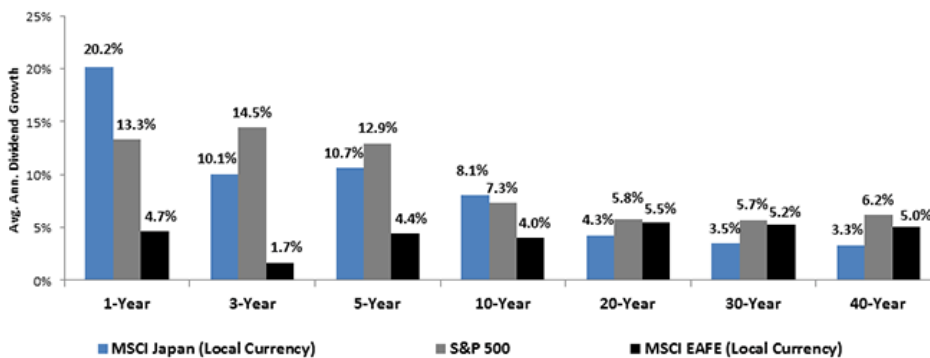


# CAPTURING QUALITY AND DIVIDEND GROWTH IN JAPAN

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Japanese equities have been among the best performing global markets since late 2012.<sup>1</sup> The depreciation of the yen and the rise in equity prices have been widely noted. But looking under the hood, we've noticed another important change occurring in Japan. Japanese policy makers are attempting to break the stigma of Japan's perennially low [return on equity \(ROE\)](#) to help revitalize their equity market. **How Might They Do It?** Japanese companies are known for keeping large cash balances—a practice well suited for [deflation](#). Lowering these cash balances is one way to quickly increase ROE, and a powerful avenue to accomplish this would be increasing [dividends](#). And while U.S. dividend growth has been tough to beat over the last year, Japan's looked even better:

Index Dividend Growth (2/28/1975 to 2/28/2015)



Sources: MSCI, Professor Robert Shiller, 2/28/1975–2/28/2015. MSCI Japan and MSCI EAFE index dividend growth calculated in local currency so as to avoid the impact of fluctuating exchange rates. Period of 40 years selected to put the more current one- and three-year time frames into full historical context. Past performance is not indicative of future results. You cannot invest directly in an index.

*For definitions of indexes in the chart, please visit our [glossary](#).* **How Can You Access It?** The [WisdomTree Japan Hedged Dividend Growth Index](#) focuses on quality metrics, connecting them to the potential for future dividend growth in Japanese equities. The key tenets of this Index methodology are:

- **Forward Looking:** Half of the selection criteria for the WisdomTree Japan Hedged Dividend Growth Index are based on [long-term earnings growth expectations](#). Simply put, firms that exhibit faster earnings growth have, in our opinion, a chance to ultimately grow their dividends faster over time.
- **Quality Focused:** The other half of the selection criteria are based on the average return on equity and [return on assets \(ROA\)](#) over the past three years. By looking at both, we can mitigate the risk of becoming exposed to highly [leveraged](#) firms.
- **Currency Hedged:** Central bank policies—in particular those of the Bank of Japan (BOJ)—may lead to increased risk of fluctuating currency values. This Index hedges the impact of changes in the value of the yen against the U.S. dollar to mitigate this potential issue.

**How Does This Index Look against the JPX-Nikkei Index 400?** On January 6, 2014, the Tokyo Stock Exchange began calculating a new index, the JPX-Nikkei Index 400. Instead of simply including listed

companies and weighting them by [market capitalization](#), this index was among the first in Japan to select companies based on measures of profitability, corporate governance and other factors meant to incentivize “investor-friendly” practices.<sup>2</sup> A new index is one thing, but even more important is the fact that the [Government Pension Investment Fund \(GPIF\)](#) and the Bank of Japan (BOJ) are buying equities with the goal of tracking the performance of this index. These are some of the biggest players in Japan leading by example and putting in a wall of [liquidity](#) for firms that gain inclusion. One of the critical early questions we asked was how the WisdomTree Japan Hedged Dividend Growth Index compares to the JPX-Nikkei Index 400. We found that<sup>3</sup>:

- More than 97% of the weight of the WisdomTree Japan Hedged Dividend Growth Index is in stocks that are also included in the JPX-Nikkei Index 400. Since both indexes focus on quality and profits—albeit in different ways—this did not surprise us.
- Return on equity for the WisdomTree Japan Hedged Dividend Growth Index (10.2%) was slightly higher than it was for the JPX-Nikkei Index 400 (9.5%), but the return on assets (ROA) figure for the WisdomTree Index (3.0%) was about twice that of the JPX-Nikkei Index 400 (1.6%), leading to almost 45% lower leverage. An interesting point on the subject of leverage: the WisdomTree Japan Hedged Dividend Growth Index had less than 4% weight to Financials, whereas the JPX-Nikkei Index 400 had 18.0% weight to this same sector, certainly a notable difference.

**Introducing the WisdomTree Japan Hedged Dividend Growth Fund (JHDG)** The [WisdomTree Japan Hedged Dividend Growth Fund \(JHDG\)](#) is designed to track the performance of the WisdomTree Japan Hedged Dividend Growth Index. We are excited to add this tool to our Japan toolkit in order to give investors more options to think about what is happening in Japan as well as how they might like to express their views in a portfolio context.

<sup>1</sup>Source: Bloomberg, with data from 11/30/12 to 2/28/15. <sup>2</sup>Source: Tokyo Stock Exchange JPX-Nikkei Index 400 information page, as of 3/6/15. <sup>3</sup>Source for the below bullets is Bloomberg, with data as of 2/28/15.

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You cannot invest directly in an index.

## DEFINITIONS

**Return on Equity (ROE)**: Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

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

**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.

**Long-Term Earnings Growth Expectations**: Compilation of analyst estimates of the growth in operating earnings expected to occur over the next full business cycle, typically 3 to 5 years, sourced from Bloomberg.

**Return on assets (ROA)**: Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

**Leverage**: Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

**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.

**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.

**Government Pension Investment Fund (GPIF)**: Japan's largest public pension fund.

**Liquidity**: The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.