

DISSECTING THE JAPAN HEDGED EQUITY REBALANCE

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We think it is important to be mindful of how an annual rebalance back to an underlying fundamental such as dividends can help manage valuation risks. With market capitalization-weighted indexes, when constituents increase in price compared to other stocks, they gain greater weight and increase their impact on the performance of the index. WisdomTree Indexes employ a rules-based rebalancing mechanism that adjusts relative weights based on underlying dividend trends. This is all the more important as Japan transitions from a momentum-led market in 2013 toward a more traditional value opportunity that we believe Japan represents today. **Explaining the Rebalance Process** During the rebalancing process, which occurs once per year for each Index, the relationship between price change and dividend growth is measured. Dividend Growth is a key factor in determining which companies get increased weight at each rebalance. This is a crucial differentiating factor of WisdomTree's indexing approach. Below we outline how the annual screening data impacted the WisdomTree Japan Hedged Equity Index. We will compare its sector composition before the rebalance to its sector composition after. Additionally, we compare its underlying sector performance to the broad Index to look at the average performance of sectors that saw their weights increase or decrease. It is the interaction of dividend growth and price performance that provides the basis for determining which sectors tend to see increases or decreases in weight at the annual WisdomTree Index rebalance. Sectors that exhibit particularly strong performance must grow their dividends commensurately to maintain their weights. Sectors exhibiting weaker performance (assuming, of course, they're not reducing their dividends commensurately) could be more likely to have their weights increased. **WisdomTree Japan Hedged Equity Index (WTIDJH) Sector Changes**

	Sectors of WTIDJH	Prior Weight ¹	Sector Performance ²	New Weight ³	Change in Weight	Performance of Sector Relative to Index
Underperforming Sectors	Financials	6.4%	0.5%	11.9%	5.5%	-8.6%
	Consumer Discretionary	21.8%	3.2%	24.8%	3.0%	-5.8%
	Materials	8.9%	7.6%	9.2%	0.3%	-1.4%
Outperforming Sectors	Consumer Staples	9.3%	9.9%	9.1%	-0.3%	0.9%
	Health Care	10.2%	12.2%	8.1%	-2.1%	3.1%
	Industrials	27.0%	14.4%	23.1%	-3.9%	5.3%
	Information Technology	15.2%	15.2%	13.3%	-2.0%	6.2%
	Energy	1.0%	41.6%	0.5%	-0.5%	32.6%
Sectors That Underperformed		37.2%	3.8%	45.9%	8.7%	-5.3%
Sectors That Outperformed		62.8%	18.7%	54.1%	-8.7%	9.6%

Sources: WisdomTree, Bloomberg, as of 5/31/14. Past performance is not indicative of future results. You cannot invest directly in an index.

¹Index weight before 5/31/14 screening.

²Performance of specified sector from last year's rebalance date to 5/31/14.

³Index weight after rebalance, based on 5/31/14 screening.

• **Relative Value Rotation** – The sectors that underperformed the Japan Hedged Equity Index—Financials, Consumer Discretionary and Materials—saw weight increase from 37.2% before the rebalance to 45.9% afterward. That same total weight was reduced from the other five sectors that had outperformed the market by 9.6% on average. • **Financials Saw Largest Increase in**

Weight – An increase of 5.5%, which was driven primarily by the addition of Mizuho Financial Group and Tokio Marine Holdings. Other noticeable increases were Nomura Holdings and Mitsubishi UFJ Financial, which both displayed positive dividend growth over the period but saw negative performance. On aggregate, the sector was the worst performing over the period but displayed relatively high dividend growth, hence earning a higher weight. Other noticeable additions were in the Consumer Discretionary sector, which saw the highest total dividend growth but underperformed the broader index by almost 6 percentage points. • **Industrials and Health Care Saw Largest Reduction in Weight** – A decrease of 3.9% and 2.1%, respectively. These reductions were driven primarily by their comparatively strong performance but low relative dividend growth. Noticeable reductions within the Industrial sector were Fanuc Corp. and Sumitomo, which saw their prices appreciate greater than their dividends. **Conclusion** The wisdomTree annual rebalance is a key element of the added value of wisdomTree’s Index methodology and can help manage valuation risks. With market capitalization-weighted indexes, when constituents increase in price compared to other stocks, they gain greater weight and increase their impact on the performance of the index. wisdomTree Indexes use dividend growth as a key factor in determining which companies get increased weight at a rebalance. The dividend approach also tilts weight to higher-dividend-yielding stocks. With interest rates so low in Japan, we think the dividend yields on Japanese stocks are a compelling motivator for Japan’s households and institutions to increase their weight to Japanese equities over cash or bonds. One can see the current valuation statistics and dividend yield on the Japan Hedged Equity Index [here](#). To read the full research on our Japan Index rebalance, click [here](#).

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DEFINITIONS

Fundamentals: Attributes related to a company's actual operations and production as opposed to changes in share price.

Dividend: A portion of corporate profits paid out to shareholders.

Valuation risk: The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.

Momentum Stocks: Stocks characterized by high sensitivity to sentiment and perception of potential, with lower sensitivity to actual business operation.

Dividend growth: The growth in trailing 12-month dividends for the specified universe.