
LOOKING PAST THE NARRATIVE ON JAPAN INTO FUNDAMENTALS

Jeremy Schwartz — Global Head of Research
09/21/2018

One of the markets caught up in global trade fears that continues to perplex investors is Japan. The Japanese markets are trading near their lowest [valuation](#) levels in the last 30 years, supported by increased profitability, better returns on capital and improving profit margins. A recent article in The Wall Street Journal by Mike Bird summarizes sentiment and the environment nicely:

“Something strange is going on with corporate Japan: Profits have soared. . . . Yet foreign investors, by and large, aren’t that interested. . . . After decades of stagnation, profitability has soared under Prime Minister Shinzo Abe’s economic revival program, dubbed [Abenomics](#). Profit margins at nonfinancial firms hit a record 7.7% in the second quarter. This ratio, which compares earnings before interest payments and taxes with sales, rarely topped 4% until a few years ago.”¹

While Japan tends to trade with its currency and global [macro](#) sentiment, this market behavior masks some strong underlying trends in corporate governance and profitability.

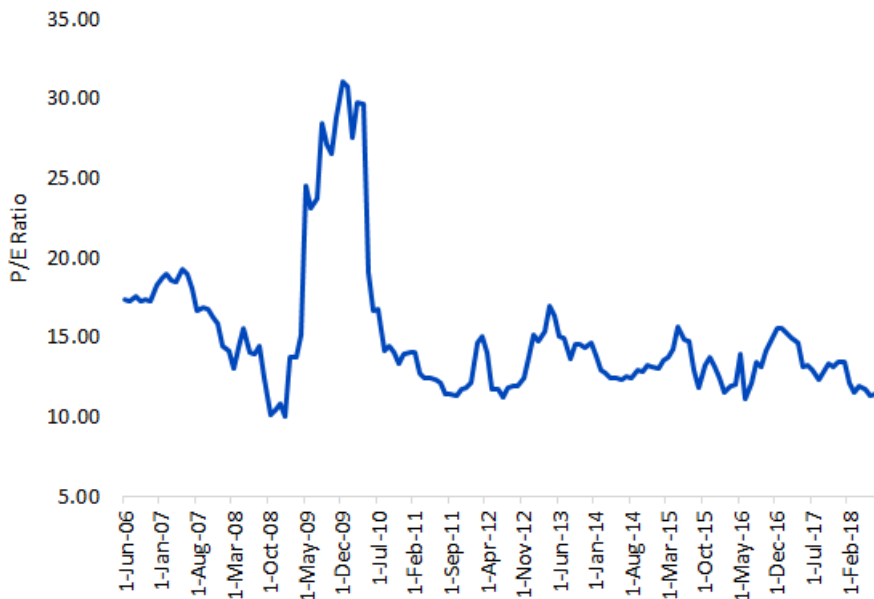
One element of Abenomics involved the creation of new stock indexes that encouraged a focus on [return on equity \(ROE\)](#). Companies have responded, increasing both [dividends](#) and [buybacks](#) and better managing the cash on the “bloated [balance sheets](#)” (which are often cited as a reason to stay away from corporate Japan).

Below, I review some of the key fundamental attributes of the [WisdomTree Japan Dividend Index](#) (which also serves as the underlying for the [WisdomTree Japan Hedged Equity Index](#)) to show how globally oriented Japanese companies are trading on valuation and a multiple basis.

The median [price/earnings \(P/E\) ratio](#) over the last 12 years was 13.9x, and the latest P/E ratio was 11.8x, a 20% discount to the median. These valuation levels are similar to the depression during the [financial crisis](#) 10 years earlier, before earnings collapsed.

The P/E ratio has only been lower in these 12 years less than 4% of the time—meaning that Japan is in the 96% range for inexpensiveness on P/E ratio valuation in the last 12 years.

