

JAPANESE SMALL CAPS: ACCESSING THE DOMESTIC ECONOMY

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The Land of the Rising Sun offers the potential for an exciting investment opportunity. Since Shinzo Abe was elected prime minister in late 2012, the focus has been on “Abenomics¹.” Central to Abenomics is an expansionary fiscal stimulus, expansionary monetary policies and structural reforms aimed at ending Japan’s deflationary² cycle. Such policies have increased positive sentiment in the equity markets and introduced a potential spillover on the wealth of the Japanese citizenry, which could ultimately manifest in the form of higher local consumer demand.

Consider that:

- + **Shinzo Abe has outlined a growth strategy for long-term structural changes that has the potential to benefit the local economy and industries.**
- + **Small-cap companies are often more sensitive to Japan’s local demand than large caps.³**
- + **Japanese small caps currently sell at relatively lower prices than large caps.⁴**
- + **Japanese small-cap value stocks have historically outperformed Japanese small-cap growth stocks over longer holding periods.⁵**

SMALL CAPS HAVE LOCAL CUSTOMER BASE: DOMESTIC DEMAND

One feature of Japanese small-cap companies is that they are more exposed to local economic prospects and hence more reflective of domestic demand than exporters that operate globally.

Many are familiar with WisdomTree’s Japan Hedged Equity Index. This Index specifically excludes firms that derive more than 80% of their revenues from within Japan, thereby tilting toward Japan’s global exporters. We believe that the unhedged WisdomTree Japan SmallCap Dividend Index (WTJSC) serves as a potential complement to this approach, as the vast majority of its revenue is derived from within Japan.

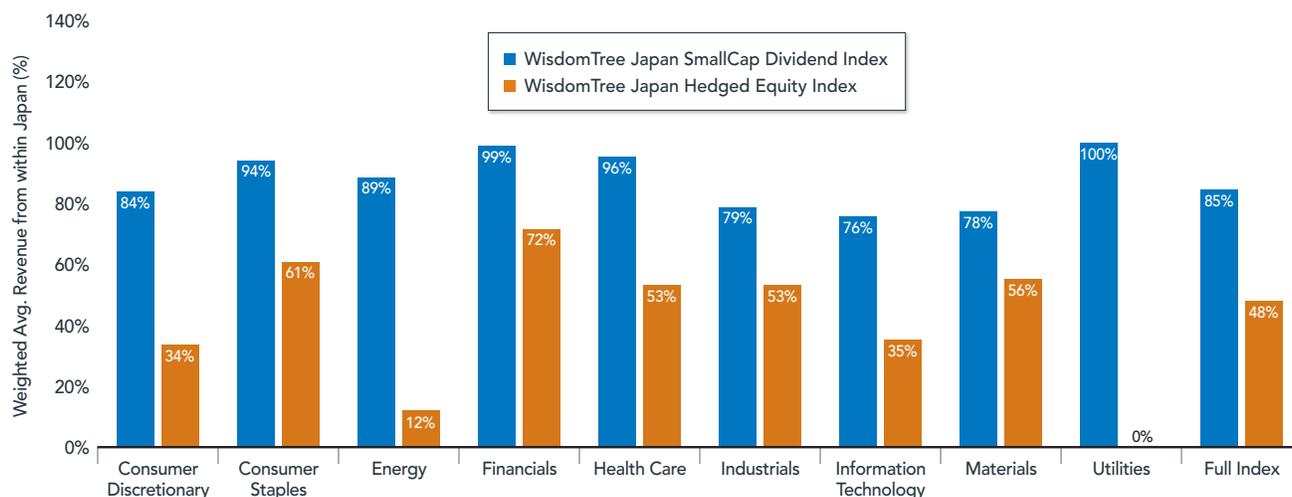
¹ Abenomics: Series of policies enacted after the election of Japanese prime minister Shinzo Abe on December 16, 2012, aimed at stimulating Japan’s economic growth.

² Deflation: The opposite of inflation, characterized by falling price levels.

³ “Small-cap companies” refers to those included in the WisdomTree Japan SmallCap Dividend Index. “Large caps” refers to those included in the WisdomTree Japan Hedged Equity Index.

⁴ “Japanese small caps” refers to the companies in the MSCI Japan Small Cap Index. “Large caps” refers to companies in the MSCI Japan Index. Valuation data is as of 3/31/2014. Source: Bloomberg.

