

A SURPRISINGLY LOW-VOL ASSET CLASS

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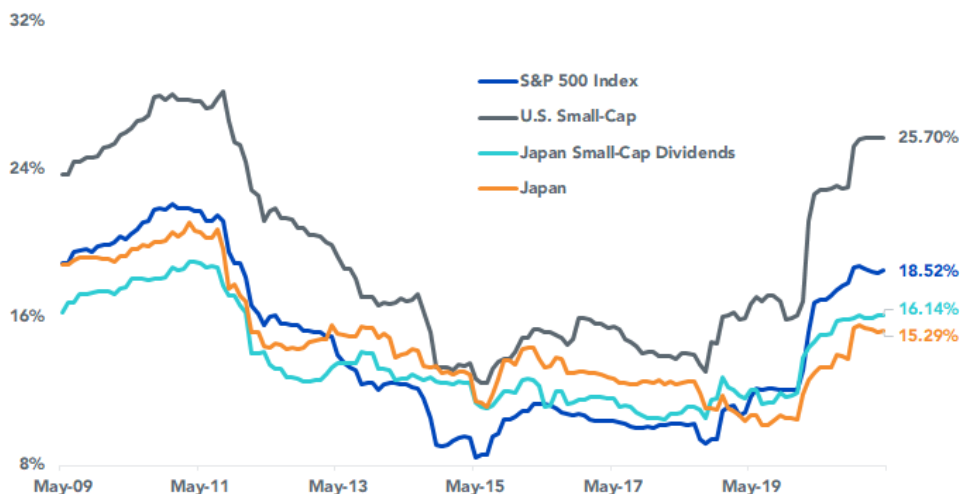
Relative [valuation](#) discounts typically reflect higher [volatility](#), slower [earnings growth](#) and/or less predictable earnings.

When investors think of foreign [small-cap](#) equities, they often intuitively expect discounted valuations relative to U.S. [large caps](#), to compensate for higher volatility. While we are seeing discounted valuations in foreign small caps, these discounts are not necessarily driven by higher volatility.

Looking at rolling three-year standard deviations, the [Russell 2000 Index](#) clearly has higher volatility than the [S&P 500 Index](#). But Japanese small caps generally have been lower vol than U.S. large caps for much of the last decade and considerably lower vol than U.S. small caps.

Relative to Japanese large caps—an important comparison as both indexes are measured in U.S. dollars and the risk-off nature of the yen dampens volatility relative to local currency returns—small caps had only modestly higher volatility in the most recent period, but they have had lower volatility over most of this time frame.

Rolling 36-Month Standard Deviation

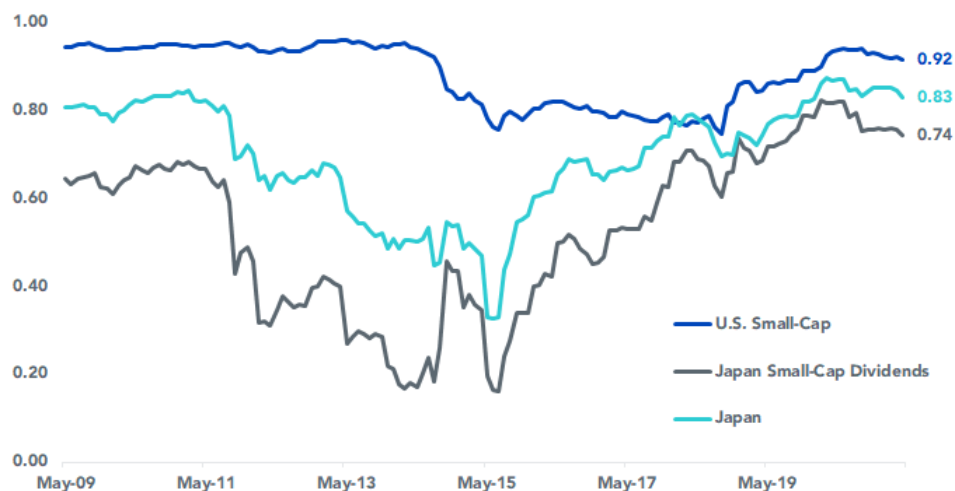


Sources: WisdomTree, FactSet, Russell, 5/31/09–4/30/21. U.S. Small Cap = Russell 2000 Index. Japan Small-Cap Dividends = WisdomTree Japan SmallCap Dividend Index. Japan = MSCI Japan Index. Inception date of the WisdomTree Japan SmallCap Dividend Index was 6/1/06. Past performance is not indicative of future results. You cannot invest directly in an index.

