

MANAGING VALUATION RISK BY REBALANCING

Tripp Zimmerman – Director, Research
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[Previously](#) we wrote about why we believe we are still in the early innings of Japan’s transformation, and a more virtuous cycle has been kick-started with the weakening of the yen, earnings growth and signs of inflation instead of [deflation](#) in price levels. [Recently](#) we wrote about how the total dividends paid by Japanese companies reached a record high of ¥7.86 trillion and that we believe these trends in [dividend growth](#) should remain very supportive. [dividends](#) are a [fundamental](#) metric of value and one thing we think is going to motivate local investors out of cash and government bonds and into equities. We think it is important to be mindful of how an annual rebalance back to an underlying fundamental such as dividends can help manage [valuation risks](#)—a key factor in why the non-cap-weighted indexes are included in the “smart beta” category of indexes. With [market capitalization-weighted](#) indexes, when constituents increase in price compared to other stocks, they gain greater weight and increase their impact on the performance of the index. WisdomTree Indexes employ a rules-based rebalancing mechanism that adjusts relative weights based on underlying dividend trends. **Quantifying the Fundamental Rebalance** During the rebalancing process, which occurs once per year for each Index, the relationship between price change and dividend growth is measured. Dividend growth is a key factor in determining which companies get increased weight at each rebalance. This is a crucial differentiator of WisdomTree’s indexing approach.

- **Typical Additions in weights** – Companies whose relative stock prices fell while their dividends were flat or grew would typically see increased weight in WisdomTree Indexes.
- **Typical Reduction in weights** – Companies whose stock prices increased relative to their peers while their dividend growth rates were lower than their peers would typically see reduced weight in WisdomTree Indexes. In the table below, we quantify the dividend growth for companies that received increases or decreases in weight, and compare that to the overall universe.

Japan Rebalance Statistics

		WisdomTree Japan Hedged Equity Index	WisdomTree Japan Hedged SmallCap Equity Index	WisdomTree Japan SmallCap Dividend Index
Median Dividend Stream Growth	Raise	28.3%	21.8%	23.9%
	Lower	5.8%	0.5%	-0.8%
	All	9.7%	7.4%	6.7%
Median Total Return	Raise	2.4%	0.2%	1.6%
	Lower	11.9%	13.0%	10.7%
	All	9.2%	9.1%	7.9%

Sources: WisdomTree, Bloomberg, 5/31/13–5/31/14. Dividend growth and performance numbers are measured in yen for the WisdomTree Japan Hedged Equity and WisdomTree Japan Hedged SmallCap Equity, but the WisdomTree Japan SmallCap Dividend is measured in USD. Past performance is not indicative of future results. You cannot invest directly in an index.

- **Dividend Growers Saw Weight Increase** – The companies that saw their weight increase at the rebalance had a median dividend growth that was typically 20 percentage points higher than the companies

that saw weight reduced at the rebalance. • **Underperformers Typically Saw Weight Increase** – Performance is also a key driver of relative changes. The typical stock that saw its weight increase had a median total return that was 9 to 13 percentage points lower than the median of stocks that had weight lowered. **Conclusion** we interpret Japan's current valuations and record *Dividend Stream*[®] levels as very positive indicators of underlying market fundamentals. We believe these fundamentals, coupled with the ongoing "[third arrow](#)" Abenomics reforms, should help provide a notable foundation for potential future gains. The annual rebalance is a key element of the added value of WisdomTree's Index methodology and can help manage valuation risks going forward. To read the full research on our Japan Index rebalance, [click here](#).

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DEFINITIONS

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

Dividend growth: The growth in trailing 12-month dividends for the specified universe.

Qualified dividends: Dividend paid by corporations meeting certain criteria defined by the Internal Revenue Service and therefore eligible in certain instances to be taxed at rates below a tax filer's tax bracket on ordinary income.

Fundamental value: The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.

Valuation risk: The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.

Market capitalization-weighting: 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.

Third arrow policies: The part of Japan's Abenomics process of reform that is focused on structural changes intended to promote economic growth.