⁵ Refers to the performance of the MSCI Japan Small Cap Value Index versus the performance of the MSCI Japan Small Cap Growth Index for the 10-year period 3/31/2004 to 3/31/2014.

FIGURE 1: SMALL CAPS DERIVE MORE REVENUE FROM WITHIN JAPAN [As of 5/31/2013 Index Screening]

Sources: WisdomTree, Bloomberg, Standard & Poor's. You cannot invest directly in an index. Past performance is not indicative of future results. Holdings subject to change.

- + **Small Caps 85% Exposed to Domestic Revenues:** WisdomTree's Japan SmallCap Dividend Index derives 85% of its weighted average revenues from within Japan. That creates a potentially complementary picture to WisdomTree's Japan Hedged Equity Index, which derives less than 50% of its weighted average revenue from within Japan.
- + **Exposed to the Local Consumer Sectors:** Companies from the Consumer Discretionary and Consumer Staples sectors in the Japan SmallCap Dividend Index see 84% and 94%, respectively, of their weighted average revenues coming from within Japan. These firms are therefore in a good position to benefit from any improvements in consumption due to Abe's policies.
- + **Exposure to the Yen through Direct Ownership of Japanese Stocks:** No currency derivatives⁶ are used in the calculation of the WisdomTree Japan SmallCap Dividend Index, nor in the WisdomTree Japan Small Cap Dividend Fund (DFJ) that is designed to track the performance of the Index after costs, fees and expenses.
- + **High sensitivity to dividend paying stocks:** WTJSC consists only of Japanese stocks that pay dividends and is weighted annually based on the cash dividends companies pay. This annual rebalancing process gives the Index a "value tilt" relative to traditional market capitalization-weighted⁷ indexes.

⁶ "Currency derivatives" refers to forward contracts meant to mitigate the impact of the yen's performance on the returns of the WisdomTree Japan SmallCap Dividend Index or the WisdomTree Japan SmallCap Dividend Fund that is designed to track the performance of the Index after costs, fees and expenses.

⁷ Market capitalization-weighted: Market cap = share price x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

JAPAN'S SMALL CAPS SELL AT LOWER VALUATION MULTIPLES

A further consideration for Japanese small caps is that they tend to trade at more discounted prices—lower valuation multiples—than their large-cap peers.

FIGURE 2: JAPANESE SMALL CAPS TEND TO TRADE AT LOWER PRICE-TO-BOOK VALUE RATIOS

[1/30/1998–3/31/2014]



Source: Bloomberg. Period chosen based on data availability for the MSCI Japan Small Cap Index. Past performance is not indicative of future results. You cannot invest directly in an index.

- + 28% Average Discount:** Over the period of available history, we can see that the MSCI Japan Small Cap Index has tended to trade at an average discount of 28% to the MSCI Japan Index in price-to-book value ratio⁸ terms.⁹
- + What Does a Value of 1.0x Indicate?** For much of the past four years, Japanese small caps have traded at price-to-book value ratios of less than 1.0x, and they are currently trading at just 1.0x. When stocks sell at a price multiple below book value, it indicates that the market is implying that the firm would be worth more broken up and sold piecemeal than if it continued to operate as a business. If these firms' revenue and earnings growth prospects begin to improve, valuation¹⁰ opportunities like this can have the potential to be very attractive.

WHAT ABOUT THE LONG-TERM RETURNS?

Skeptics may look at the approximately 15-year period shown in figure 2 and think "value trap¹¹." Japan's small caps have traded at inexpensive valuations for a long time, but that doesn't mean that solid returns must necessarily

⁸ Price-to-book value ratio: Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

