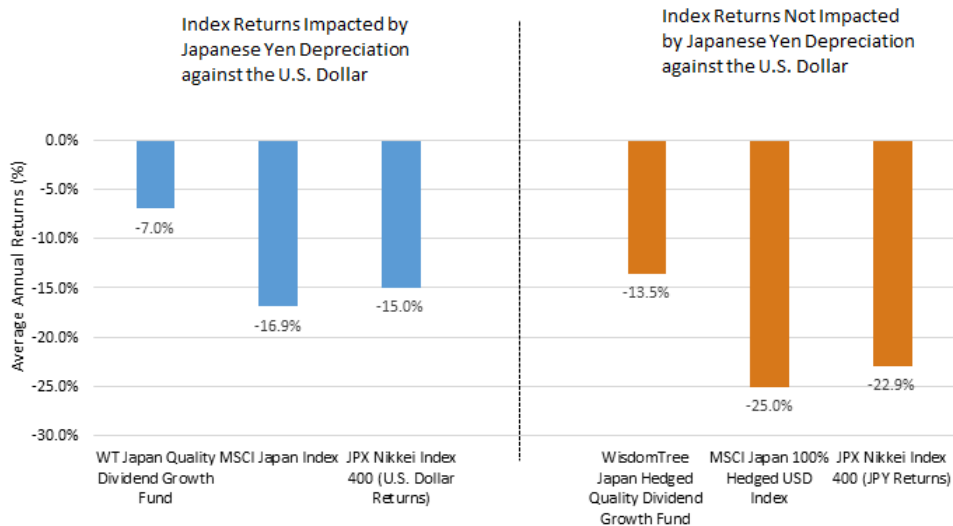
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The Bank of Japan surprised the markets by expanding its [monetary stimulus](#) program in January with the introduction of a new tool we'll call "[NIRP](#)" [negative interest rate policy](#) policy. The key bottom line we see from this action: Japan remains extraordinarily committed to achieving its 2% [inflation](#) goal and will not hesitate to expand into pursuing new policies if it continues to fall behind on its inflation mandate. In that vein, we expect the central bank to continue taking this deposit rate more negative over time. The central bank's commitment to stimulate the economy, along with corporate reforms designed to encourage better shareholder returns and capital distributions, are two of the many reasons we are bullish on Japanese equities in the long term. But how should one best invest in Japan, especially to capitalize on rising shareholder distributions? First there is a question of currency risk. Many of the monetary policies introduced by Japan have driven the yen down versus the U.S. dollar. Some of the yen weakness abated in 2015 and 2016, as [volatility](#) picked up and the yen strengthened with elevated risk sentiment.<sup>1</sup> WisdomTree believes yen currency risk is uncompensated risk and would advocate for [hedging](#) currency exposure to Japan. It helps that as Japan takes rates more negative, an investor is typically paid the relative interest rate differentials of higher U.S. interest rates and negative interest rates in Japan to hedge the yen. But WisdomTree has tools for Japan, including both unhedged and hedged exposures for the same underlying equity strategy. **Japan Quality Dividend Growth ETFs: Both Yen Hedged and Unhedged** WisdomTree launched two innovative Japanese exchange-traded funds (ETFs) in 2015 tied to WisdomTree's [quality](#) factor Indexes: a currency-hedged version, the [WisdomTree Japan Hedged Quality Dividend Growth Fund \(JHDG\)](#), and an unhedged ETF, the [WisdomTree Japan Quality Dividend Growth Fund \(JDG\)](#).<sup>2</sup> WisdomTree views its quality factor approach as an important differentiating factor from the [JPX-Nikkei Index 400](#), which also has a focus on [return on equity \(ROE\)](#) in driving stock selection. Both of WisdomTree's quality Indexes for Japan select the 300 companies that rank best on quality factors (three-year average ROE and three-year average [return on assets \(ROA\)](#)) and a growth factor (based on [long-term earnings growth expectations](#)). There is a high overlap with the companies in the [WisdomTree Japan Quality Dividend Growth Index](#) and the JPX-Nikkei Index 400 (246 companies in are in BOTH Indexes, comprising more than 96% of the weight of the WisdomTree Japan Quality Dividend Growth Index), but we would say that the WisdomTree Index has the faster-growing and lower-[leverage](#) segment of the JPX-Nikkei Index 400.<sup>3</sup>

