
BULLISH YEN? THINK JAPAN SMALL CAPS

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A major macro story in August has been the sharp appreciation of the yen following the Bank of Japan's rate hike, as well as the expectations for the Fed to start cutting rates in the U.S.

We often discuss currency hedging as a preferred way to own Japan as one can isolate exposure to the stocks from currency.

But what if you have a bullish view on the yen or just prefer being unhedged? We think more locally oriented small market capitalization stocks (small caps) could be well suited in stronger yen periods.

For some, small caps may bring memories of all the unprofitable companies sitting in the [Russell 2000 Index](#) and the higher volatility associated with these more speculative companies.¹

The story is quite different in Japan. Let's review the fundamental story and then focus on recent performance and a way to blend small caps in with other Japan exposure.

First, Let's Take a Look at Valuations

When we look at Japan small caps we note that WisdomTree has a specific Index that has been live since June 2006, the [WisdomTree Japan SmallCap Dividend Index](#). This Index selects the smaller-cap, dividend-paying companies in Japan and weights them on the basis of their cash dividends paid on an annual basis.

Considering:

- The dividend-weighted nature of the WisdomTree Japan SmallCap Dividend Index, and
- The fact that so many Japanese small-cap companies pay dividends

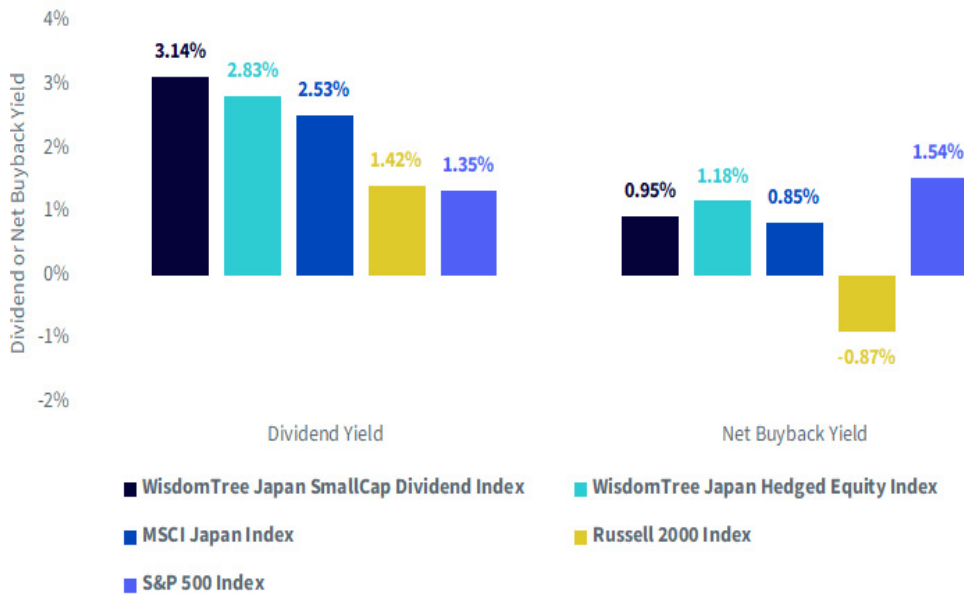
We end up with an Index that has a dividend yield twice that of the aforementioned Russell 2000 Index, shown in figure 1. The Russell 2000 Index is weighted based on market cap and a lot of U.S. small-cap companies do not pay dividends, so this comparison is telling us a key difference between small caps in these markets.

As we were building figure 1, we thought:

- The WisdomTree Japan SmallCap Dividend Index exemplifies Japan's small caps. It's important to be able to compare this to something with which U.S. investors are more familiar—their home-market small caps—with the Russell 2000 Index.
- Additionally, we want to be able to show how Japan's small caps compare to Japan's large caps, which is why we include the [WisdomTree Japan Hedged Equity Index](#) and the [MSCI Japan Index](#).
- Finally, most U.S. investors have the greatest familiarity with the [S&P 500 Index](#) benchmark, so we include that as another reference point, in this case for U.S. large caps.