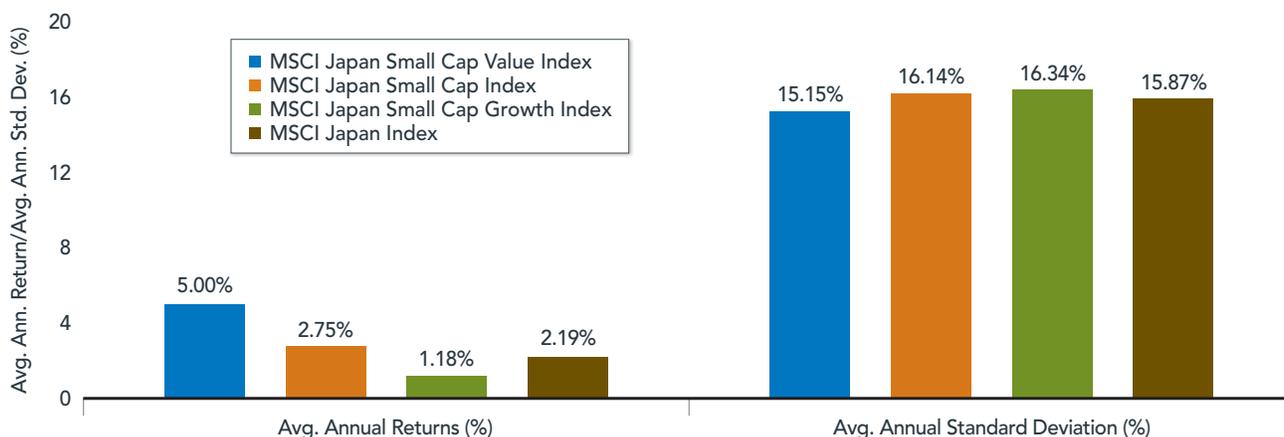
⁹ This analysis utilizes the MSCI Japan Small Cap and MSCI Japan indexes so as to showcase a historical perspective of almost 15 years. It encompasses the available data on Bloomberg for the MSCI Japan Small Cap Index.

¹⁰ 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.

¹¹ Value trap: Situation where equities based on certain metrics may look relatively inexpensive but may continue to remain so for a potentially extended period.

follow. In figure 3A, we compare the 10-year risk and return of the MSCI Japan Small Cap Value and Small Cap Growth indexes, as well as the broader small-cap and even large-cap segments. We consider whether a valuation-sensitive discipline to Japan’s small caps has, in fact, yielded any benefits at all.

FIGURE 3A: SMALL CAP VALUE DELIVERS STRONGLY IN JAPAN [3/31/2004–3/31/2014]



Source: Zephyr StyleADVISOR. Past performance is not indicative of future results. You cannot invest directly in an index.

+ Strongest Returns with Lowest Risk: We see that the MSCI Japan Small Cap Value Index generated the highest returns over this 10-year period, and it did so with the lowest risk¹² of the indexes shown. Ultimately, we believe that the attractive risk/return trade-off exhibited by this asset class historically makes the idea of “small value” strategies for Japan definitely worth considering.

FIGURE 3B: SMALL CAP VALUE DELIVERS STRONGLY OVER VARIOUS TIME FRAMES [3/31/2004–3/31/2014]

Index	WT Index Inception Date	1 year	3 years	5 years	Since WT Index Inception	10 years
WisdomTree Japan SmallCap Dividend Index	6/1/2006	7.52%	8.59%	13.44%	1.73%	N/A
MSCI Japan Small Cap Value Index		6.63%	8.11%	13.33%	1.94%	5.00%
MSCI Japan Small Cap Index		6.53%	7.72%	12.80%	0.31%	2.75%
MSCI Japan Small Cap Growth Index		6.42%	7.28%	12.20%	-1.36%	1.18%
MSCI Japan Index		7.53%	5.38%	10.35%	-0.60%	2.19%

Sources: WisdomTree, Zephyr StyleADVISOR. Past performance is not indicative of future results. You cannot invest directly in an index.

+ Since WTJSC’s inception in June of 2006, both it and the MSCI Japan Small Cap Value Index have outperformed the MSCI Japan Small Cap Index as well as the predominantly large-cap MSCI Japan Index. It’s only been over the most recent one-year period—when Abe’s policies have contributed to an

¹² Risk: Also “standard deviation,” which measures the dispersion of actual returns around an average value over a specific period. Higher values indicate a higher probability for returns to be farther from this average value.

environment of yen depreciation—that the large-cap MSCI Japan Index has overtaken the MSCI Japan Small Cap Value Index. This is largely due to the global exporters being made more competitive by the weakening yen.

- + For the 3-year and 5-year periods, the WisdomTree Japan SmallCap Dividend Index was able to outperform all of the Japan indexes listed. However, since WTJSC's inception, it slightly lagged the MSCI Japan Small Cap Value Index. WTJSC is absent from figure 3A because it does not yet have a 10-year performance history.

HOW TO SELECT SMALL-CAP VALUE STOCKS IN JAPAN

WisdomTree believes dividends are one of the most important indicators of relative valuations for stocks and the market as a whole. And when it comes to Japanese small caps, we believe dividends can be especially important, given the low income currently available in other Japanese fixed income instruments.

