

How Abenomics Affects the Revenue Generation of Japan's Companies

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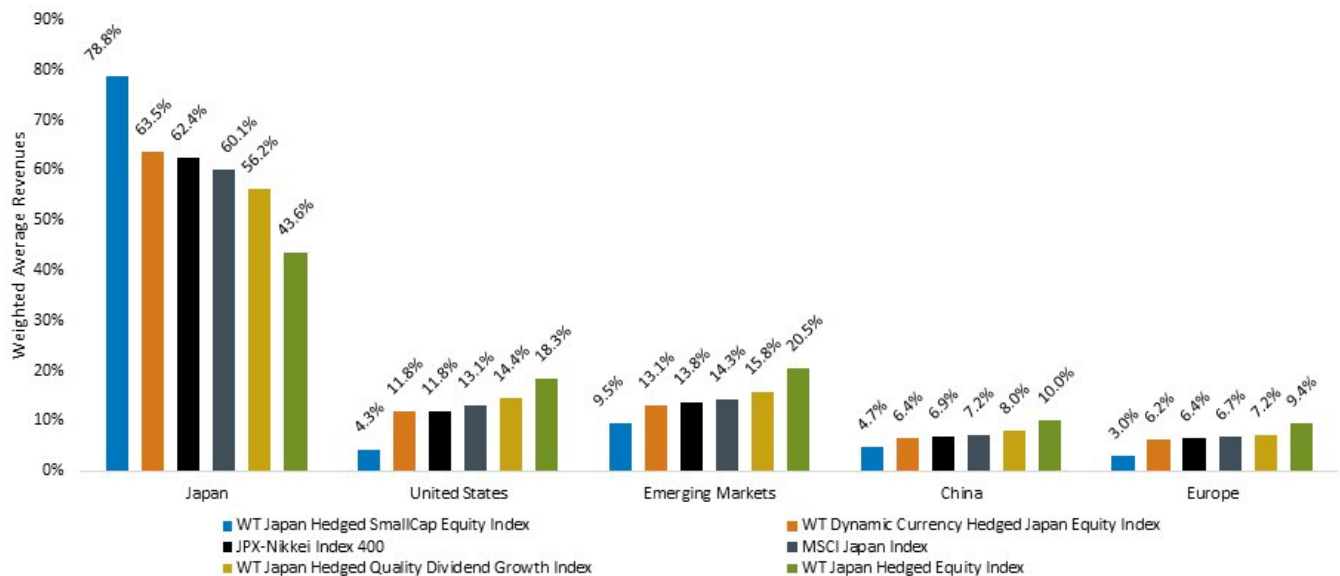
In the start of 2016, global equity markets experienced significant volatility, often accompanied by concerns of global growth prospects, especially surrounding anything related to China and emerging markets. We believe that understanding the countries where holdings are located is only part of the geographic picture. **It Is Critical to Understand Where Firms Are Generating Their Revenues** We find that understanding where the revenue of holdings comes from can be a highly complementary approach when evaluating potential investments. This is particularly prudent in Japan, where:

- Many small-cap companies are very sensitive to trends in the local Japanese market.
- Many larger multinational companies are very sensitive to global macroeconomic developments.

Two Layers of Abenomics We see Abenomics as a multifaceted approach meant to stimulate economic growth in Japan:

- **Weakening of the Japanese yen**, most often cited against the U.S. dollar, is one important consequence of Abenomics. The immediate impact has notably been a positive factor in the earnings performance of large multinational exporters in Japan, whose products and services become more competitive as the yen declines in value.
- **Stimulation of Japanese aggregate demand** is another consequence, as Abenomics also seeks to encourage such growth. Putting the “deflationary mindset” in the rearview mirror and encouraging companies to raise wages may increase consumption in Japan.

Bottom line: Thinking about where firms are generating their revenues can lead to a more finely tuned sensitivity to the goals of Abenomics. **Where Are Japanese Equity Indexes Generating Their Revenues?**



Sources: WisdomTree, FactSet, Bloomberg as of 12/31/15.

For definitions of indexes in the chart, visit our [glossary](#). **Global Multinationals** The [WisdomTree Japan Hedged Equity Index](#) (“Japanese exporters”) gained attention as the Bank of Japan (BOJ) and economic factors caused the yen to fall nearly 32% against the U.S. dollar from the start of Abenomics through February 29, 2016.¹ The companies in this Index are selected based on their global revenue base and have less than 80% of their revenue coming from inside Japan. The logic for this strategy is simple: Focus on companies that will benefit from a weaker local currency (exporters) while reducing that currency’s impact on the returns of the U.S.-based investor. As the currency weakens, the exports of countries that trade in that currency will likely become more attractive. Those firms that derive more revenue from abroad should then outperform with a boost in exports. The consequence, however, is a large degree of global macroeconomic sensitivity. **The Marriage of Quality and Growth with Currency-Hedge Wrapper** Another strategy that has gained attention in the current market volatility is the [WisdomTree Japan Hedged Quality Dividend Growth Index](#). With a Japanese revenue exposure of 56% as of December 31, 2015, it offers a step back from the export tilt of the Japanese exporters. This methodology aims to seek out quality firms that are often better positioned in volatile market environments. The growth factor ranking is based on long-term earnings growth expectations, while the quality factor ranking is based on three-year historical averages for return on equity and return on assets. The companies are then weighted on cash dividends paid. Combining these quality and growth screens with a currency hedge, we believe, can be a helpful strategy in the face of market uncertainty. **Unlocking Small-Cap Potential While Mitigating Currency Risk** Small-cap equities are often cited for their “local focus,” and if we look at the 79% Japanese geographic revenue exposure of the [WisdomTree Japan Hedged SmallCap Equity Index](#) as of December 31, 2015, we find that this holds true with almost twice the revenue from Japan as the Japanese exporters. It also has half the exposure as Japanese exporters to the emerging markets and only 5% directly tied to China. This Index also applies a currency hedge to the yen and has a dividend-weighting process for constituents. Also note that while the WisdomTree Japan Hedged SmallCap Equity Index has appreciated 32.0% since its inception, its price-to-earnings (P/E) ratio has actually fallen

from 19.0x to 13.8x.² **A Dynamic Yen Hedge, More Balanced Revenue Exposure** WisdomTree more recently created a Japanese equity Index, in partnership with Record Currency Management, that applies a dynamic currency hedge to the yen based on three underlying currency signals: interest rate differentials, momentum and value. The hedge ratio is adjusted once a month, and the current hedge ratio in place for February was set to be 50.0%.³ The underlying equity strategy for this Index is a broad dividend-weighted allocation to stocks trading in yen, and this Index, without a revenue filter, has a more balanced exposure to Japanese revenue than the Japanese exporters discussed above. ¹Refers to the period 11/30/12–2/29/16. ²Sources: WisdomTree, Bloomberg, from the inception of the WisdomTree Japan Hedged SmallCap Equity Index on 5/1/13 to 2/29/16. ³Sources: WisdomTree, Record Currency Management, with data as of 2/1/16.

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.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.

Investments focusing on certain sectors and/or smaller companies may be more vulnerable to any single economic or regulatory development.

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.