
HOW WE'RE ALLOCATING TO JAPAN TODAY

Joseph Tenaglia – Director, Model Portfolios
08/09/2018

Since WisdomTree's inception in 2006, Japan has been one of our areas of focus. Two of our original 20 fund launches were Japan exchange-traded funds (ETFs), and we were the first company to offer currency hedging in Japan in an ETF wrapper. Japan continues to be an area we're passionate about—particularly as it pertains to [currency hedging](#)—and we are often asked about our thoughts on the markets there. Despite having slightly negative performance in the first half of 2018, Japan remains one of our favored regions for many reasons.

[Valuations](#) are the most attractive of any developed market, with our [WisdomTree Japan Hedged Equity Index](#) trading at just 11.4x earnings. Profitability has markedly improved in recent years, with the [Tokyo Stock Price Index](#) at an all-time high in earnings and a post-crisis high in return on equity. [The Bank of Japan indicated in its July meeting that it remains committed to strong monetary stimulus](#) through both low [interest rates](#) and its [yield curve](#) control program. Corporate reform advancements have shown up in metrics such as record lows in cross-shareholdings¹ and a fourfold increase in companies with multiple independent directors.² This is all on top of a widening [interest rate differential](#) between the U.S. and Japan, providing investors in [hedged](#) Japanese equities a tailwind of over 2% annually (and rising).

With so many reasons to be [bullish](#), the question almost always comes up: How should I allocate to Japan?

Digging into 2018 Performance

A recent addition to WisdomTree's website is our [Index Performance Attribution tool](#). While offering common attribution classifications such as basic sector and market cap breakdowns, it also analyzes different fundamental groupings, such as [return on equity](#) and [volatility quintiles](#). In the case of our WisdomTree Japan Hedged Equity Index (which includes only export-focused companies), we also include a geographic revenue filter.

Year-to-date through June 30, the WisdomTree Index trailed the [MSCI Japan Local Currency Index](#) by 2.69%, and using the geographic revenue grouping in the attribution tool, it is clear why. Domestically focused stocks in Japan were up 2.04% through June—beating the exporters by nearly 780 basis points in just six months! Given that on a net basis the yen has roundtripped and is basically flat on the year (having started at 112, strengthening to 104 and ending June at 110), the gap in performance between those who are and are not reliant on currency fluctuations is stark.

WTIDJH - WisdomTree Japan Hedged Equity Index VS. MXJP - MSCI Japan Local Currency Index

Geographic Revenue Attribution As of: 6/30/2018

MTD QTD **YTD** 1Y 3Y 5Y Since Inception

| Category | Attribution Component | | | | Average Category Weight | | | Category Performance | |
|----------------|-----------------------|-----------------|---------------|-------------------|-------------------------|------------------|---------|----------------------|------------------|
| | Allocation | Stock Selection | Interaction | Total Attribution | Index Weight | Benchmark Weight | +/- Wgt | WT Index Return | Benchmark Return |
| Domestic Focus | -1.37% | 0.00% | 0.00% | -1.37% | 0.00% | 26.74% | -26.74% | 0.00% | 2.04% |
| Export Focus | -0.50% | -0.60% | -0.22% | -1.32% | 100.00% | 73.26% | 26.74% | -6.35% | -5.72% |
| Total | -1.87% | -0.60% | -0.22% | -2.69% | - | - | - | -6.35% | -3.66% |

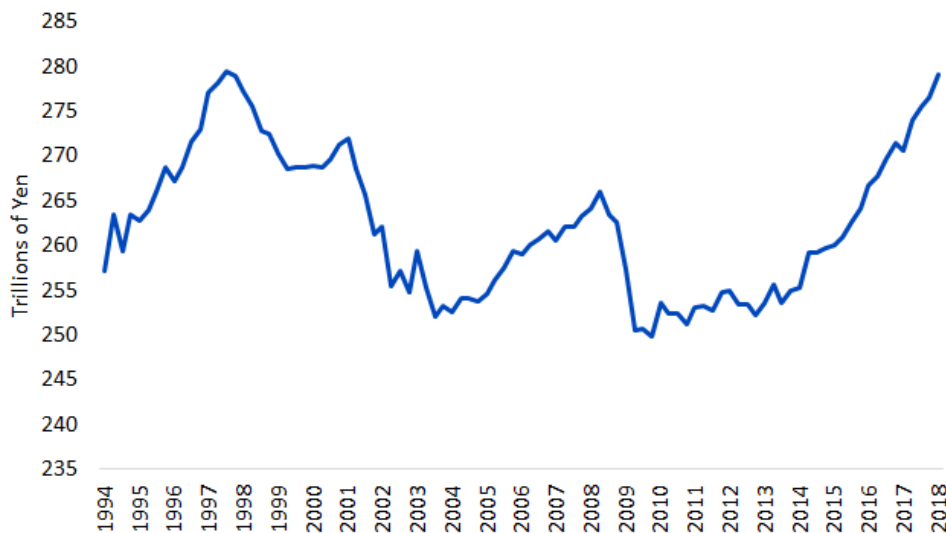
Sources: WisdomTree, FactSet, for the period 12/31/17–6/30/18. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included 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.

