ONE WAY TO MANAGE SMALL-CAP VALUATION RISK

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A common refrain we hear across all different types of investors is this: "U.S. equity markets are becoming expensive."

The fact is that U.S. equity returns have been strong for an extended period, and many market analysts are thinking that they won't be able to continue their strong run indefinitely.

What Contributed to the U.S. Rally We've Witnessed?

If we take a step back and assess some of the factors contributing to the strong U.S. equity run, we may be able to locate those—or at least similar—conditions beginning to show themselves in other markets. These markets could be ripe for a similar run, potentially in the future, at least if history is any guide.

- **Low Interest Rates & Easy Monetary Policy for an Extended Period:** The U.S. Federal Reserve (Fed) has only just begun to normalize the size of its balance sheet and raise the Fed Funds policy interest rate. Since the global financial crisis of 2008–09, there has been nearly a full decade of easy monetary conditions in the U.S., and though we don't believe that is the sole determinant of higher equity markets, it was certainly an important factor.
- **Recent Reduction in Regulations:** Among the Trump administration's policy priorities is the reduction in regulations to make it easier for firms to do business. It's possible that less regulatory restriction could help allow productivity to rise off the very low levels we've seen of late. That may have the potential to extend the U.S. equity rally that has been intact for almost 10 years.
- **Massive Innovation in Technology Firms:** Hardly a day that goes by that at least one of the following "F-A-N-G" (Facebook-Amazon-Netflix-Google) companies isn't mentioned. These companies have shaken up how many things—for instance, buying Thanksgiving dinner—are done. While the performance of these companies has been incredibly strong, it is very difficult to say that these firms are in a bubble akin to what we saw at other companies in the 1999–2000 period, which we now know of as the "tech bubble."

Abenomics Might Create a Similar Set of Conditions in Japan

On December 16, 2012, Prime Minister Shinzo Abe began his tenure. Since then, over a period of almost five full years, we have seen:

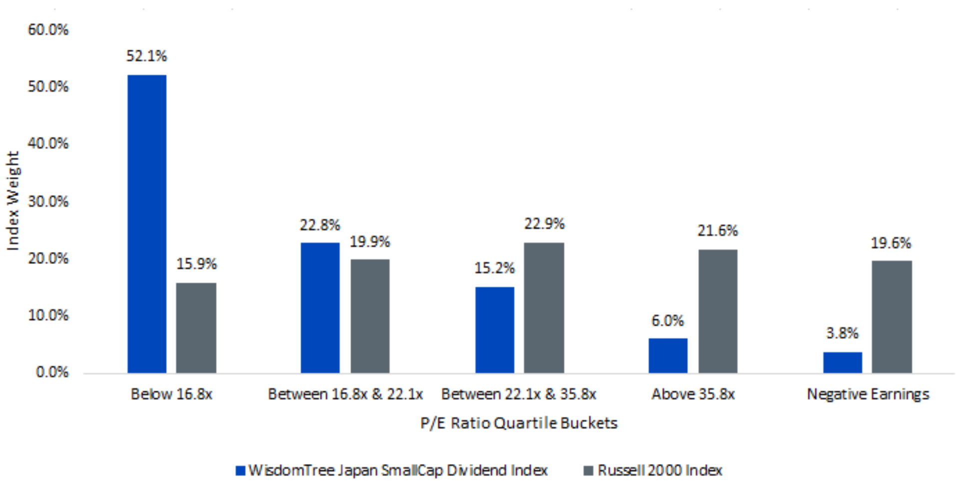
- **Exceptionally Easy Monetary Policy:** The Bank of Japan (BOJ) saw the U.S. example from the Fed and has since taken it many steps further. For example, instead of stating a specific purchase amount of monetary expansion for each month, the BOJ has committed to buying an unlimited number of Japanese government bonds (JGBs) such that yields to the 10-Year tenor are close to 0%.[1] This is in addition to buying equities and real estate.
- **Encouragement of Using Cash & Improving Corporate Governance:** One of the biggest issues in Japan has been corporate governance and the lack of utilization of cash on corporate balance sheets. We're seeing buybacks and dividends increase,[2] and we're also seeing capex (which we wrote about in our "Japan GDP: Into the Sweet Spot" article accelerating.[3]
- **Cutting Corporate Taxes:** As of this writing, we're waiting to see what, if anything, will be announced in terms of U.S. corporate tax policy changes. Notably, Japan has been lowering its corporate tax rates during the Abenomics period.[4]
- **Massive Innovation:** Japanese firms are some of the most technologically advanced in the world. We've seen lots of activity in health care and biotech (which makes a lot of sense with such an "old" society), as well as in other areas like ship-building.

Small Caps: Emphasize Favorable Conditions in a Given Market

Large-cap companies are becoming more and more global, so it is increasingly difficult to attribute their success or failure to activities in their country of domicile. The S&P 500 Index in 2017 is a great example—we haven't seen much in the way of favorable fiscal policy momentum in 2017 as of this writing, but a weaker U.S. dollar has been a boon for earnings on the export side of the equation.