Are Japanese Small Caps Good Diversifiers?

The Russell 2000 consistently prints [correlations](#) to the S&P 500 above 0.9. The Japanese small cap market is one of least correlated to the S&P 500, even though it has risen from as low as a 0.16 correlation.

Rolling 36-Month Correlation (to S&P 500 Index)



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The lower correlation and lower volatility yield a [beta](#) to the S&P 500 that consistently has been roughly half that of the U.S. small-cap market. If looking for market exposure with less S&P 500 beta, Japan small caps represent that.

Rolling 36-Month Beta (to S&P 500 Index)



Sources: WisdomTree, FactSet, Russell, 5/31/09–4/30/21. U.S. Small Cap = Russell 2000 Index. Japan Small-Cap Dividends = WisdomTree Japan SmallCap Dividend Index. Japan = MSCI Japan Index. Inception date of the WisdomTree Japan SmallCap Dividend Index was 6/1/06. Past performance is not indicative of future results. You cannot invest directly in an index.

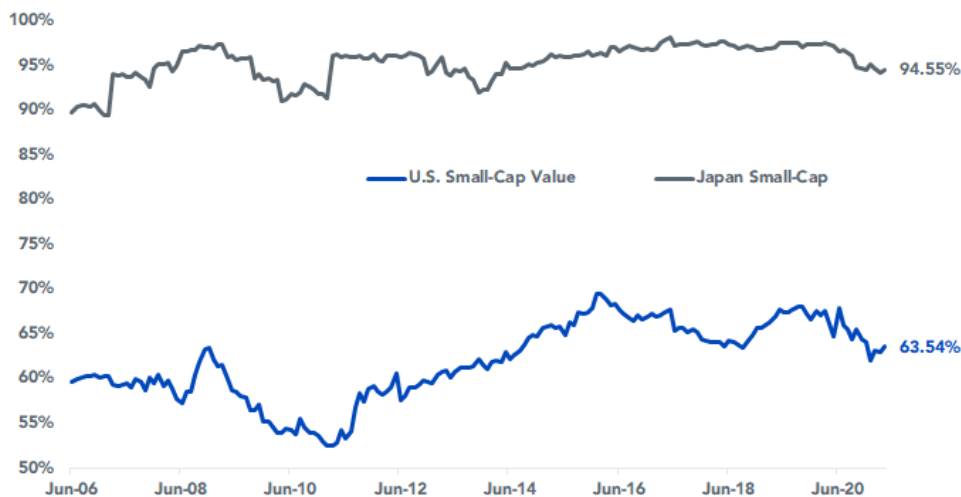
What Contributes to the Lower Vol?

For one: dividend payers.

In the U.S., we don't think of small caps as dividend payers—the Russell 2000 Value Index has less than two-thirds of its index weight in dividend payers. In Japan, 95% of the weight of small caps is dividend payers.

What is more, their dividends were more stable during the COVID-19 pandemic than U.S. small caps that were slashing dividend payouts. This was partly because Japanese companies have more cash on their balance sheets and more conservative payouts to cushion dividends from cuts.

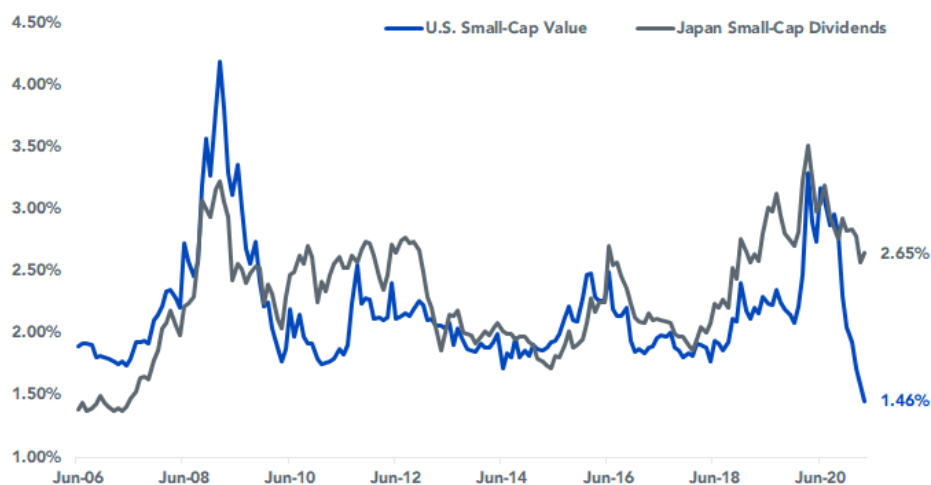
Percent Index Weight in Dividend Payers



Sources: WisdomTree, FactSet, Russell, MSCI, 6/30/06–4/30/21. U.S. Small-Cap Value = Russell 2000 Value Index. Japan Small Cap = MSCI Japan Small Cap Index. Past performance is not indicative of future results. You cannot invest directly in an index.