WisdomTree Japan Dividend Index–P/E Ratio Excluding Negative Earnings

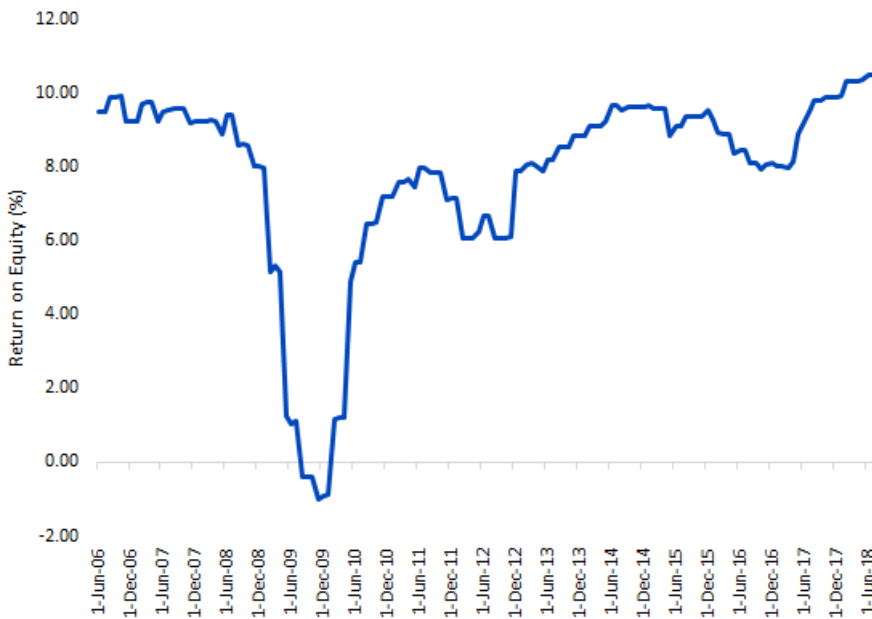


Sources: WisdomTree, FactSet. Data for the period 1/1/06–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

These low valuations come despite the broad improvement in one of WisdomTree’s preferred “[quality](#)” metrics: ROE. In the 12 years we have been calculating it for the WisdomTree Japan Dividend Index, there had never been a ROE figure greater than 10%—in 2006, when we launched the Index, it was close to those levels, but it dropped sharply during the financial crisis and has been building back slowly ever since.

Showing the relative profitability figures and better management of corporate balance sheets, we saw this figure go past 10% in 2018. We also see room for further improvement given the broad increase in shareholder returns and still-high cash levels on balance sheets that are starting to get paid out. ROE figures for a similar U.S. index are closer to 15%—and as Japan tries to attract more global capital, being good stewards of capital should keep pushing ROEs higher.

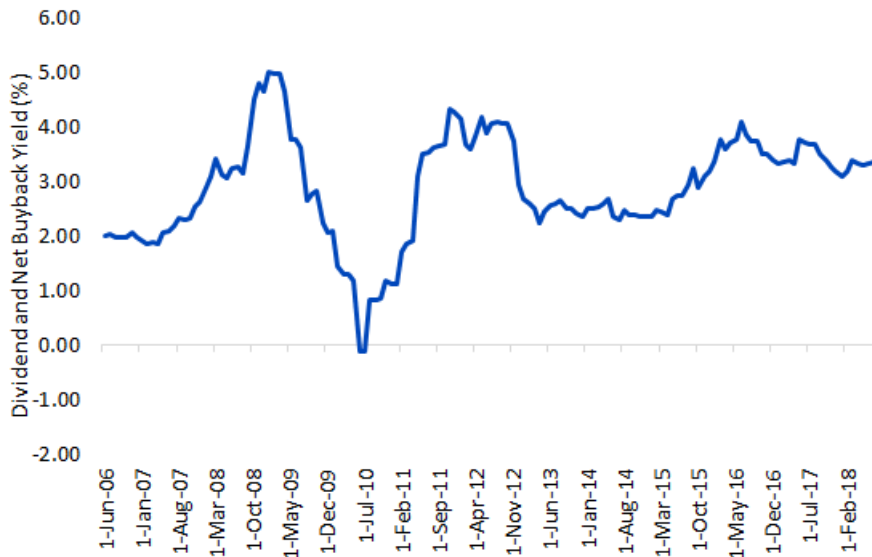
WisdomTree Japan Dividend Index–Return on Equity



Sources: WisdomTree, FactSet. Data for the period 1/1/06–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

The [dividend yield](#) on our Index is 2.7%, and the net buyback yield was 0.7% at the end of August, giving a total dividend and net buyback yield of 3.4%. The median of this ratio over the last 12 years has been 2.9%. In general, the broad increase in this ratio ever since the end of 2012 shows that corporate Japan has been driven by rising dividends and buybacks and not just rising prices—that was also reflected in the declining P/E ratios presented earlier.

WisdomTree Japan Dividend Index–Dividend and Net Buyback Yield



Sources: WisdomTree, FactSet. Data for the period 1/1/06–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

In early 2018, Japan traded down largely with global sentiment on trade fears and uncertainty associated with U.S. policy—not for some decrease in its fundamental measures of value. While many believe Japan will always be a “value trap,” we see good evidence that corporate payouts are favoring more shareholder-friendly actions and see quality metrics and margins improving.

On September 17, Josh Demasi tweeted something that I think summarizes the situation quite well:



Josh Demasi

@Macropsychology

Follow

The Nikkei is fascinating wrt the behavioral component. The narrative is **finally** beginning to catch up to the fundamental story.

7:58 AM - 17 Sep 2018

For most of this year, the narrative was that Japan is going to be hurt by trade wars and perhaps a peaking in global growth and slowdown in China. Improved trade dynamics between Japan and China might be one outcome of the U.S.-China spat that many are not factoring into their models. We like Japan as an underowned value opportunity.

¹Mike Bird, "Profits Jump at Japanese Companies, but Foreign Investors Don't Bite," The Wall Street Journal, 9/9/18.

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.

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, Kara Marciscano, 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

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.

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.

Macro : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

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

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

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

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new position.

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.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

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.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.