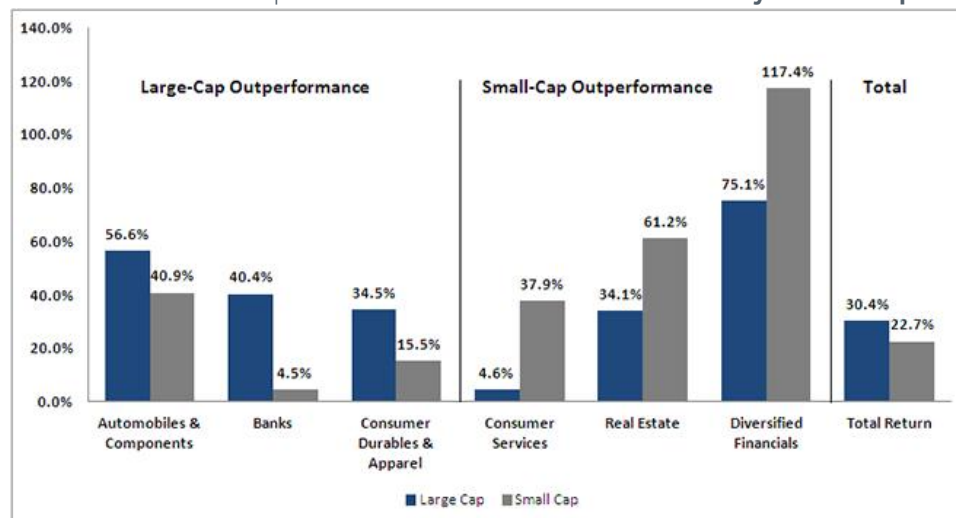


JAPANESE LARGE CAPS DIVERGE FROM SMALL CAPS

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08/26/2013

Japanese stocks have soared since Shinzo Abe was elected prime minister based on the belief that his “[Abenomics](#)” policies will reinvigorate Japan. All of Abenomics’ goals are aimed at one thing: promoting economic growth in Japan. **A Depreciating Yen Helps Japanese Large Caps** Thus far, Abenomics has coincided with a weaker yen, which has helped large multinational companies that sell products overseas. Products of these companies generally become more attractive to foreign buyers when the yen weakens. Also, overseas sales converted back to a weak yen translate to more yen revenue, ultimately adding to the bottom line. **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. Monetary policy provided an initial positive jolt, but more structural reforms are needed. Abe is still working on these structural reforms—and I expect more will be done this year. I believe we may just be in the early innings of renewed growth in local consumer demand. **Return Differences among Large Caps and Small Caps** Small caps are often more sensitive to the local economy than large caps. Below I contrast the difference in performance between Japanese large caps and small caps by comparing the [MSCI Japan Index](#) to the [WisdomTree Japan SmallCap Dividend Index](#). The MSCI Japan Index represents the largest-market capitalization firms in Japan, while the WisdomTree Japan SmallCap Dividend Index represents smaller-capitalization, dividend-oriented firms. Although there are vast performance differences among the many [industry groups](#), small caps as a whole have lagged large caps over the period shown below.



Sources: Bloomberg, WisdomTree. Past performance is not indicative of future results. You cannot invest directly in an index. Performance period is 10/31/12–08/08/13. Large-cap companies are represented by the MSCI Japan Index, small-cap companies by the WisdomTree Japan SmallCap Dividend Index.

• Large-Cap Banks

Outperform – The largest-cap banks, such as Mitsubishi UFJ Financial Group, Mizuho Financial Group and Mitsui Financial Group, are all up over 40% during the period. These three banks have profited more from a weaker yen and a rising equity market than some of their smaller counterparts. They have benefited from increased capital market activity, investment trust sales and brokerage fee income, all of which continues to grow with the stock market recovery. **• Small-Cap Real Estate and Diversified Financials Outperform on Domestic Trends** – Real estate companies and real estate investment trusts ([REITs](#)) have been among the strongest performers. The Bank of Japan has been buying REITs, which has provided a tailwind for the industry. **• Automobiles and Consumer Durables Increase on Yen Weakness** – Large

automakers such as Nissan, Honda, Mazda and Toyota have all benefited from a weakening yen due to their export-oriented business models. Yen weakness has accounted for a majority of the automakers' recent profitability, and Toyota just announced that ¥260 billion of their approximately ¥270 billion profit could be attributed to yen weakness.¹ Consumer durables companies such as Sony and Panasonic have also benefited from a weakening yen, essentially making their products more attractive to overseas customers and boosting foreign profits through a lower, more advantageous exchange rate.

- **Consumer Services Tied to Local Economy** – The large performance difference in the consumer services industry is mainly a result of the industry group composition. A majority of these firms are tied to the local economy. As consumer confidence continues to increase, I expect this industry group to continue to benefit.

Potentially Focus on Smaller Companies for Future Domestic Growth I believe the relationship between the Japanese large- and small-cap equity performance has been influenced by the yen's substantial movements. Although some small-cap industries have already begun to benefit from Abe's policies (e.g., real estate and diversified financials), I think the majority of the smaller-cap stocks have yet to fully benefit. Small-cap stocks typically export less and are more sensitive to the domestic economy than large-cap stocks. As I mentioned earlier, the structural reforms should help stimulate consumer demand, eventually benefiting smaller-cap companies.

WisdomTree Japan Small-Cap Indexes WisdomTree has two different small-cap Indexes that track dividend-paying stocks in Japan. Although each Index provides exposure to companies that we believe are more geared toward local Japanese revenue and consumption, they have opposite exposure to currency risk.

- **WisdomTree Japan SmallCap Dividend Index** – includes exposure to the yen
- **WisdomTree Japan Hedged SmallCap Equity Index** – [hedges](#) out the currency risk

Conclusion I don't believe Abenomics will fade quickly on the monetary side—it has only just begun its fiscal and structural reforms. Promises have been made to focus on long-term results and to release Japanese citizens from the deflationary cycle. Although Japan's global exporters are in favor, the focus could shift toward the more domestically sensitive firms that we see in small caps. With new options for the currency-hedged side of small caps, one can now decide on the optimal allocations—do I want the currency exposure or do I want to hedge it? I believe a number of investors may pair currency-hedged options with non-currency-hedged options to diversify their approach.¹Source: Toyota FY2014 1Q Financial Results : Earnings Release Presentation (08/02/2013)

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DEFINITIONS

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.

MSCI Japan Index : A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.

WisdomTree Japan SmallCap Dividend Index : Designed to provide exposure to dividend-paying small-capitalization companies in Japan.

Industry group classification : Organizes companies into industrial groupings based on similar production processes, similar products or similar behavior in financial markets.

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.