All this said, we note that US small caps (Russell 2000 Index) are persistent share issuers due to unprofitable companies having to raise more equity to fund expenses (exemplified by a negative net buyback yield in figure 1). Japan small caps are seeing competitive buybacks with their large-cap peers. The 0.95% net buyback yield for the WisdomTree Japan SmallCap Dividend Index is in the same ballpark as that of the MSCI Japan Index and not too far behind that of the WisdomTree Japan Hedged Equity Index.

Figure 1: Japan’s Small Caps Offer Strong Fundamentals Related to Returning Capital to Shareholders through Dividends and Buybacks



Sources: WisdomTree, Bloomberg, FactSet. Data is as of 8/5/24, except in the case of the MSCI Japan Index’s net buyback yield, where data availability limits this statistic to month-end data as of 6/31/24. You cannot directly invest in an index. Return of capital is not guaranteed.

Increased dividends and buybacks—the primary avenues of returning cash to shareholders—represents one of our central theses for Japan’s equities. Actions from the Tokyo stock exchange could get companies to raise their price-to-book ratios above 1, thereby forcing change in the board rooms of Japanese companies.² Small caps have further to go than large caps for further actions.

Now, for Japan Small Caps’ More Local Business Orientation

Small caps are less susceptible to movements in the exchange rate and actually have delivered lower volatility than large caps over recent and long-term history.³

For large exporters, exemplified by a company like Toyota or Tokyo Electron, with large sales occurring outside of Japan, the yen becomes an important factor for earnings growth. These companies are also what most hedge funds and larger global investors trade to get their Japan exposure. This focus can bring more volatility.

To put some investment tools on the table to allow us to measure specific groups of companies:

- [WisdomTree Japan Hedged Equity Fund \(DXJ\)](#): This Fund is designed to track, before fees and expenses, the total return performance of the WisdomTree Japan Hedged Equity Index. The primary selection attribution is that every company needs to get less than 80% of its revenue from inside Japan, giving the strategy a tilt toward export-oriented, global companies. The strategy also includes only dividend-paying companies, weighted by cash dividends, but since almost all Japanese companies pay dividends, this is not a very selective criterion. Importantly, the “hedged” in both the Index and Fund name refers to neutralizing the currency exposure—specifically the movement in the exchange rate between the U.S. dollar and Japanese yen. The impact of this exchange rate is designed to neither help nor hurt returns.
- [WisdomTree Japan SmallCap Dividend Fund \(DFJ\)](#): This Fund is designed to track, before fees and expenses, the total return performance of the WisdomTree Japan SmallCap Dividend Index. The focus here is on excluding the larger-cap companies within Japan and getting the focus onto the smaller companies. The strategy includes only dividend payers, weighted by cash dividends, but is very broad due to the fact that most listed companies in Japan do pay dividends. This strategy includes exposure to both the underlying, small-cap stocks in Japan as well as the movement of the U.S. dollar versus the Japanese yen.
- [iShares MSCI Japan ETF \(EWJ\)](#): The largest exchange-traded fund (ETF) by assets under management that focuses on exposure to Japanese equities is the iShares MSCI Japan ETF, which tracks the total return performance of the MSCI Japan Index. Per MSCI’s methodology, this is a broad-market Japan equity index with exposure to large-cap and mid-cap stocks. The free-float market capitalization weighting does push more weight toward the largest companies. Additionally, there is exposure to movements in the U.S. dollar to Japanese yen exchange rate.

Blending Local and Global Companies of Japan?

We had a natural thought—what if a blend of locally oriented and globally oriented Japanese companies could be created?

We sought to consider taking [DFJ](#) and [DXJ](#):

- Allocations were meant to be 50% [DFJ](#) and 50% [DXJ](#), with a quarterly rebalancing frequency.
- There is a recognition that [DXJ](#) is exposed to globally oriented Japanese exporters and that it is neutralizing the currency exposure.
- There is a recognition that [DFJ](#) is exposed to locally oriented Japanese small caps and that is including the currency exposure.