**Has WisdomTree's Approach Been Effective?** In order to zero in on this question from the standpoint of stock selection, we looked to analyze the performance of JDG and JHDG. We compared the unhedged Fund to the [MSCI Japan](#) and JPX-Nikkei 400 Indexes that were impacted by the yen's depreciation against the U.S. dollar, and we compared the hedged fund to the MSCI Japan and JPX-Nikkei 400 Indexes that were not impacted by this depreciation. [Please see here for standardized returns of JHD and JHDG.](#) **Focusing on Quality Has Outperformed the Market**

(Both	Hedged	&	Unhedged)
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Source: Bloomberg, with period from 5/28/15 to 2/8/16, the live period for the WisdomTree Funds shown. You cannot invest directly in an Index.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at [www.wisdomtree.com](http://www.wisdomtree.com).

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

Looking at a table of the sector exposures of the WisdomTree Japan Quality Dividend Growth Funds (both share the same constituents and sector exposures) and the [market capitalization-weighted](#) MSCI Japan Index, there are a few notable sector tilts worthy of discussion:<sup>4</sup> 1) The WisdomTree Japan Quality Dividend Growth Funds (both the hedged and unhedged versions) have been significantly under-weight Financials (with weights averaging less than 5% versus close to 20% in the MSCI Japan Index), due to the inclusion of ROA as a factor in the selection process. Financials tend to have high leverage and typically low return on assets, so they tend to receive less weight in WisdomTree's Japan Quality Dividend Growth Funds. Since the launch of these Indexes, Financials has been among the weakest-performing sectors and has been dragging down the MSCI Japan Index. This has been the second biggest contribution to relative performance for the WisdomTree approach. 2) The biggest contribution to relative performance has come from a sector in which the relative weight differential is smaller, but the stock selection impact has been much greater: the Telecommunication Services sector. WisdomTree Japan Quality Dividend Growth Funds have had about a 6% average over-weight to this sector, but the average stock return from the sector was much higher than that of the MSCI Japan Index. 3) The biggest drag in performance for the WisdomTree Japan Quality Dividend Growth Funds has been the 3.6% over-weight and selection in the Industrials sector. This also has been a weak-performing sector, but the value added from other sectors more than made up for this sector's drag in performance. **Attribution: WisdomTree Japan Quality Dividend Growth**

Sector	% Average Weight			Total Return (USD %)			Local Returns (JPY %)			Total Attribution <sup>1</sup> (in U.S. Dollars) (%)
	JDG/JHDG	MSCI Japan	+/-	JDG/JHDG	MSCI Japan	+/-	JDG/JHDG	MSCI Japan	+/-	
<b>Totals</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>	<b>-6.31</b>	<b>-12.12</b>	<b>5.81</b>	<b>-12.61</b>	<b>-18.15</b>	<b>5.54</b>	<b>5.81</b>
Telecommunication Services	11.2	5.3	5.7	25.37	8.73	16.64	16.76	1.26	15.50	2.97
Financials	4.7	19.5	-14.8	-5.91	-23.17	17.25	-12.37	-28.44	16.07	1.69
Consumer Staples	10.7	7.4	3.2	14.07	11.98	2.10	6.24	4.29	1.95	1.07
Consumer Discretionary	24.3	22.0	1.9	-13.28	-16.39	3.11	-19.23	-22.13	2.90	0.87
Information Technology	12.7	10.4	2.0	-13.55	-17.40	3.85	-19.49	-23.07	3.58	0.50
Materials	7.2	5.6	1.4	-19.16	-19.46	0.30	-24.71	-24.99	0.28	-0.01
Energy	0.1	0.9	-0.7	-1.85	-15.43	13.57	-2.55	-21.24	18.68	-0.02
Utilities	0.1	2.6	-2.5	1.68	-4.38	6.06	0.96	-10.94	11.91	-0.33
Health Care	6.3	7.7	-1.5	7.68	12.65	-4.96	0.29	4.91	-4.62	-0.70
Industrials	22.8	18.8	3.6	-16.77	-13.48	-3.28	-22.48	-19.42	-3.06	-0.73

Source: Bloomberg, with period from 5/28/15 to 2/8/16, the live period for the WisdomTree Funds shown. You cannot invest directly in an Index.

