

Which Japan Policies Are Actually Working?

Published June 20, 2016

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The conventional wisdom is that Japan is in turmoil. A recent discussion I had with Jesper Koll (JK), WisdomTree Japan CEO, and Scott Callon (SC), the Chairman of Ichigo, a publicly traded real estate company in Japan, helps shed light on some key areas where the policies of Japanese prime minister Shinzo Abe are actually working. **Jesper, many say the negative rates policy of the Bank of Japan (BOJ) is a failure. Do you agree?** JK: The reality is that the negative rate policy is actually working, in my view. Negative rates force a transfer of profits from banks to private sector risk takers, which is exactly what “Abenomics” is all about. Moreover, negative rates have triggered record outflows from Japanese pension funds to overseas assets. In the three months since the end of January (when the BOJ announced the negative rate policy¹), a record \$130 billion was invested abroad, mostly in U.S. fixed income assets but also some Asian equities (approximately 15%)². Right now, due to a relatively low cost to hedge these assets, it is clear that the Japanese are hedging their foreign currency exposure. If the U.S. were to tighten interest rates, which would raise the cost to hedge the U.S. dollar exposure, those hedges should come off and we can see a renewed bout of yen weakness. **These negative interest rates are also spurring huge demand for mortgages and refinancing, a further transfer of disposable income to consumers. Jesper, is it just the low rates or are there other forces adding to growing demand for residential property?** JK: I believe that Japan is in a “demographic sweet spot” for residential properties. The reason is the tightness of the labor markets, particularly for the young generation in their 20s and 30s where the population is dropping by more than 200,000 people every year now.³ This forces companies to hire full-time rather than part-time employees, an exact turnaround from the past 20 years when basically the only net employment growth was part-timers. Last year (2015), Japan created net full-time employment of around 260,000—the first positive upturn in full-time employment in over one decade.⁴ Leading companies are now rehiring part-time workers onto full-time contracts. This boosts incomes, raises job security and gives access to credit. In Japan, part-time workers cannot get a mortgage. This turnaround in the quality of employment is key to Japan’s positive dynamics—Japan is creating a new middle class. This is exactly why demand for homes and condominiums is rising, why mortgage credit is growing. Most importantly, it is a structural upturn in the demand for real estate, not just a cyclical pickup. Combine the rise of Japan’s new middle class with a 0.6% 10-year fixed-rate mortgage⁵ and you’ve got a powerful case for real estate in general, residential in particular. **Ichigo has a 20% return on equity (ROE)—one of the highest in the Japanese real estate industry and in the Japanese market more broadly. Scott, do you believe Abe’s focus on ROE as a target is making companies better capital stewards?** SC: Yes, I do. To start with Ichigo, we have spent the last eight years working to get better at what we do, which is preserving and improving Japanese real estate. We are fully committed to generating a globally best-in-class ROE. Across the broader market, there has been a shift toward better capital management and better returns

to shareholders as a result of Abenomics. With respect to Abe's "third arrow," which is structural reform, there are three positive changes you can point to. 1. There has been a significant cut in the corporate tax rate. This is very important to shareholders. At a 40% tax rate, shareholders kept only 60 cents of every dollar the company made. At 30%, shareholders keep 70 cents, which is a 17% increase in profits⁶. All things held equal, that makes Japanese companies and their shares 17% more valuable. 2. There has been an increase in labor force participation by Japanese women, which is now the highest in history. This is both a social good and an economic good and supports higher levels of economic activity. 3. Corporate governance is dramatically better. Japan enacted its first corporate governance code on June 1, 2015.⁷ The new code has supported a market-wide focus on higher returns for shareholders. Japan now has a bill of rights for shareholders and a constitutional document for corporations. ***Do you expect to see more active voices voting against the management team if they don't deliver capital stewardship?*** SC: Yes. Japan has changed, and in a positive way for equity investors. For 20 years, poor stock market performance was linked very specifically to 1) overly tight monetary policy, which BOJ governor Haruhiko Kuroda has now fixed, and 2) less-than-world-class corporate governance that the new corporate governance and stewardship codes are now fixing. The corporate governance has given fundamental rights to shareholders. The stewardship code has asked investors to exercise those rights. The pension funds are obligated to exercise those rights. We have already begun to see increase in negative votes at shareholder meetings, direct dialogue with companies, and positive pressure for change. This is also why we have seen record levels of share repurchases by Japanese companies, which is reflective of the fact that share prices are low and arguably undervalued.⁸ Valuation is critical, in my view. If companies buy back shares at prices that are above fundamental value, the buybacks destroy shareholder value. But Japanese companies are productively buying back shares when they should because the shares are inexpensive. Management is increasingly focused on doing the right things for shareholders. 1Source: "Introduction of Quantitative and Qualitative Monetary Easing with a Negative Interest Rate," Bank of Japan, 1/29/16. 2Source: Bank of Japan, as of 3/31/16. 3Source: Statistics Bureau of Japan, Ministry of Internal Affairs and Communications. Data as of 2/16. 4Source: "Full-Time Workers on the Rise as Businesses Seek Talent," Nikkei Asian Review, 2/17/16. 5Source: Taiga Uranaka, "Negative Rates a Boon to Mortgage Refinance for Japan's Internet Banks," Reuters, 3/31/16. 6Source: Jiji Kyodo, "Japanese Government Mulls Corporate Tax Cut to Below 30% in Fiscal 2016," The Japan Times, 11/25/15. 7Source: "Japan's Corporate Governance Code: Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term," JPX Tokyo Stock Exchange, 6/1/15. 8Sources: WisdomTree, FactSet, with data on Japanese equities measured from 12/31/13 to 3/31/16.

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