We’d emphasize that this is for illustrative purposes seeking to create a baseline from which people can think about diversifying the business focus of different kinds of Japanese companies.

Figure 2: Performance

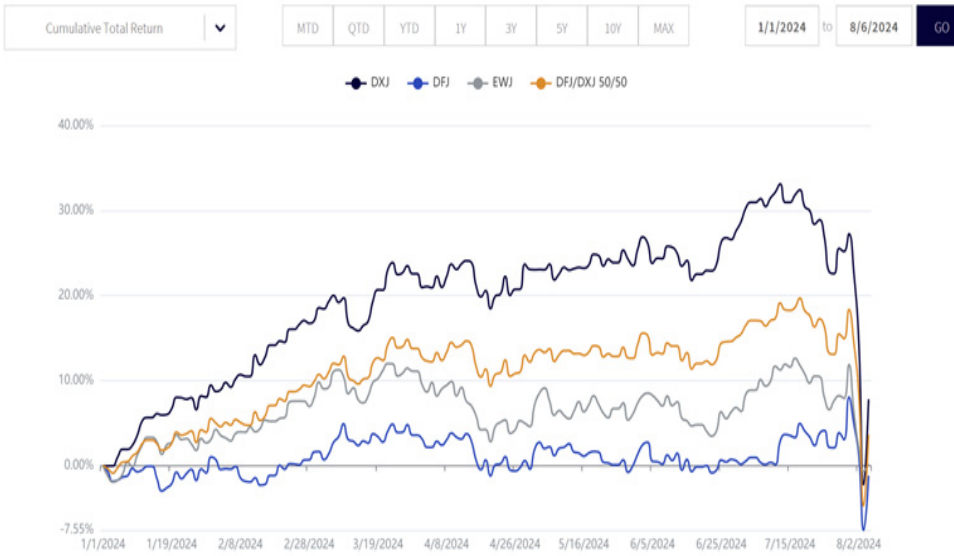
| Fund Name | Fund Ticker | Fund Expense Ratio | Fund Inception Date | Year-to-Date | 1-Year | 3-Year | 5-Year | 10-Year |
|---|-------------|--------------------|---------------------|--------------|--------|--------|--------|---------|
| Portfolio: DFJ/DXJ 50/50 (NAV) | N/A | N/A | N/A | 15.09% | 27.92% | 14.93% | 13.52% | 9.43% |
| WisdomTree Japan SmallCap Dividend Fund (NAV) Blend | DFJ | 0.58% | 6/16/06 | 0.60% | 14.67% | 2.94% | 5.02% | 5.57% |
| WisdomTree Japan Hedged Equity Fund (NAV) Blend | DXJ | 0.48% | 6/16/06 | 27.60% | 38.85% | 26.29% | 21.50% | 12.77% |
| WisdomTree Japan Hedged Equity Fund (NAV) | DXJ | 0.48% | 6/16/06 | 27.60% | 38.85% | 26.29% | 21.50% | 12.77% |
| WisdomTree Japan Hedged Equity Fund (MP) | DXJ | 0.48% | 6/16/06 | 29.21% | 39.14% | 26.64% | 21.68% | 12.82% |
| WisdomTree Japan SmallCap Dividend Fund (NAV) | DFJ | 0.58% | 6/16/06 | 0.60% | 14.67% | 2.94% | 5.02% | 5.57% |
| WisdomTree Japan SmallCap Dividend Fund (MP) | DFJ | 0.58% | 6/16/06 | 1.41% | 14.74% | 3.16% | 5.14% | 5.60% |
| iShares MSCI Japan ETF (NAV) | EWJ | 0.50% | 3/12/96 | 6.84% | 12.33% | 2.08% | 6.29% | 5.20% |
| iShares MSCI Japan ETF (MP) | EWJ | 0.50% | 3/12/96 | 7.19% | 12.63% | 2.15% | 6.35% | 5.22% |

