BANK OF JAPAN INCREASES ETF PURCHASES AND EXTENDS DURATION

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Last Friday, the Bank of Japan (BOJ) decided to adjust its monetary policy. The policy board voted to keep constant the level of balance sheet growth at ¥80 trillion per annum, but it voted to change the “quality” of its future asset purchases: it added a new exchange-traded fund (ETF) buying budget that potentially encourages smart beta ETF product development in Japan; and it raised the maximum maturity of its Japanese government bond (JGB) buying from 10 years to 12 years, thus extending the reach of “Operation Twist” that may ultimately keep the yield curve flat. While we applaud the BOJ’s attempt to signal a more sophisticated portfolio rebalancing approach to the market, the move can only be viewed as fine-tuning and technical. **Pragmatism, not the Return of Complacency and Incrementalism** Japan’s market sold off after the announcement. But we very much caution against interpreting this move as the return of old-style BOJ gradualism and complacency, which, in the perception of many investors, marked BOJ policy before Governor Kuroda took over in early 2013. Why? Friday’s decision was driven by Governor Kuroda’s strategic pragmatism, in our view. First of all, it is entirely consistent with the BOJ’s modestly upbeat assessment of current economic conditions and future outlook. Importantly, on inflation expectations, the board reconfirmed its statement that some indicators have recently shown relatively weak developments[1]. Governor Kuroda has stressed time and again that inflation expectations are the key determinant for success or failure of his policy; “…relatively weak developments” keeps the door open for added action, in our view. More to the point, Friday’s decision is very prudent. After all, the same week brought fundamental change in monetary policy from Japan’s key financial and economic partners: the Federal Reserve (Fed) raised rates, and China changed its currency policy. In this context, policy makers in the third largest global economy are smart to adopt a stance of watchful waiting. In short: Japan is keeping its powder dry in case the Fed’s and/or China’s moves begin raising deflation risks. If global conditions push the aforementioned “relatively weak developments” (for inflation expectations) further downward, the BOJ will not hesitate to counter with a decisive quantitative boost, in our view. We maintain our call for added monetary easing to be in place by April-May, i.e., a boost in the ¥80 trillion balance sheet growth target or the introduction of negative interest rates. **Quality Easing—Encouraging Smart Beta ETFs and Extending “Operation Twist”** So while quantitative easing was put on hold, here are the qualitative easing decisions that were made: • The ETF buying program will be expanded by ¥300 billion, from ¥3 trillion to ¥3.3 trillion. The added ¥300 billion will be invested from April 2016 on. ¥3 trillion of ETF purchases will continue to buy Nikkei 225, TOPIX and JPX400. • While the new ¥300 billion ETF budget will include the purchase of JPX400 ETFs; the goal is to buy ETFs that specifically focus on firms that proactively invest in human and productive capital. • We interpret the new ETF budget as the BOJ’s endorsement of more innovation and product development for Japan’s ETF/smart beta providers. Note that there are no smart beta, fundamentally weighted or theme-based ETFs listed in Japan —and that the BOJ will purchase only Tokyo-listed Japan ETFs. The only listed ETFs are of the major indexes—TOPIX, Nikkei 225 and JPX400—and ETFs tracking the standard industry sub-sectors of these indexes (with the latter being highly illiquid). • The

BOJ keeps fixed its JGB bond-buying budget at a rate of ¥80 trillion per annum • The BOJ raises the maturity of eligible JGBs from 7–10 years to 7–12 years • In short: more ammunition for “Operation Twist” to flatten the yield curve beyond 10 years • The BOJ will also accept as eligible collateral for BOJ credit 1) foreign currency-denominated loans on deeds; and 2) housing loans • The BOJ will maintain its real estate investment trust (REIT)-buying budget at ¥90 billion but will raise the maximum it can buy of any one REIT security from 5% to 10% of total outstanding. [1]BOJ Policy statement, December 2015.

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DEFINITIONS

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.

Maturity : The amount of time until a loan is repai.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Inflation : Characterized by rising price levels.

Deflation : The opposite of inflation, characterized by falling price levels.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Nikkei 225 Stock Average Index : A price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

Tokyo Stock Price Index (TOPIX) : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

JPX-Nikkei 400 : is composed common stocks whose main market is the TSE 1st section, 2nd section, Mothers or JASDAQ market (in principle). The components are reviewed annually to keep the representativeness of the market. The Annual Review shall be conducted at the end of August as follows.(1)1000 stocks are selected based on trading value in the past 3 years and the market value on the selection base date (the end of June) of the Annual Review, (2)Each stock is scored by 3-year average ROE, 3-year cumulative operating profit and market value on the selection base date with the weights on the each indicator 40%, 40%, 20% respectively, (3)400 stocks are selected by the final ranking with the scores calculated in (2) and qualitative factors from the perspectives of corporate governance and disclosure. In case of delisting of the components due to a merger or bankruptcy etc, new stocks shall not be added in principle. When the Annual Review is conducted, the number of components is back to 400, therefore the index is calculated with less than 400 components until then.

Illiquidity : The state of a security or other asset that cannot easily be sold or exchanged for cash without a substantial loss in value. Illiquid assets also cannot be sold quickly because of a lack of ready and willing investors or speculators to purchase the asset. The lack of ready buyers also leads to larger discrepancies between the asking price (from the seller) and the bidding price (from a buyer) than would be found in an orderly market with daily trading activity.

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.