

FLows POTENTIAL: FUND MANAGERS REMAIN UNDER WEIGHT JAPAN

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The recent bout of aggressive [monetary policy easing](#) by the Bank of Japan (BOJ), combined with the direct purchases of equities by the Japanese Government Pension Investment Fund (GPIF), has brought on a new period of positive sentiment toward Japanese equities. In [previous blog posts](#), we have outlined the direct buying by the BOJ and GPIF and how that should translate to greater inflows into Japanese equities. We have maintained that equity [valuations](#) remain supportive for the Japanese markets and want to discuss another set of [market participants](#) who may be looking to add exposure to Japan: mutual fund managers in the U.S. operating global portfolios who appear to us to be still under-weight Japan in their portfolios. Some have described Japan as a crowded trade, in that many investors were already “all-in” in 2013 with strong inflows of \$150 billion in terms of foreign investor purchases. However, our review of the U.S. mutual fund data—based on funds that offer information about country allocations—shows that money managers are still under-weight Japan compared to more passive foreign indexes that allocate based on [market capitalizations](#). Below we discuss some key takeaways that summarize flow data in both the [open-ended](#) and exchange-traded fund (ETF) space—while maintaining a focus on Japanese equity allocations. **Japan Equity Allocations and AUM across Broad-Based Open-Ended and ETF Funds Domiciled in the U.S.**

AUM of U.S.-Domiciled Japanese-Centric Funds (bn USD)	Dec-11	Jun-12	Dec-12	Jun-13	Dec-13	Jun-14	Sep-14
Open Ended Funds	\$2.02	\$1.97	\$1.88	\$2.62	\$2.95	\$4.00	\$4.17
ETF	\$6.33	\$6.21	\$6.94	\$21.64	\$27.98	\$26.59	\$26.77
Total AUM	\$8.35	\$8.18	\$8.82	\$24.26	\$30.93	\$30.59	\$30.95
U.S. Domiciled Broad-Based Open-Ended Funds	Dec-11	Jun-12	Dec-12	Jun-13	Dec-13	Jun-14	Sep-14
US OE Foreign Large Caps	13.48%	13.73%	12.72%	14.85%	14.31%	14.08%	13.77%
Total AUM(bn USD)	\$564.27	\$607.69	\$690.90	\$748.75	\$924.82	\$1,028.85	\$811.01
U.S.-Domiciled Broad-Based ETF Funds	Dec-11	Jun-12	Dec-12	Jun-13	Dec-13	Jun-14	Sep-14
US ETF Foreign Large Caps	18.77%	18.42%	16.77%	19.35%	17.81%	16.71%	17.58%
Total AUM (bn USD)	\$55.97	\$55.60	\$66.36	\$72.47	\$96.64	\$107.96	\$105.08
OE vs ETF Over/Under-Weight (-) to Japanese Equities (%)	-5.29%	-4.69%	-4.05%	-4.49%	-3.50%	-2.63%	-3.81%

Sources: WisdomTree, Morningstar as of 10/31/14; the foreign large-cap category encompasses subcategories that fall under the foreign large-cap growth, foreign large-cap value and foreign large-cap blended strategies. Past performance is not indicative of future results. Subject to change.

• **Total Assets under Management in Dedicated Japanese Equities grew 270%.** Since December 2011, total assets in Japanese dedicated equity funds in the ETF and open-ended space grew from \$8.35 billion to \$30.95 billion in September 2014. - **Japan Dedicated ETFs Expanding AUM Market Share:** In December 2011, Japan-focused ETFs had 3x the AUM of Japan-focused open-ended funds for total AUM of \$8.35 billion. By September 2014, mutual fund assets doubled, but ETF assets quadrupled, so the ratio of Japan dedicated ETF AUM was 6.4x the Japan dedicated open-ended fund AUM. According to the data above, this is one illustration of how ETFs have become preferred access vehicles for country exposures. • **Broad Open-Ended Funds Appear Under-Weight Japanese Equities:** When compared to the ETF Funds in the same Morningstar category, foreign large caps, active managers have allocated 13.77% to Japanese stocks, while passively managed ETF strategies have a 17.58% allocation to Japanese equities. This reflects 3.81% under-weight allocation to equities in Japan. If active managers were to close this under-weight position, it could lead to more inflows to Japanese equities. - **Potential for Flows:** If the managers we tracked removed their under-weight position, this would imply

additional inflow of approximately \$31 billion to Japanese equities. To put this in perspective, this is approximately one-third the total assets in the ETF foreign large-cap category within the U.S. - **Important Note:** This context of potential flows is only from a subset of the broad market universe of funds where country allocation data is available. We identified \$811 billion of fund assets where Japan country exposure is reported, but the total size of the foreign large blend category is approximately \$1.1 trillion. If other funds that do not report Japan exposures show similar patterns of being under-weight Japanese equities, the amount of flows to Japan from just U.S. diversified mutual funds could thus be closer to \$42 billion. Since the inception of "Abenomics," [TOPIX](#) returned 77.64% cumulatively.¹ Interestingly, the yen decreased significantly over this period, which neutralized some of the equity price rise and lowered the relative exposure in market cap benchmarks. In the ETF space, flows have gone toward [currency-hedged](#) ETFs over the last two years, which help neutralize this effect. Global investors may slowly be convinced to stow away their two-decade-long perception of poor Japanese equity market performance. Japanese Prime Minister Shinzo Abe's team is showing a strong commitment to breaking the [deflation](#) cycle. After two lost decades of poor performance for Japanese equities, money managers may have to re-evaluate their habitual under-weighted Japan position on the back of a weakening yen, improving earnings outlook and still very reasonable market valuation multiples. **Unless otherwise stated, data source is Morningstar, as of 10/31/14.** ¹Total returns between 11/30/12 and 10/31/14.

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

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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.

Market participant: Anyone interacting with the ETFs in some capacity. It can be end investors, market makers, hedgers, authorized participants.

Market Capitalization: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

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.

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.

Currency hedging: Strategies designed to mitigate the impact of currency performance on investment returns.

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