Source: wisdomTree, specifically data from the Fund Comparison Tool in the PATH suite of tools, as of 6/30/24. NAV denotes total return performance at net asset value. MP denotes market price performance. **Past performance is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end and standardized performance and to download the respective Fund prospectuses, click the relevant ticker: [DFJ](#), [DXJ](#).**

We can see in figure 3:

- [DXJ](#), from the start of 2024 through July, had returned something close to 30%, cumulatively. Then, we have the massive downdraft, where the return drops to slightly negative. After August 5, which was the worst single day for Japan's equity performance going back to October 1987 (as we mentioned before), we saw a bit of recovery on August 6, which is shown there as well.
- [DFJ](#) did not even return 10%, cumulatively, through July 2024—so [DXJ](#) was the clear winner, at least until the big drawdown. [DFJ](#) benefited from being exposed to the yen's appreciation, which muted the equity drawdown occurring on August 5. EWJ also benefited from being exposed to this currency move.
- The 50/50 mix of [DFJ/DXJ](#) allows one to think about both locally oriented and globally oriented Japanese companies, and also allows one to be 50% exposed to the currency performance. For some, it could be a more complete way of thinking about Japan's equities, especially if they see positive attributes to the exposure.

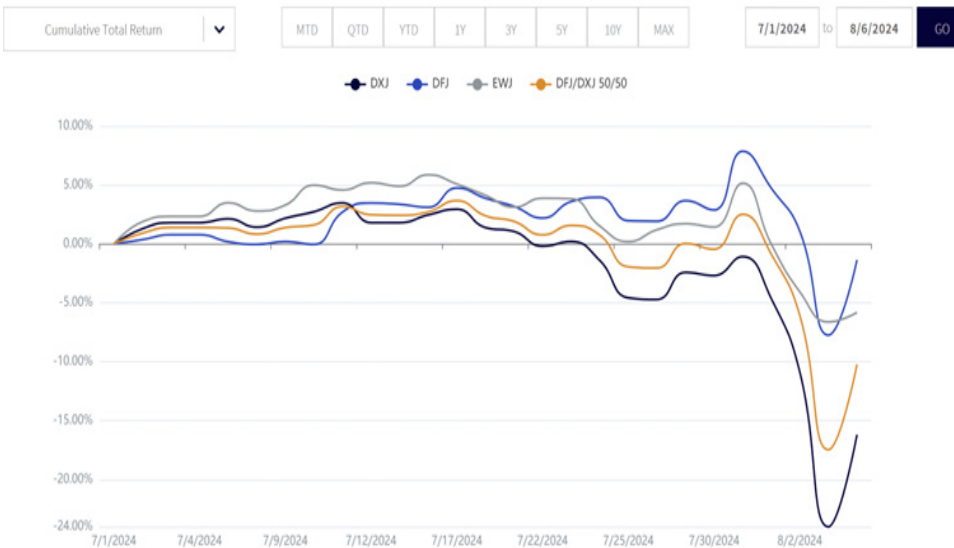
Figure 3: Year-to-date 2024 (January 1, 2024, to August 6, 2024)



Source: WisdomTree, specifically data from the Fund Comparison Tool in the PATH suite of tools, as of 8/6/24. NAV denotes total return performance at net asset value. MP denotes market price performance. Past performance is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end and standardized performance and to download the respective Fund prospectuses, click the relevant ticker: [DFJ](#), [DXJ](#).

Figure 4 drills down from figure 3 looking at the full year-to-date period to now, the third quarter 2024 to date period. Effectively, it zooms in on the drawdown. We can more clearly see how [DFJ](#) and [EWJ](#) benefited from being exposed to the yen's appreciation, which counteracted the drop in equity markets. Of course, the 50/50 [DFJ/DXJ](#) blend was somewhere between these and [DXJ's](#) return, which experienced the full equity market return with no mitigation.

