

A Focus on Japan Small Caps for Domestic Demand

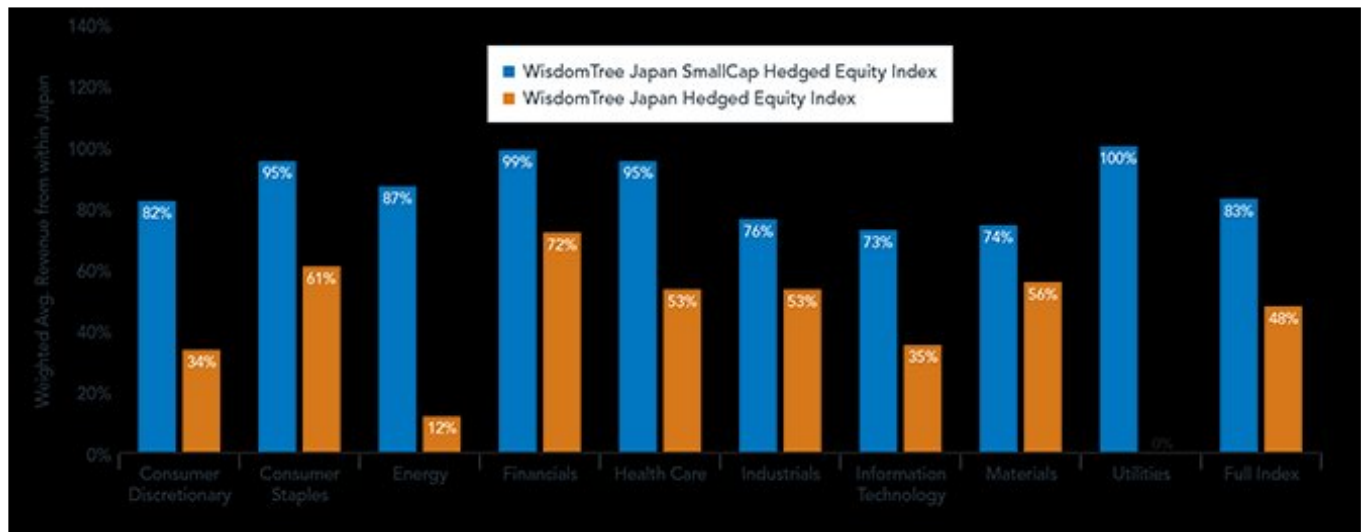
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Jeremy Schwartz, CFA

Global Chief Investment Officer

2013, in many ways, has been the year of Japan. Interest in Japanese stocks has soared with a rising equity market and weakening currency based on optimism about prime minister Shinzo Abe and his “Abenomics” policies to reinvigorate Japan. Abenomics focuses on a “three-arrow” policy of fiscal stimulus, monetary stimulus and structural reforms. All of Abenomics’ goals are aimed at one thing: promoting economic growth in Japan. The country has been mired in a slow-growth, deflationary slump for some time, and Mr. Abe is determined to reverse that painful cycle of deflation. **A Depreciating Yen Helps Japanese Exporters** Thus far, one side effect (if not a central goal of Abenomics) has been weakness in the yen. We created an Index (the WisdomTree Japan Hedged Equity Index) to focus on companies we believe stand to benefit from a weaker yen—those companies that are exporters and have a global revenue base.¹ We hedge the yen from that Index to prevent exchange rate movements from impacting the performance of the Index. **Domestic Consumption Is the Government’s Larger Focus** However, at its core, Abenomics is designed to stimulate economic growth in Japan—by encouraging Japanese consumers to come off the sidelines where they have sat with significant savings for a long time. Domestic consumption is an important element of Abenomics. To expand our coverage of Japanese stocks beyond just the exporters, we have created an additional Japan Hedged Equity Index focused on the small-cap part of the equity markets that we believe are more levered to local Japanese revenue and consumption. **Key attributes of the small-cap focus of the Japan SmallCap Hedged Equity Index:** 1. Small-cap stocks typically export less and are more sensitive to the domestic economy than large-cap stocks. 2. While the WisdomTree Japan Hedged Equity Index has a revenue filter excluding firms that generate more than 80% of their revenue from Japan, the WisdomTree Japan SmallCap Hedged Equity Index has no such revenue screen and is meant to be broadly inclusive of Japanese small-cap dividend payers. This new Index seeks to balance the export nature of large caps with the more domestic consumption element of many small caps.

Local Consumption Levered: How Much Revenue Comes from Japan?



• **Small Caps Are Locally Based:** The WisdomTree Japan SmallCap Hedged Equity Index derives nearly twice the amount of revenue from within Japan (83%) than the WisdomTree Japan Hedged Equity Index on a weighted average basis. • Over half the constituents of the Japan SmallCap Hedged Equity Index have 100% of their revenue coming from Japan. • **Sector Comparisons:** The WisdomTree Japan SmallCap Hedged Equity Index derives a greater weighted average revenue from within Japan than the WisdomTree Japan Hedged Equity Index in all 10 industry sectors. Consumer Staples, Financials, Health Care and Utilities stand out as being the most locally based, but even the Consumer Discretionary sector (which is the most globally based sector in the export basket) has 82% of its revenue coming from Japan. **Additional Valuation Advantage** The WisdomTree Japan SmallCap Hedged Equity Index also exhibits a valuation advantage compared to the WisdomTree Japan Hedged Equity Index as of the May 31, 2013, Index Screening: • The WisdomTree Japan SmallCap Hedged Equity Index has a [price-to-earnings \(P/E\) ratio](#) of about 13x earnings and a [price-to-book value \(P/B\) ratio](#) of .8x. • The WisdomTree Japan Hedged Equity Index has a P/E ratio of about 14x earnings and a P/B ratio of 1.2x. We believe this relationship between the Japanese large and small cap equities to be impacted by a lot of international investor interest in Japan—the large global revenue generators in the WisdomTree Japan Hedged Equity Index are the firms that these investors would know, whereas the smaller firms in the WisdomTree Japan SmallCap Hedged Equity Index would be less familiar. **Conclusion** We believe that Abenomics will not fade quickly—on both the monetary and fiscal side, commitments have been made with a focus on long-term results and a willingness to stay the course. That points to a need for flexibility: Japan's global revenue generators might be in favor some of the time, while at other times the focus could shift more toward the more domestically sensitive firms. In conceptualizing how best to measure the performance of Japanese equities, it could make sense to consider each of what we believe are quite different ways of looking at a single country's equities. 1Companies with a global revenue base are identified as companies that have less than 80% of their revenue coming from Japan.

Important Risks Related to this Article

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