<sup>1</sup>Total Attribution: refers to the portion or entire return that is derived from or attributable to a particular subset of a portfolio.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at [www.wisdomtree.com](http://www.wisdomtree.com)

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## Funds (JDG & JHDG)

For investors looking to add exposure to Japan, WisdomTree has been known for its currency-hedged approach to exporter companies in its primary Japan ETF, the [WisdomTree Japan Hedged Equity Fund \(DXJ\)](#). But this is not the only broad-based way to allocate to Japan that WisdomTree offers. Whether it is an unhedged ETF for those who believe the yen may rise, or a Fund for those who do not want currency exposure in a hedged ETF, both of our Japan Quality Dividend Growth ETFs (JDG for unhedged and JHDG for hedged) represent important exposure that we believe compares favorably to traditional Japanese benchmarks. <sup>1</sup>Source: Bloomberg, with levels of the yen versus the U.S. dollar studied from 4/13 (initiation of qualitative and quantitative monetary easing) to 2/16/16. <sup>2</sup>The WisdomTree Japan Hedged Quality Dividend Growth Fund (JHDG) was designed to track the returns, before expenses, of the WisdomTree Japan Hedged Quality Dividend Growth Index. The WisdomTree Japan Quality Dividend Growth Fund (JDG) was designed to track the returns, before expenses, of the WisdomTree Japan Quality Dividend Growth Index. <sup>3</sup>Sources: WisdomTree, Bloomberg, as of 2/5/16, based on ROE, ROA and long-term earnings growth estimates. <sup>4</sup>Source for numbered paragraphs: Bloomberg, with data from 3/3/14 to 2/5/16.

## Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing their investments on certain sectors may be more vulnerable to any single economic, regulatory or sector-specific development. This may result in greater share price volatility.

The Funds focus their investments in Japan, which can be impacted by the events and developments in Japan that can adversely affect performance. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. As these Funds can have a high concentration in some issuers, the Funds can be adversely impacted by changes affecting those issuers. The Funds invest in the securities included in, or representative of, their Indexes regardless of their investment merit, and the Funds do not attempt to outperform their Indexes or take defensive positions in declining markets.

The currency-hedged Funds use various strategies to attempt to minimize the impact of changes in the Japanese yen against the U.S. dollar, which may not be successful. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. Due to the investment strategy of these Funds, they may make higher capital gain distributions than other ETFs. Please read each Fund's prospectus for specific details regarding each Fund's risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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

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You cannot invest directly in an index.

## DEFINITIONS

**Monetary stimulus** : refers to attempts to use monetary policy like lowering interest rates or quantitative easing to stimulate the economy.

**Negative Interest Rate Policy (NIRP)** : A monetary policy where by interest rates.

**Inflation** : Characterized by rising price levels.

**Volatility** : A measure of the dispersion of actual returns around a particular average level.&nbsp;bsp.

**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.

**Dividend growth** : The growth in trailing 12-month dividends for the specified universe.

**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.

**JPX-Nikkei 400** : is composed common stocks whose main market is the TSE 1st section, 2nd section, Mothers or JASDAQ market (in principle). The components are reviewed annually to keep the representativeness of the market. The Annual Review shall be conducted at the end of August as follows.(1)1000 stocks are selected based on trading value in the past 3 years and the market value on the selection base date (the end of June) of the Annual Review, (2)Each stock is scored by 3-year average ROE, 3-year cumulative operating profit and market value on the selection base date with the weights on the each indicator 40%, 40%, 20% respectively, (3)400 stocks are selected by the final ranking with the scores calculated in (2) and qualitative factors from the perspectives of corporate governance and disclosure. In case of delisting of the components due to a merger or bankruptcy etc, new stocks shall not be added in principle. When the Annual Review is conducted, the number of components is back to 400, therefore the index is calculated with less than 400 components until then.

**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.

**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.

**Leverage** : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

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

**Market capitalization-weighting** : 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.