Figure 4: Performance for Third Quarter 2024 to Date



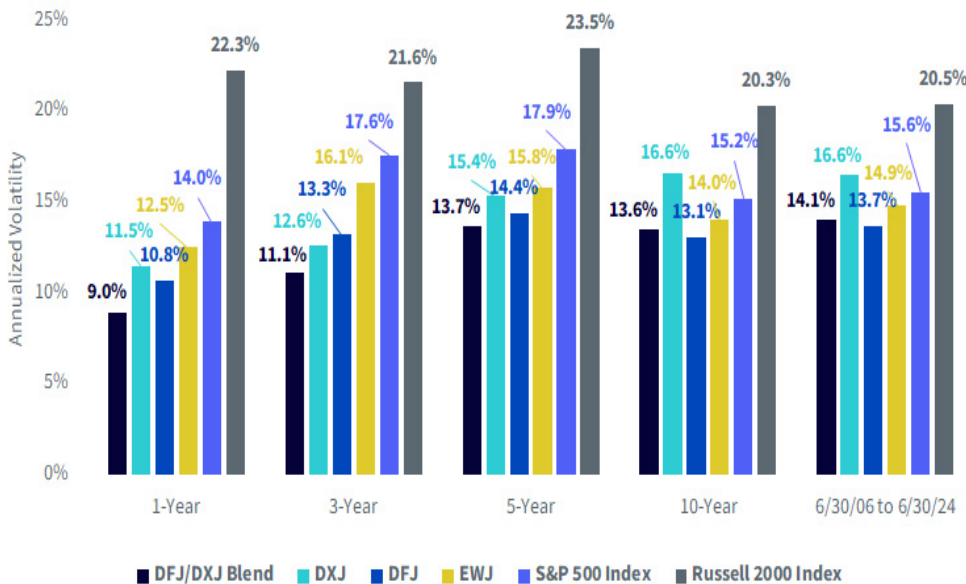
Source: WisdomTree, specifically data from the Fund Comparison Tool in the PATH suite of tools, for the period 7/1/24-8/6/24. NAV denotes total

return performance at net asset value. MP denotes market price performance. Past performance is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end and standardized performance and to download the respective Fund prospectuses, click the relevant ticker: [DFJ](#), [DXJ](#).

Are Japanese small caps too exotic? Frequently, "exotic" becomes somewhat of a dirty word in investment strategy depiction because the volatility is so far beyond more familiar exposures. What's notable is that Japan small caps are one of the lower volatility equity exposures one can include in a portfolio. We show this against the S&P 500 and Russell 2000 indexes—again, because these are measures with which U.S. investors are quite familiar. In figure 5:

- Over each of the periods shown, the annualized volatility of the returns of the Russell 2000 Index is much higher than all of the other strategies shown.
- Both [DFJ](#) and [EWJ](#) include exposure to different baskets of Japanese equities AND exposure to the movements in the exchange rate between the yen and U.S. dollar. Exposure to this exchange rate has tended to have a volatility-muting impact on equity baskets because at times when the equities are falling significantly, there has been a tendency for the yen to appreciate.
- [DXJ's](#) volatility is being driven solely by the basket of equities, as it is hedging the currency exposure.
- The [DFJ/DXJ](#) blend, which we introduced earlier, has indicated, for illustrative purposes, a notable volatility profile over the respective periods.

Figure 5: Comparison of Annualized Volatility



Source: WisdomTree, specifically data from the Fund Comparison Tool in the PATH suite of tools, for the period 6/30/06–6/30/24. NAV denotes total return performance at net asset value. MP denotes market price performance. You cannot directly invest in an index.

There is another avenue through which people can view Japan's small caps in order to better think about how risky they may be: Earnings. [WisdomTree's Fund Comparison tool](#) can take different baskets of equities and calculate an array of statistics. In

