Considerations for Investing in Japan Now

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Given the uncertainty surrounding how quickly Japan will be able to rebuild its economy and address the fallout of nuclear reactor issues, it would not have been surprising to see large outflows from the region. However, the reverse has occurred—since the tragedy, assets in Japanese ETFs have increased.[1] This rather remarkable display of positive sentiment toward Japan includes the following:

+ **The cover of *Barron's* on March 21, 2011, proclaimed, "Buy Japan Now," reflecting unbridled enthusiasm that the Japanese market will recover from the ravages of the earthquake and tsunami;**
+ **Warren Buffett recently said: "If I owned Japanese stocks, I would certainly not be selling them because of the events of the past 10 days or so… Something out of the blue like this, an extraordinary event, really creates a buying opportunity."[2]**

HOW SHOULD INVESTORS BUY JAPAN?

We believe there are two considerations when investing in Japan:

+ **The role of the yen on total return**
+ **The role small caps may play in the recovery**

THE ROLE OF THE YEN ON TOTAL RETURN

We published earlier research that documented a negative relationship between Japan's equity markets and its currency—a strong yen was connected to equity market weakness. Revenues for Japanese companies selling goods and services globally have been under pressure as the yen has strengthened. In our estimation, the most significant long-term hurdle Japan's recovery faces may not be related entirely to the tsunami or earthquake but rather to continued gains in the yen.

The coordinated global central bank intervention announced on March 17—the first in 10 years—had an immediate effect in weakening the yen.[3] Unlike the outpouring of analysts suggesting equity markets are attractive, we have not seen evidence of large-scale bullishness on the currency. In fact, many believe the earthquake ought to have a long-term negative impact on the yen. Additionally, we believe that U.S. interest rates are a determining factor driving the recent yen strength, and if the U.S. removes its zero-interest rate policy, we anticipate the yen may weaken over time.

Traditionally, international investing means taking on currency exposure. However, uncertainty over the yen's future argues that investors should consider how to factor currency exposure into Japan equity allocations. One option is a 50/50 allocation to include/not include yen exposure that could be categorized as a "regret minimization" allocation.[4] By splitting allocations, investors can minimize the "regret" of being fully invested on the wrong side of the currency trade.

[1] Sources: WisdomTree, Bloomberg
[2] Source: Jun Yang and Andrew Frye, "Buffett Says Japan Earthquake Creates 'Buying Opportunity,'" Bloomberg, March 21, 2011
[3] Finance officials from the G-7 countries (United States, Japan, Germany, Britain, France, Italy and Canada) agreed to help Japan intervene in the currency markets with the stated goal of weakening the yen.
[4] See Sébastien Michenaud and Bruno Solnik, Applying Regret Theory to Investment Choices: Currency Hedging Decisions, Journal of International Money and Finance, vol. 27, no. 5 (September 2008): 677–694.

SAMPLE JAPAN ALLOCATION MODELS: WITH—AND WITHOUT—CURRENCY EXPOSURE

View of Yen Prospects versus U.S. Dollar	Equity Exposure with Yen Exposure	Equity Exposure without Yen Exposure
Traditional international allocations	**100%**	**0%**
High conviction yen strengthens vs. USD	100%	0%
Low conviction yen strengthens vs. USD	75%	25%
Neutral on the direction of the yen	**50%**	**50%**
Low conviction yen weakens vs. USD	25%	75%
High conviction yen weakens vs. USD	0%	100%

Hypothetical examples
Source: WisdomTree, 2011
Asset allocation cannot assure a profit nor protect against a loss.

THE ROLE SMALL CAPS[5] MAY PLAY IN THE RECOVERY

For those who are not concerned about the direction of the yen, we see a strong argument for investment in the small-cap segment of Japan. First, on a price-to-book ratio[6] ("P/B ratio"), Japan small-cap stocks, as a category, are currently among the cheapest in the world:

Index	P/B Ratio (as of 3/21/11)
WisdomTree Japan Small Cap Dividend Index	0.73x
MSCI EAFE Index	1.47x
MSCI Japan Index	1.06x
S&P 500 Index	2.25x
Russell 2000 Index	2.05x

This means that, on average, Japan small-cap companies are currently selling at prices 50% cheaper than the broader developed world and 65% cheaper than U.S. market averages.

But perhaps even more significant, Japan small caps represent greater direct exposure to the companies and sectors that will likely lead the local reconstruction/recovery effort (as opposed to many large-cap Japanese companies that are export driven and operate globally). Consider the following:

+ **Small caps tend to have greater exposure to sectors that may lead the infrastructure recovery effort, including Construction and Engineering, Industrials and Materials;**
+ **Small caps tend to have limited exposure to two sectors that are at the center of the current crisis and may be most financially challenged by the recovery effort, including Insurers and Utilities.**

[5] Small-capitalization stocks are those with relatively lower market capitalization. Market capitalization is equal to price times shares outstanding. For Japan, WisdomTree defines its small-capitalization universe as the dividend-paying stocks in Japan that are ranked 301 or lower when ranked by market capitalization.
[6] The price-to-book ratio is a measure of the aggregate market value of an index or set of stocks divided by their aggregate book value. Book value is an accounting metric that determines the aggregate shareholder equity of the company or its assets minus its liabilities. A lower price-to-book ratio means the markets are cheaper, a higher price-to-book value means the markets are more expensive.

WISDOMTREE JAPAN ETFs

+ WisdomTree Japan Hedged Equity Fund: DXJ

DXJ provides exposure to Japanese equities while neutralizing exposure to the yen. If the global central banks are successful in their effort to weaken the yen, we see DXJ as the equity ETF that could stand to benefit the most relative to other Japan ETFs. View DXJ Fund Details.

+ WisdomTree Japan SmallCap Dividend Fund: DFJ

DFJ provides exposure to more than 350 small-cap dividend payers in Japan. As outlined, many of these small-cap companies are directly connected to the local economic and infrastructure recovery effort. View DFJ Fund Details.

The WisdomTree Japan SmallCap Dividend Index measures the performance of dividend-paying small-capitalization companies in Japan. After the 300 largest companies have been removed from the WisdomTree Japan Dividend Index, the remaining companies are chosen for inclusion in the Index. Companies are weighted in the Index based on annual cash dividends paid. The MSCI EAFE Index (Europe, Australasia, Far East) is a free-float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. & Canada. The MSCI Japan Index is a free-float-adjusted market capitalization index that is designed to measure developed market equity performance in Japan. The S&P 500 Index is a capitalization-weighted index of 500 stocks selected by the Standard & Poor's Index Committee, designed to represent the performance of the leading industries in the U.S. economy. The Russell 2000 Index is a capitalization-weighted index that measures the small-cap segment of the U.S. equity universe, selecting stocks ranked 1001-3000 by market capitalization from the Russell 3000 Index.

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