

JAPANESE FINANCIALS: OPPORTUNITY OR VALUE TRAP?

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Recently, Japan has lost its allure among global investors, but I think this will only be temporary, and given the underlying earnings growth, I believe Japan offers an attractive opportunity, which I discussed in more detail [here](#). It is important to remember that we are still in the early innings of "[Abenomics](#)" and that the Bank of Japan (BOJ) remains, by far, the most expansionary central bank in the world¹. The financials are the lowest-priced part of Japan's market, as measured by the [price-to-earnings ratio](#) or [price-to-book ratios](#), and could be a higher [beta](#) exposure for those who want to make what is now a [contrarian](#) allocation to Japan. Hedge Funds See Opportunity One value investor who doesn't shy from contrarian investments, David Einhorn, recently announced a position in a regional Japanese bank. In Einhorn's quarterly letter, he wrote: "We established a position in Resona, the largest Japanese regional bank, at a price of ¥547, representing 0.8x book value and 8x earnings."² Those who do not want to select individual stocks but like the concept might be interested in the following: [WisdomTree Japan Hedged Financials Index](#) Characteristics

GICS Sub-Industry Name	Weight	Estimated Price-to-Earnings Ratio	Price-to-Book Ratio	Median Total Return	
				(12/31/13-04/30/14)	(11/30/12-04/30/14)
WT Japan Hedged Financials Index	100.0%	10.6x	0.77x	N/A	N/A
Diversified Banks	30.6%	8.7x	0.75x	-20.9%	58.5%
Regional Banks	28.3%	11.8x	0.63x	-4.8%	27.7%
Property & Casualty Insurance	12.7%	12.2x	0.75x	-13.5%	66.0%
Investment Banking & Brokerage	8.4%	10.0x	1.07x	-29.0%	114.1%
Life & Health Insurance	6.7%	14.8x	0.82x	-15.4%	43.1%
Other Diversified Financial Services	5.2%	10.7x	1.07x	-20.0%	80.5%
Consumer Finance	3.6%	12.2x	1.29x	-14.8%	50.9%
Specialized Finance	3.6%	13.2x	1.28x	-21.5%	48.6%
Asset Management & Custody Banks	1.0%	8.6x	0.88x	-28.4%	93.7%

Sources: WisdomTree, Bloomberg, 04/30/14. The median is the value within a dataset at which 50% of all observations occur above and 50% occur below. You cannot invest directly in an index.

For definitions of indexes in the chart please visit our [Glossary](#). • The broader basket of Japanese financials represented by the WisdomTree Japan Hedged Financials Index (WTJFH) has more than 30% in diversified banks with an estimated P/E ratio of 8.7x and similar price-to-book ratio of 0.75x. • Another 28% of the WTJFH is allocated to regional banks like Resona with an estimated P/E ratio of 11.8x and even lower price-to-book ratio of 0.63x. • The broad index of WTJFH had a similar P/B ratio as Resona of 0.77x but higher P/E ratio at 10.6x. **Other interesting takeaways from the WisdomTree Japan Hedged Financials Index:** • **Investment Banking & Brokerage** – After strong returns in the 2013 calendar year, the capital markets industry was one of the biggest laggards in the WTJFH Index, with a median return of approximately -29%.³ Even though both Nomura Holdings Inc. and Daiwa Securities, two of the largest firms in the industry, reported strong increases in net income for the most recent fiscal year, they saw trading and investment revenue decline from their Q1 2013 highs. If Prime Minister Shinzo Abe is successful in stimulating [inflation](#), the hordes of cash held by households likely will enter risk assets in order to sustain purchasing power, which should ultimately benefit the industry. • **Divergence Among Banks** – The diversified banks industry includes two of the largest banks in Japan, Mitsubishi UFJ Financial Group and Sumitomo Mitsui Financial Group, which happen to be some of the lowest-priced banks from a price-to-

earnings perspective at 6.9x and 5.8x earnings, respectively⁴. But they have also been some of the worst performers in 2014, both down more than 20%⁵. These larger banks have been helped since the start of Abenomics from the earnings generated by their brokerage or investments businesses, which has actually detracted from performance year-to-date as their trading and investment revenue fall from the highs. The regional bank industry, which includes smaller-capitalization banks, was the best-performing industry year-to-date, but its performance hasn't been as high compared to other industries since Abenomics began. **Potential Opportunity** Another hedge fund investor, Mark Yusko, recently wrote about continuing to favor financials and exporters in Japan. He stated, "I am always struck that investing, oddly, is the only business I know where when things go on sale, people run out of the store, and the further the prices fall, the further they run. We are very content to stay in the Japanese equity store and continue to accumulate shares of great businesses at cheaper prices in a market that we anticipate will be the best performing developed market over the coming decade."⁶ Japan is one of the lowest-priced regional markets on a price-to-earnings basis and the only market that actually had earnings outpace price gains over the most recent year.⁷ I believe equity markets will remain supported as Abenomics continues to gain traction and especially as Abe makes more progress on his growth strategy for Japan (the "[third arrow](#)" of Abenomics). While broad-based approaches should continue to serve many investors well, those looking to allocate to the lowest-priced sector of the Japanese market should look to financials. For current holdings of the WisdomTree Japan Hedged Financials Index click [here](#).

¹Sources: WisdomTree, Bloomberg, 04/30/14 ²Source: Greenlight Capital, Q1 2014 Investor Letter ³Sources: WisdomTree, Bloomberg, 12/31/13-04/30/14 ⁴Sources: Bloomberg, 04/30/14 ⁵Sources: WisdomTree, Bloomberg, 12/31/13-04/30/14 ⁶Source: Morgan Creek Capital, Q4 2013 Market Review & Outlook ⁷Sources: WisdomTree, Bloomberg, 04/30/13-04/30/14

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Investments focused in Japan may increase the impact of events and developments associated with the region, which can adversely affect performance. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty.

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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.

Beta: A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Contrarian: Practice of seeing what the majority of market participants are focused on and attempting to look in the complete opposite direction.

WisdomTree Japan Hedged Financials Index: An index weighted by float-adjusted market capitalization, designed to provide exposure to Japanese financial companies while at the same time neutralizing exposure to fluctuations between the yen and the U.S. dollar.

Inflation: Characterized by rising price levels.

Third arrow policies: The part of Japan's Abenomics process of reform that is focused on structural changes intended to promote economic growth.