Moreover, Japanese companies—both large and small—are predominantly dividend payers. Consider the fact that, as of March 31, 2014, more than 95% of the weight of the MSCI Japan Small Cap Index was in firms that had paid at least one dividend over the prior 12 months. For reference, this same metric for the Russell 2000 Index stands at less than 50%. Dividend-focused small-cap strategies in Japan are therefore highly representative of the Japanese small-cap equity landscape.¹³

One way to measure the exposure of Japanese small-cap dividend stocks to the value index discussed above is through correlation¹⁴ with a higher number, particularly a number close to 1.00, indicating that the returns of two indexes have tended to move in a close relationship.

FIGURE 4: DIVIDEND FOCUS SHOWS HIGH CORRELATION TO SMALL CAP VALUE [6/1/2006–3/31/2014]¹⁵

Correlation Matrix	(1)	(2)	(3)	(4)	(5)
(1) WisdomTree Japan SmallCap Dividend Index	1.00	0.99	0.98	0.97	0.88
(2) MSCI Japan Small Cap Index	0.99	1.00	0.99	0.99	0.89
(3) MSCI Japan Small Cap Value Index	0.98	0.99	1.00	0.94	0.88
(4) MSCI Japan Small Cap Growth Index	0.97	0.99	0.94	1.00	0.88
(5) MSCI Japan Index	0.88	0.89	0.88	0.88	1.00

Sources: WisdomTree, Zephyr StyleADVISOR. Past performance is not indicative of future results. You cannot invest directly in an index.

¹³ Source: Bloomberg, as of 3/31/2014 for both MSCI Japan Small Cap Index and Russell 2000 Index.

¹⁴ Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly opposite directions.

¹⁵ For our analysis in Figure 4, we take the returns of the WisdomTree Japan SmallCap Dividend Index since its June 1, 2006 inception and compare their correlation to an array of other Japan equity indexes.

+ Japanese Small-Cap Equity Strategies Exhibit High Correlation: Each small-cap equity strategy shown displayed a high correlation with the other small-cap strategies. We believe this speaks mostly toward the fact that many Japanese small caps do in fact pay dividends, contributing to our dividend-focused strategy being very inclusive of the small-cap market at large.

50/50 CURRENCY BLEND THAT IS EFFECTIVELY “YEN NEUTRAL”

To hedge or not to hedge? At WisdomTree, we have seen great interest in our Japan Hedged Equity Index, which hedges the yen’s impact on returns. Since Prime Minister Abe’s election on December 16, 2012, we have seen significant depreciation of the yen against the dollar. Combined with the very positive performance of Japan’s equity market, a currency-hedged approach has looked quite strong.

However, that’s not to say that a currency-hedged approach is the sole way to invest in Japan. Currencies rarely, if ever, move in a straight line. If one were to blend the WisdomTree Japan Hedged Equity Index with the WisdomTree Japan SmallCap Dividend Index, we believe that the potential exists to:

- + Be Currency Neutral:** This blend would have a portion of the portfolio that would benefit from currency appreciation, as well as a portion hedged to protect against currency depreciation.
- + Lower Volatility:** Unhedged approaches to markets where the currency and equities exhibit negative correlation have the potential to be less volatile than hedged approaches, as the currency tends to both buffer the downside and provide headwind to the upside.

FIGURE 5: THE WISDOMTREE 50/50 JAPANESE BLEND COMPARED TO OTHER JAPAN EQUITY INDEXES

[2/1/2010–3/31/2014]

Index	Return	Avg. Ann. Std. Dev. ¹	Sharpe Ratio ²	Maximum Drawdown ³	Up Capture ⁴	Down Capture ⁵	Beta ⁶
WisdomTree Japan SmallCap Dividend Index	9.8%	13.1%	0.74	-9.2%	87.7%	68.3%	0.77
WisdomTree Japan Hedged Equity Index	7.3%	17.3%	0.42	-23.1%	107.8%	99.6%	1.04
50/50 WT Japan Blend ⁷	8.9%	14.1%	0.62	-14.2%	98.3%	83.8%	0.90
MSCI Japan Small Cap Value Index	9.9%	14.4%	0.68	-11.1%	98.3%	78.8%	0.87
MSCI Japan Small Cap Index	9.3%	13.8%	0.67	-10.8%	93.5%	76.8%	0.85
MSCI Japan Small Cap Growth Index	8.7%	13.8%	0.62	-12.1%	88.8%	75.0%	0.83
MSCI Japan Index	5.7%	14.5%	0.39	-19.7%	100.0%	100.0%	1.00

Sources: WisdomTree, Bloomberg, Zephyr StyleADVISOR. Period selected due to the 2/1/2010 inception date of the WisdomTree Japan Hedged Equity Index. Past performance is not indicative of future results. You cannot invest directly in an index.