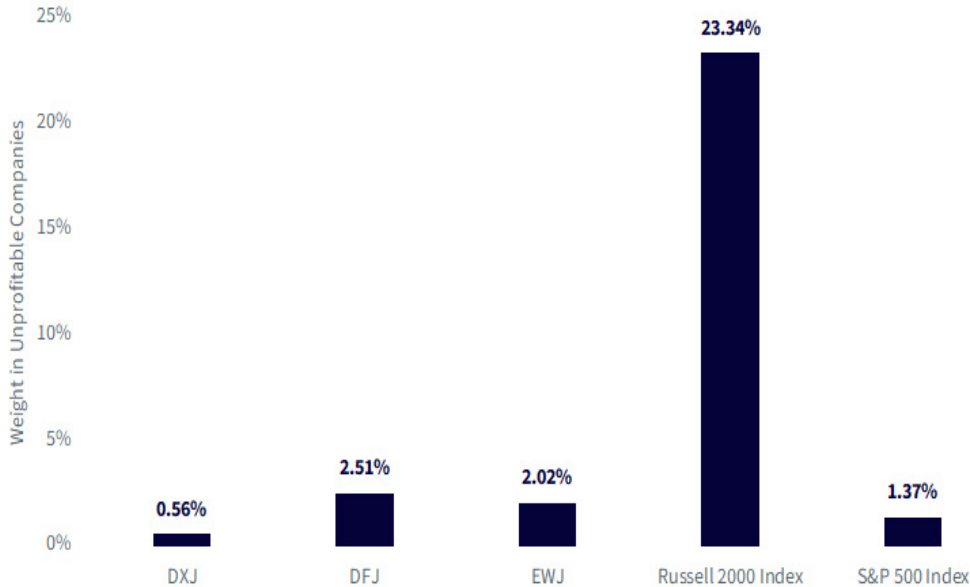
figures 5 and 6, we look at:

- Exposure to unprofitable companies
- Median earnings growth over one, three and five years

Figure 6 puts [DFJ](#) at a similar level as EWJ in terms of weight in unprofitable companies. Both [DXJ](#) and the S&P 500 Index have an even lower exposure to unprofitable companies—but not by massive amounts.

The standout number in figure 6 is that the Russell 2000 Index—which we show because we know that investors are far more familiar with U.S. small caps than Japan small caps—had a 23.34% exposure to unprofitable stocks.

Figure 6: Gauging Exposure to Unprofitable Companies



Source: WisdomTree, FactSet, with data accessed in WisdomTree’s PATH Fund Comparison tool as of 6/30/24. You cannot directly invest in an index.

Figure 7 allows us to look at median earnings growth within these same strategies. Again, the Russell 2000 Index stands out with a negative figure over one year, a figure above 28% over three years, and then a figure above 13.5% over five years. For each time period, it was either the highest or the lowest.

[DFJ](#) was more in the middle, with figures looking very similar to that of EWJ. On a three-year basis, it’s also interesting that the S&P 500 Index had a lower median earnings growth than [DXJ](#), [DFJ](#) and EWJ. When looking at medians and not weighted averages, the size of the so-called Magnificent 7⁴ is accounted for such that it does not skew the figures.

