
BLENDING EMERGING MARKETS WITH JAPAN TO MANAGE VOLATILITY

Kyle Peterson – Research Analyst
02/16/2017

The last six years have brought no shortage of surprises, such as the [bear market](#) in commodities, divergent [monetary policies](#) and, most recently, the Trump presidency.

From a global markets perspective, there have been large dispersions in the returns of different regions around the world.

U.S. equity markets have generated impressive returns and far and away outperformed international markets such as Europe, Japan and emerging market (EM) equities.

This is clearly evident to us when we contrast the return profile of the [MSCI ACWI Index](#) (which includes the U.S. markets) and the [MSCI AC World ex-US Index](#) below. Even with the United States comprising just 50% of the exposure in the MSCI ACWI Index on average over the last seven years, this Index with the U.S. still managed to outperform the MSCI AC World ex-US by 416 basis points (bps), and it did so with 164 bps lower [volatility](#).¹

EM Drag

Emerging market equities were a significant drag on the performance of the MSCI AC World ex-US, culminating in extreme pessimism in January 2016. Since then, emerging market equities have staged a significant rally, leading many investors to reconsider their allocations.

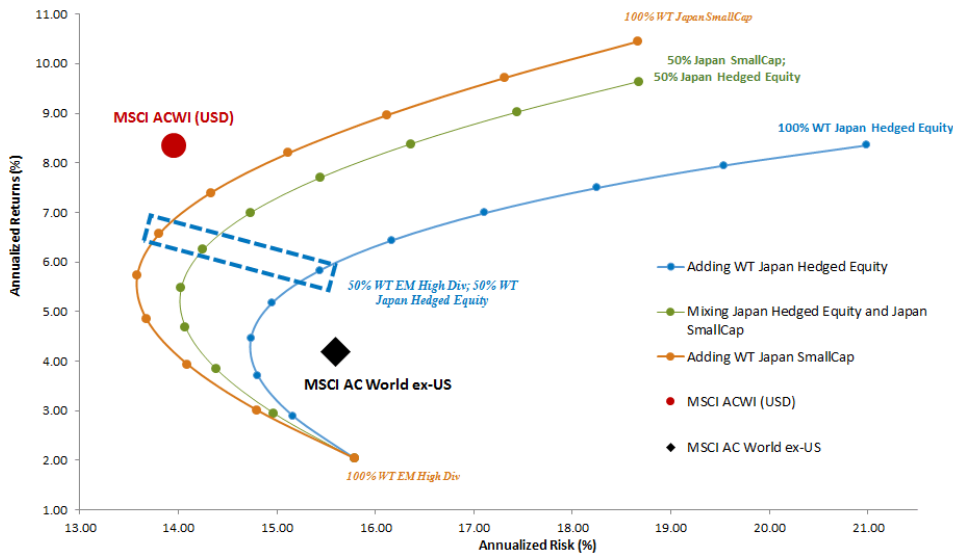
Japan, on the other hand, has maintained a strong fundamental backdrop to attract investment in both the large-cap exporters and domestically focused small-cap equities. The recent resurgence of interest in emerging market equities has led us to explore potentially complementary allocations.

What Emerging Markets and Japan Have in Common: China

Japan can be one of most cyclical areas of the market relative to trends in global growth. China, despite the competitive and strained ties portrayed in the media, is a large importer of Japanese goods and represents one of the growth drivers for Japan.

Below we exhibit a study of the risk and return characteristics of blending different WisdomTree Japan and emerging markets strategies.

Adding [WT EM High Dividend](#) to WT Japan Allocations
(2/1/2010–1/31/2017)



Index Blend	Adding WT Japan Hedged Equity Index		Mixing Japan Hedged Equity and Japan SmallCap		Adding WT Japan SmallCap Dividend Index	
	Ret (%)	Risk (%)	Ret (%)	Risk (%)	Ret (%)	Risk (%)
100% WT EM High Dividend Index	2.03	15.79	2.03	15.79	2.03	15.79
50% EM High Div; 50% WT Japan Blend ¹	5.83	15.44	6.26	14.25	6.57	13.81
100% WT Japan Hedged Equity Index	8.36	20.98	9.63	18.67	10.45	18.66

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

¹Mix is a 50/50 equal-weighted split of allocations to Japan Hedged Equity Index and Japan SmallCap Dividend Index returns

For definitions of indexes in the chart, visit our [glossary](#).

Complementing Your Exposures

This analysis looks at different ways of constructing global ex-U.S. combinations of exposure.

Achieving Lower Volatility than the MSCI AC World ex-US

1. **Japan Hedged and EM Blends:** Despite both Japan and emerging markets having individually high levels of volatility, a unique 50/50 blend of the [WisdomTree Japan Hedged Equity Index](#) (WT Japan Hedged Equity) and the [WisdomTree Emerging Markets High Dividend Index](#) (WT EM High Div) had a lower volatility than the MSCI AC World ex-US and higher returns over this period. One particularly interesting comparison is that of the 50% WisdomTree EM High Dividend Index and 50% WisdomTree Japan Hedged Equity Index, which returned 5.83% compared to the MSCI AC World ex-US's 4.19% with less volatility.
2. **Lowering Risk Further:** The [WisdomTree Japan SmallCap Dividend Index](#) (WT Japan SmallCap), which does not hedge the yen, had strong returns and a lower volatility profile than the WT Japan Hedged Equity Index. Adding this into combinations of emerging markets would have provided strong risk mitigation over this period. The WisdomTree Emerging Markets High Dividend combined with the unhedged WisdomTree Japan SmallCap Dividend Index is the orange line in the chart, and a 50/50 blend of the two, WT Japan SmallCap and EM High Dividend, returned 6.57% compared to the MSCI AC World ex-US of 4.19%.
3. The line in green shows the blending of a 50/50 split of Japan Hedged Equity and Japan SmallCap Dividend allocation at one end and EM High Dividend on the other end. This shows a realistic allocation to Japan that is tuned into the weakening yen and its potential benefits to exporters as well as Team Abe's commitment to generating growth at home, which small caps stand to benefit from. For those who believe the

yen is going to be a critical driver of Japanese markets, this combination could be a good middle ground of Japanese exposure.

In the case of the WisdomTree Japan Hedged Equity Index, the EM portion benefited from having the U.S. dollar hedge by lowering the net dollar exposure of the blend. [This is a point that Jeremy Schwartz has brought up before](#) when addressing a strong U.S. dollar. Contrast this with the WisdomTree Japan SmallCap Dividend Index, which is unhedged and better represents a locally focused view on Japan.

Hedging the yen has added to volatility for Japanese exposures due to the negative [correlation](#) between Japanese stocks and the currency. The properties of the yen when unhedged on the WT Japan SmallCap, combined with the WT Japan Hedged Equity (a strong dollar play) and the WT EM High Dividend (a weak dollar beneficiary), provide a unique set of international exposures.

¹Sources: WisdomTree, Bloomberg, 2/1/10–1/31/17.

Important Risks Related to this Article

Investments focused in Japan increase the impact of events and developments associated with the region, which can adversely affect performance.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only. You cannot invest directly in an index.

DEFINITIONS

Bear market: A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Monetary policy: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

MSCI ACWI Index: A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

MSCI AC world ex-US Index: Measures the performance of companies incorporated in both emerging markets and developed markets, excluding the United States. Index weighting is by market cap.

volatility: A measure of the dispersion of actual returns around a particular average level.

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.

Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.