Japan’s Domestic Market Thriving

That said, the strength of Japan’s domestic market is no surprise to us and something we have been talking about for some time. Consider the health of the U.S. labor market, with jobless claims hovering around 200,000 and unemployment down to just 3.9%. Compare that to the far stronger 2.4% unemployment rate in Japan—made even more impressive thanks to an enviable rising participation rate. There are now an astounding 1.62 open jobs for every applicant in Japan, the most since 1974.³

As a result of its demographic-aided tight labor market, Japan has broken a two-decade downward trend in wage growth, and employee cash earnings growth just reached the highest rate since 1997. The pickup in wages is trickling down to help spark domestic demand and consumption within the Japanese economy, and given this backdrop, it should come as no surprise that domestically focused stocks have outperformed in 2018.

Japan’s Nominal Wages



Sources: WisdomTree, Japan Cabinet Office, as of 3/31/18; reflects latest date of available data.

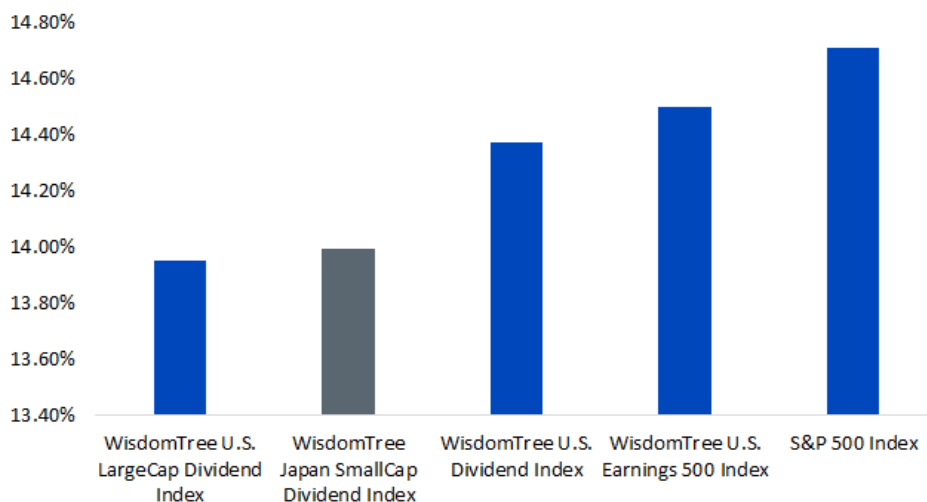
Biggest Beneficiaries with the Smallest Volatility

Arguably the top beneficiaries of Japan’s domestic growth revival are [small caps](#). Japanese small caps are an underrated (and underallocated to) asset class in our view,

and they're a longtime favorite within WisdomTree. We launched the industry's first Japanese small-cap ETF, the [WisdomTree Japan SmallCap Dividend Fund \(DFJ\)](#) in 2006, beating even the [market cap-weighted](#) options to the market.

While Japan's domestic demand story is timely, an added benefit of investing in Japan small caps is their [low volatility](#). In fact, of every index we manage with a 10-year track record, the [WisdomTree Japan SmallCap Dividend Index](#) is the second-least volatile over that time frame—with lower volatility than indexes consisting of U.S. dividend-paying stocks, the most profitable U.S. large caps and the [S&P 500](#). Counteracting yen exposure unquestionably helps dampen volatility, but small caps also have had less volatility than their large-cap counterparts. Counterintuitive as it may seem for small caps from a single country, Japanese small caps have effectively helped reduced risk in investor portfolios for the last decade.

10-Year Standard Deviation



Sources: WisdomTree, Morningstar Direct, for the 10-year period ending 6/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

How We Allocate to Japan Today

Within many of WisdomTree's ETF model portfolios, Japan continues to be an over-weight position. Outside of having broad international developed exposure, our over-weight is obtained by equally splitting a hedged Japan exporter allocation with unhedged Japan small caps.

Trade tensions aside, global growth remains strong, and given our view that U.S. interest rates will continue to tick higher over time, hedged Japan equities (which have had a high correlation to U.S. yields) could be some of prime beneficiaries. That, coupled with the domestic momentum in Japan and the relative protection offered by the yen if global risk sentiment should turn south, suggests [unhedged](#) small caps are an unexpected safe spot.

Importantly, both the [large](#) and small caps have strong fundamentals underpinning them. Both are at all-time highs in [dividends](#) and earnings, and large and small caps alike have more than doubled their profits since the start of [Abenomics](#).

Without a strong directional view on the yen, we think this two-pronged approach may be the best and most complete way to allocate to Japan today.

Unless otherwise indicated, all data is from Bloomberg, as of June 30th 2018.

¹Nomura Securities, for fiscal year ending in March 2017.

²Nikko Asset Management, June 2017.

³Bloomberg, as of 6/30/18.

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 smaller companies or certain sectors increase their vulnerability to any single economic or regulatory development. The Fund focuses its investments in Japan, thereby increasing the impact of events and developments in Japan that can adversely affect performance. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of DFJ please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/dfj>

For the top 10 holdings of DXJ please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/dxj>

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](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only. You cannot invest directly in an index.

DEFINITIONS

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

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.

Tokyo Stock Price Index (TOPIX): A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

Interest rates: The rate at which interest is paid by a borrower for the use of money.

Yield curve: Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

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

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.

Bullish: a position that benefits when asset prices rise.

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

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

Quintile: One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

MSCI Japan Local Currency Index: A market cap-weighted index that measures the performance of the Japanese equity market in the local currency (yen).

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

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.

Low Volatility: Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

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.

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.

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: A portion of corporate profits paid out to shareholders.

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.