Similarly, in Japan, companies such as Honda, Toyota, Nissan and Panasonic are global multinationals that will be impacted by economic prospects in the U.S., Europe, China and other countries rather than solely focused on any Abenomics-related developments. Japan's small caps tend to be much more locally focused.

Price-to-Earnings Ratios for Japan's Small Caps Are Much Lower than for U.S. Small Caps

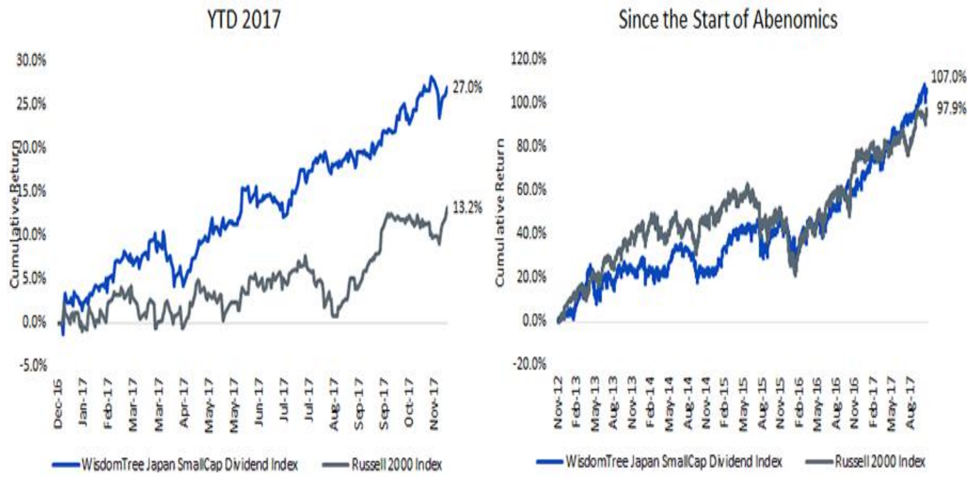


Sources: WisdomTree, Bloomberg, with data as of 11/21/17. You cannot invest directly in an index.

- The WisdomTree Japan SmallCap Dividend Index has more than 50% of its weight in firms with P/E ratios below 16.8x. The Russell 2000 only has 15.9% of its weight in such firms.
- The Russell 2000 Index has approximately 20% of its weight in firms with negative earnings over the prior 12 months. The WisdomTree Japan SmallCap Dividend Index has less than 4% of its weight in such firms.

Now, we can hear what you're saying: "Of course that is the case. The WisdomTree Japan SmallCap Dividend Index looks significantly less expensive than the Russell 2000 Index because the Russell 2000 Index's performance has been THAT much better over the past five years."

Even with More than 25% Yen Depreciation, Japan's Small Caps Factoring in Yen Weakness Still Look Strong during the Abenomics Period



Sources: WisdomTree, Bloomberg. You cannot invest directly in an index. YTD 2017 is from 12/31/16 to 11/21/17. Since the start of Abenomics is from 11/30/12 to 11/21/17.

- It’s hard to imagine anything outperforming the strength of U.S. small caps during the last five years, which happens to just about coincide with the Abenomics period. But even though the yen dropped by more than 25% versus the U.S. dollar, the WisdomTree Japan SmallCap Dividend Index, which is unhedged and has exposure to the weakening yen over this period, actually beat the Russell 2000 Index. It’s also beating it during 2017. The fact that the Japanese exposure is still less expensive on a P/E basis is therefore confirming that the earnings in Japan over this period have been THAT much stronger.

While the analysis presented here discusses the unhedged WisdomTree Japan SmallCap Dividend Index, we also have Indexes that neutralize the yen’s impact from equities with the same underlying basket of stocks. For those value-oriented investors looking for small-cap diversification, WisdomTree remains a big fan of Japanese small caps.

[1]Source: “New Framework for Strengthening Monetary Easing: Quantitative & Qualitative Monetary Easing with Yield Curve Control,” Bank of Japan, 9/21/16.

[2]Sources: Bloomberg, FactSet, with data from 11/30/12 (start of Abenomics period) to 10/31/17.

[3]Sources: Department of National Accounts, Economic and Social Research Institute, Cabinet Office, as of 6/30/17.

[4]Sources: Bloomberg, KPMG. Data is for full period of data availability from 12/31/1997 to 12/31/2017—but note the data is lagged one year. Past performance is not indicative of future results.

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.

Investments focusing on certain sectors and/or smaller companies may be more vulnerable to any single economic or regulatory development.

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You cannot invest directly in an index.

DEFINITIONS

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

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.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Normalization : The process by which a policy or action returns to its historically normal levels.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Fed Interest Rates : Refers to the Federal Funds Rate, which is the rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Bubble : when market participants drive stock prices above their “fair value” in relation to some system of stock valuation.

Abenomics : Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan’s economic growth.

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.

Buyback : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

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

Capex : Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations.

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

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.

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.

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.

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.