If you go back a decade, the average [dividend yield](#) of U.S. small-cap value stocks was higher than that of Japanese small caps. No longer—and the gap has widened considerably with strong dividend growth in Japan.

Dividend Yield

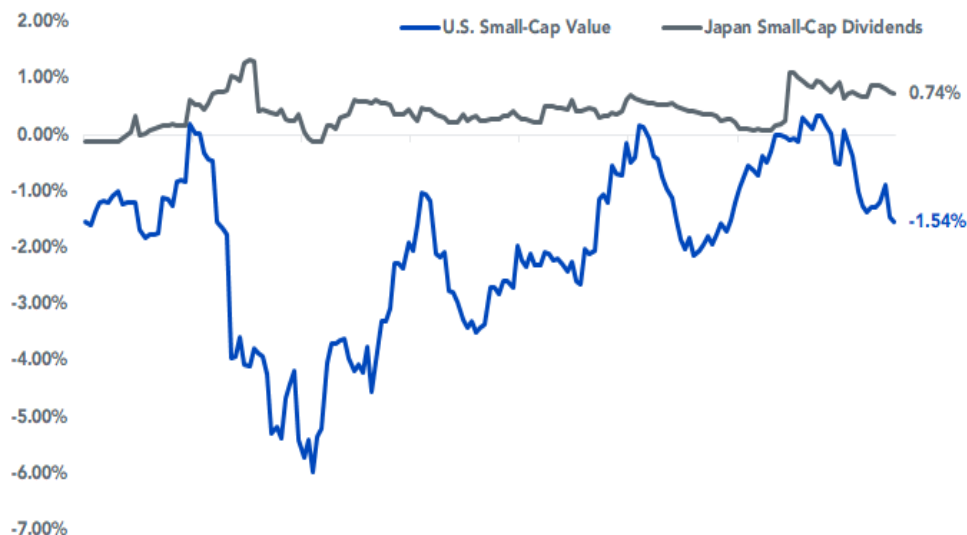


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Another factor that contributes to lower volatility is net share buybacks. The net buyback yield for U.S. small-cap value stocks has been consistently negative, and increasingly so in recent years. This means these companies are net share issuers, diluting existing shareholders.

Japanese small caps on the other hand are net share purchasers, in addition to having higher dividend yields. Share buybacks can dampen volatility by providing a source of demand to offset selling when uncertainty picks up.

Net Buyback Yield



Sources: WisdomTree, FactSet, Russell, 6/30/06–4/30/21. U.S. Small-Cap Value = Russell 2000 Value Index. Japan Small-Cap Dividends = WisdomTree Japan SmallCap Dividend Index. Inception date of the WisdomTree Japan SmallCap Dividend Index was 6/1/06. Past performance is not indicative of future results. You cannot invest directly in an index.

While higher dividends and share buybacks may be contributing to dampened volatility for Japanese equities, the [price-to-earnings](#) ratio gap is also widening between the two markets—partly driven by more money-losing companies in the U.S. value segment.

Est Price to Earnings

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The Japanese domestic economy is one of the most sensitive economies to global economic prospects. This has the negative consequence of choppy economic growth for the Japanese economy and has hampered valuation expansion in the country's equities.

With that said, corporate profitability has improved significantly since 2012, and has been substantially higher than for U.S. small caps.

Return on Equity

Figure 7_Return on Equity_v2



Conclusion

As a market with surprisingly low volatility, depressed relative valuations to even the best value U.S. small caps and high relative profitability, Japanese small caps may deserve consideration by value-starved asset allocators.

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](#).

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DEFINITIONS

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

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

Earnings growth estimates: Bloomberg analysts' long-term earnings growth expectations, which encompass the estimated growth in operating earnings per share over the company's next full business cycle, typically three to five years.

Small caps: new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Large-Capitalization (Large-Cap): A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

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.

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.

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.

Dividend yield: A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.