Figure 7: Median Earnings Growth

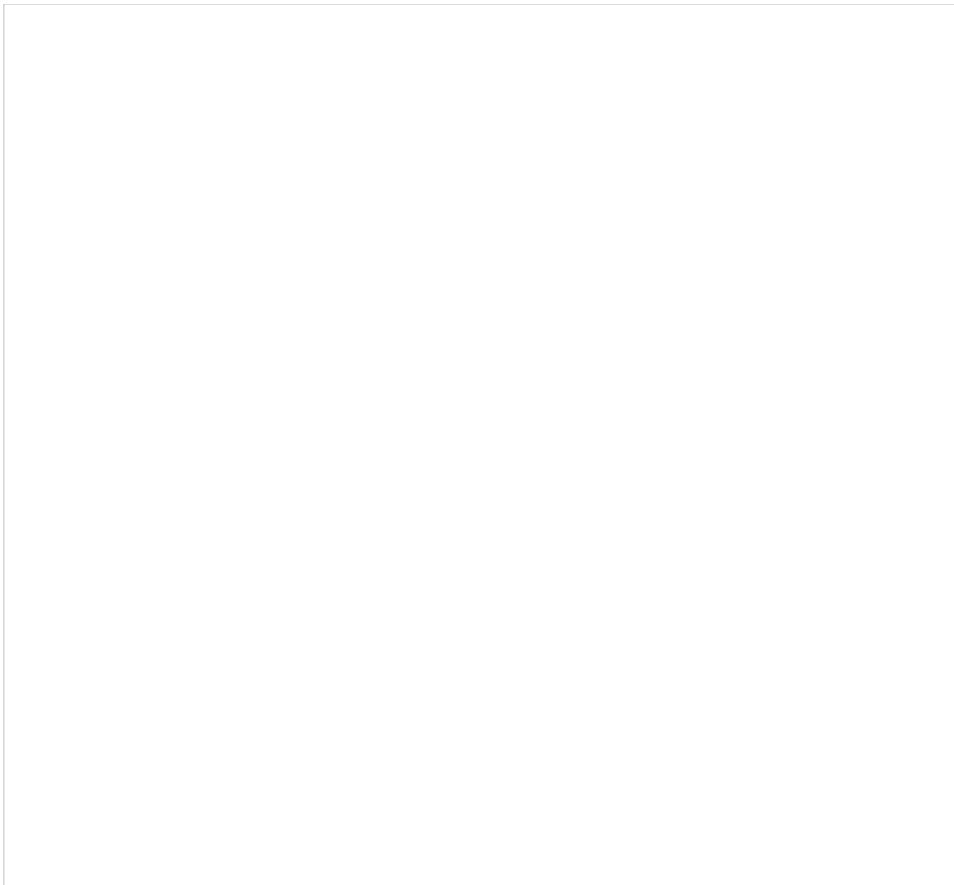


Source: WisdomTree, FactSet, with data accessed in WisdomTree's PATH Fund Comparison tool as of 6/30/24. You cannot directly invest in an index.

Conclusion: Japan Small Caps are Not as Exotic as They May Seem

We understand that many people may read these words and be thinking, wow, Japan small caps, a bit of an "esoteric allocation." We have attempted to indicate, through such figures as earnings behavior and volatility, that this may not be the case. We also note that if people are thinking about possible "yen strength," the local business exposure of Japan's small caps may be attractive.

Figure 8: Additional Information on the Funds Included in This Report



Sources: WisdomTree, iShares. Data was accessed on 8/7/24. Data availability for the [30-Day SEC Yield](#) was such that this figure was reported as of the most recent quarter-end, 6/30/24. Past performance is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end and standardized performance and to download the respective Fund prospectuses, click the relevant ticker: [DFJ](#), [DXJ](#).

¹ Source: FactSet, with data as of 7/31/24.

² Source: "Follow-up of Market Restructuring." *Japan Exchange Group*, 7/12/24, www.jpx.co.jp/english/equities/follow-up/02.html.

³ Source: MSCI, with standard deviation of returns measured in local currency terms between the MSCI Japan Index and the MSCI Japan Small Cap Index. From inception of the MSCI Japan Small Cap Index, 1/1/01, the standard deviation of monthly returns for the MSCI Japan Small Cap Index was lower through 7/31/24 than that of the MSCI Japan Index. Recent annualized 3-year standard deviation of the MSCI Japan Small Cap Index has also been lower.

⁴ Source: Refers to Microsoft, Amazon, Alphabet, Apple, Meta Platforms, Nvidia and Tesla.

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DXJ: There are risks associated with investing, including the possible loss of

principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Fund focuses its investments in Japan, thereby increasing the impact of events and developments in Japan that can adversely affect performance. Investments in currency involve additional special risks, such as credit risk, interest rate fluctuations and derivative investments, which can be volatile and may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. Due to the investment strategy of this Fund it may make higher capital gain distributions than other ETFs. Buybacks and dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

DFJ: There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing their investments on smaller companies or certain sectors increase their vulnerability to any single economic or regulatory development. The Fund focuses its investments in Japan, thereby increasing the impact of events and developments in Japan that can adversely affect performance. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of DXJ please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/dxj>

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Russell 2000 Index: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

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

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

SEC 30-Day Yield: The yield figure reflects the dividends and interest earned during the period, after deduction of the Fund's expenses. This is also referred to as the "standardized yield."