¹ Avg. Ann. Std. Dev.: A measure of how widely an investment or investment strategy’s returns move compared to its average returns for an observed period. A higher value implies more “risk,” in that there is more of a chance the actual return observed is farther away from the average return.

² Sharpe Ratio: A measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.

³ Maximum Drawdown: The maximum loss incurred without recovery over a specified period.

⁴ Up Capture: A risk statistic measuring the propensity of an index or investment vehicle to deliver positive returns when an underlying benchmark is delivering positive returns. Higher values indicate greater magnitudes of positive returns relative to this benchmark.

⁵ Down Capture: A risk statistic measuring the propensity of an index or investment vehicle to deliver negative returns when an underlying benchmark is delivering negative returns. Higher values indicate greater magnitudes of negative returns relative to this benchmark.

⁶ Beta: Measure of the volatility of an index or investment relative to a benchmark. A reading of 1.00 indicates that the investment has moved in lockstep with the benchmark; a reading of -1.00 indicates that the investment has moved in the exact opposite direction of the benchmark.

⁷ 50/50 WT Japan Blend: A blend consisting of equal parts WisdomTree Japan Hedged Equity Index and of the WisdomTree Japan SmallCap Dividend Index, rebalanced annually.

Whether one considers returns, average annual standard deviation, Sharpe Ratio or any other statistic shown in figure 5, a case can be made for the potential benefit of looking at the WisdomTree Japan SmallCap Dividend Index in tandem with the WisdomTree Japan Hedged Equity Index. Over this period (which begins with the inception date of the WisdomTree Japan Hedged Equity Index), the volatility of the WisdomTree Japan SmallCap Dividend Index was below 14% while generating close to a 10.0% average annual return. It's important to note that this Index had the highest Sharpe Ratio, lowest standard deviation and lowest beta when compared to the MSCI Japan Small Cap, Small Cap Value and Small Cap Growth indexes over the period. The 50/50 WisdomTree Japan Blend showed both a return enhancement and volatility reduction compared to the traditional MSCI Japan Index of large-cap stocks that also includes exposure to the yen.

CONCLUSION

As Abenomics continues to evolve, we believe that the commitment of Japan's government and its central bank to the stimulation of domestic demand and economic growth will remain clear. Japanese small-cap stocks have the potential to be very sensitive to these upticks in consumption of Japanese citizens, forming a nice complement to approaches that are more focused on Japanese exporters, which are helped by a depreciating yen. If Abenomics is successful over the long term, both of these equity market segments have the potential to benefit.

Dividends are not guaranteed, and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, call 866.909.WISE (9473) or visit wisdomtree.com. Read the prospectus carefully before you invest.

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 Funds focus their investments in Japan, thereby increasing the impact of events and developments in Japan, which can adversely affect performance. This may result in greater share price volatility. Due to the investment strategy of certain 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.

WisdomTree Japan Hedged Equity Index: An index designed to provide exposure to Japanese equity markets while at the same time neutralizing exposure to fluctuations of the Japanese yen movements against the U.S. dollar. Constituents are dividend-paying companies incorporated in Japan that derive less than 80% of their revenue from sources in Japan. Weighting is by cash dividends paid. WisdomTree Japan SmallCap Dividend Index: Designed to provide exposure to dividend-paying small-capitalization companies in Japan. MSCI Japan Index: A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market. MSCI Japan Small Cap Index: A free float-adjusted market capitalization-weighted index designed to measure the equity market performance of Japanese small-cap securities. MSCI Japan Small Cap Value Index: A market cap-weighted measure of the performance of the small-cap equity market in Japan, specifically those firms that display characteristics of lower price levels relative to their fundamentals. MSCI Japan Small Cap Growth Index: A market cap-weighted measure of the performance of the small-cap equity market in Japan, specifically those firms that display characteristics of higher price levels relative to their fundamentals. Russell 2000 Index: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index, representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

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