The protectionist storm opens the case for Japan small-cap equities

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Investor sentiment tilts towards small caps in H1 2018

As trade frictions escalate, protectionism appears to be back in play. Uncertainty over trade policy is being echoed in the latest Exchange traded fund (ETF) flows that are often used to gauge investor sentiment. It is no surprise that global small-cap versus large-cap equity ETF flows in Q2 2018 have widened by the highest margin, US$9.1Bn1, attaining its highest level in more than four years. The growing dispersion among small and large cap ETF flows is resonating a domestic bias amongst investors. The ensuing environment creates a potential opportunity for small-cap stocks as they are typically more exposed to underlying domestic growth while shielding investors from the protectionist drag on global growth. Small-caps offer the potential for investment returns irrespective of the wider economic backdrop.

Japan small-caps trading at a bargain?

Since the beginning of 2000, Japan small-cap stocks have consistently outperformed large-cap Japan stocks and the outperformance gap is currently at a record high (see chart below). Ironically Japan small-caps have led this feat at an average volatility of 12.4% in close comparison to 10.9% for Japan large-cap stocks, thereby defying the common misconception that adopting a small-cap strategy generates the added burden of higher volatility. For a small-cap strategy, Japan small-caps currently exhibit a much lower volatility of 13% in comparison to its peers in the US at 15% and Europe at 12%, making it a useful addition to a portfolio from an asset allocation perspective (Source: Bloomberg). The Japanese equity market is unique, as stock and local currency returns have historically been negatively correlated, helping minimise volatility.

Source: Bloomberg, WisdomTree, data available as of close 10 July 2018.

Historical performance is not an indication of future performance and any investments may go down in value.

This opens an interesting investment case for Japan small-cap stocks that currently (as of 30 June 2018) claim to have the lowest valuation among small-cap stocks across the globe, despite its strong performance. Not only are Japan small-cap stocks discounted versus their peers at 17.6x Price to Earnings (P/E) ratio, they are also trading at a 40% discount to their historical average (at 29x). Operating profit growth for small-cap Japan stocks have averaged 15% annually over the last 12 years compared to 11% for Japan large-cap stocks. Japan small-caps merit higher valuations owing to its faster growth pace.

Figure 2: Comparison of global small-cap equity valuation versus their long-term average

Source: Bloomberg, WisdomTree, data available as of close 09 July 2018. Please note long term historical average P/E represents the average P/E from 01/01/2002 up to 29/06/2018.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Structural reforms to further stimulate growth?

Unlike prior Japanese equity market rallies, such as those in 1999 or 2003, we believe strong earnings growth rather than multiple expansions underpin the current equity market rally that initiated in 2012. Japan's prime minister ShinzM Abe changed the political landscape in Japan after he returned to the government's helm in 2012, restoring economic growth and political stability. Japan is slowly emerging from its long period of deflation; the output gap is closing, and the labour market is tightening. Abe's three-pronged approach aimed at improving the fundamentals of the economy were centred on: (1) monetary easing; (2) fiscal stimulus and; (3) structural reforms. So far, the Japanese economy has reaped the benefits of both monetary and fiscal stimulus. We believe the structural reforms are currently work in progress, and this is likely to fuel domestic growth. Wage negotiations in smaller companies are underway and could likely pave the way for the much-anticipated wage growth. While Abe's political situation, where recent scandals threatens to derail the progress of the government's policies, we expect the reforms to continue regardless of whether Abe is forced to step down.

WisdomTree's dividend weighted distinctive approach

The WisdomTree Japan SmallCap Dividend Index provides a distinctive dividend weighting mechanism to access the Japanese small cap growth story. The index applies a fundamental approach to rebalancing the constituents of eligible universe by its cash dividends paid instead of its market cap. The shift away from the market cap-weighted scheme to the dividend-weighted scheme helps overweight those companies with higher dividend yields (lower priced) and underweight those companies with low dividend yield (higher-priced). The WisdomTree Japan SmallCap Dividend Index averaged a dividend yield of 2.24% compared to 1.84% for the MSCI Japan small-cap index as of 29 June 2018. We believe this differential was the key driver behind the outperformance of the WisdomTree SmallCap Dividend Index versus the MSCI Japan small-cap index (1.68%) and the large- cap MSCI Japan index (3.37%) from 31 May 2006 to 31 May 2018. The revenue breakdown among the constituents of both indices also highlights that the WisdomTree Japan SmallCap Dividend Index has a greater allocation to the domestic Japanese economy, thereby shielding investors' portfolios from the ongoing trade wars and the vagaries of the Yen.

Figure 3: WisdomTree Japan SmallCap Dividend Index offers greater exposure to the domestic economy

Source: Bloomberg, WisdomTree, data available as of close 10 July 2018

Japan is best positioned to cope with the advance of automation. As its working age population shrinks Japan is set to accelerate its development of robots to secure a lead over rival nations. In order to tap into this evolving trend, the WisdomTree Japan SmallCap Dividend Index adopts a 37% allocation to information technology and industrials sectors that provides exposure to automation, the so-called Internet of Things (IoT) and electric vehicles.

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1 Bloomberg, as of Q2 2018.

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