

A STOCK EXCHANGE IMPETUS TO IMPROVE VALUATIONS

Hyun Kang – Research Analyst
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Almost a year has passed since the Japan Exchange Group doubled down on corporate governance enhancements.

The reforms were billed as the Tokyo Stock Exchange's (TSE) biggest overhaul in 60 years and a clear attempt to reinvigorate enthusiasm for Japanese equities.¹

These initiatives included the restructuring of TSE's cash equity markets into three new segments: Prime Market, Standard Market and Growth Market—each segment having its own set of eligibility criteria.

The ultimate impact of the reshuffle was muted. After three years of deliberation, the eventual requirements for the Prime Section were substantially weakened.

Nonetheless, the reforms represented a step forward for Japanese corporate governance.

The TSE announced about half of its listed companies had a [price-to-book ratio](#) below 1x. According to the TSE, these companies are to disclose their policies and specific initiatives for improvement.

Japan has been called by many a value trap, teeming with companies that have low profitability metrics and return on capital. This wave of market reforms seeks to address such investor concerns.

Regional Index Valuations and Fundamentals

Index	P/E	P/B	Div. Yield	ROA	ROE
S&P 500	20.3x	3.9x	1.7%	4.1%	18.4%
MSCI Europe	13.9x	1.8x	2.8%	1.8%	13.2%
MSCI Japan	15.4x	1.3x	2.6%	1.2%	8.1%

Sources: S&P, MSCI, as of 2/28/23. MSCI Europe refers to MSCI EMU Index. You cannot invest directly in an index. Past performance is not indicative of future returns.

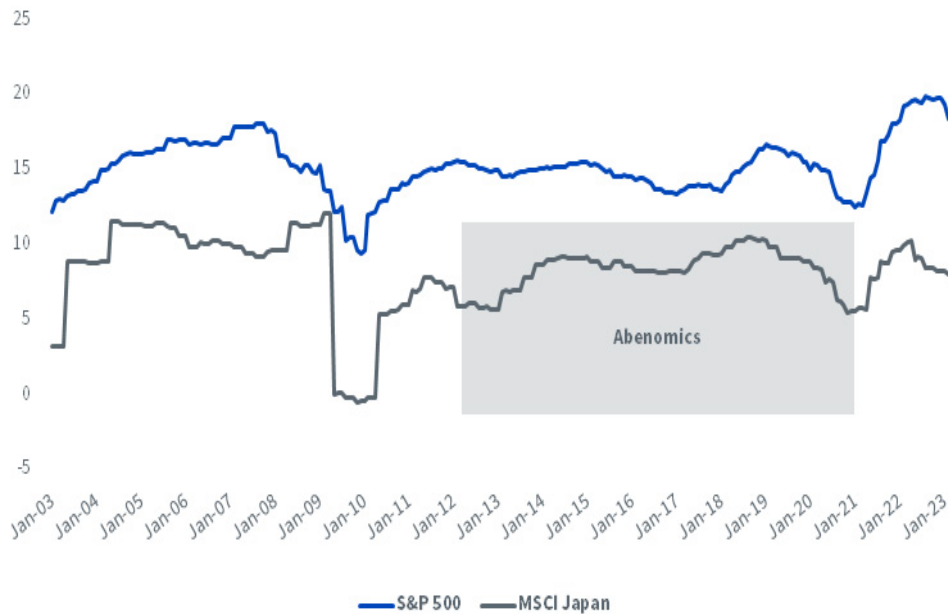
Echoes of Abenomics

The pressure on low-valuation companies to improve their practices and increase shareholder returns is reminiscent of previous initiatives during the [Abenomics](#) era, namely the launch of the JPX-Nikkei 400 Index in 2014.

Also known as the “shame” index, the JPX-Nikkei 400 included the largest and most liquid companies based on profitability metrics such as returns on equity. It got its nickname from the experience of excluded companies and their management.

Since Abenomics and the launch of the JPX-Nikkei 400, the aggregate return on equity for the MSCI Japan Index managed to creep up to over 10% before falling flat, as COVID-19 put global markets in turmoil.

Aggregate ROE, S&P 500 vs. MSCI Japan Index



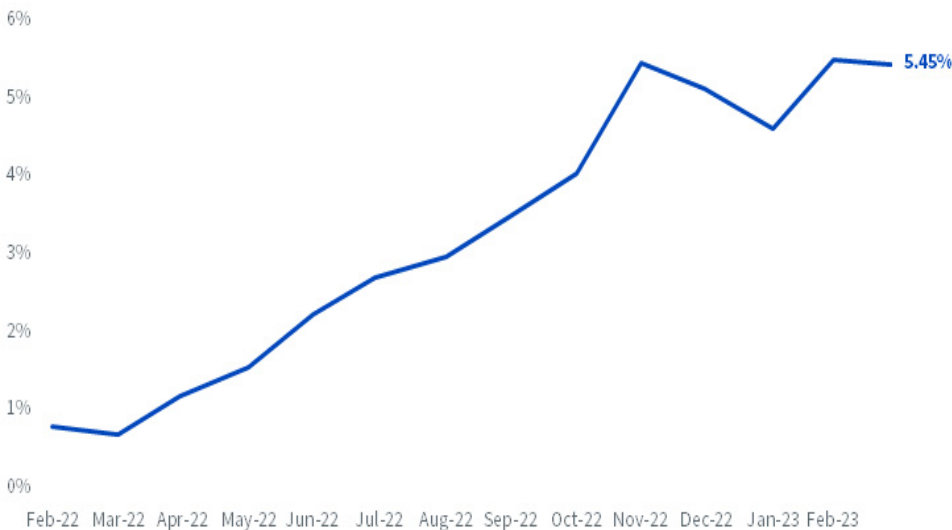
Sources: S&P, MSCI, 1/31/03–2/28/23. You cannot invest directly in an index. Past performance is not indicative of future returns.

WisdomTree Japan Equity Indexes

The [WisdomTree Japan Hedged Equity Index](#) provides exposure to Japanese equities while mitigating effects from negative movements in the Japanese yen against the dollar.

The Index selects [dividend](#)-paying, export-oriented Japanese companies. Its currency-hedged strategy also adds an interest rate differential between the U.S. and Japan, which has been increasing the amount paid to hedge over the last year. The latest [‘carry’](#) earned from hedging the yen has approached 5% a year.

Annualized Carry, Yen Hedge



Sources: WisdomTree, Refinitiv, 2/28/22–3/27/23. You cannot invest directly in an index. Past performance is not indicative of future returns.

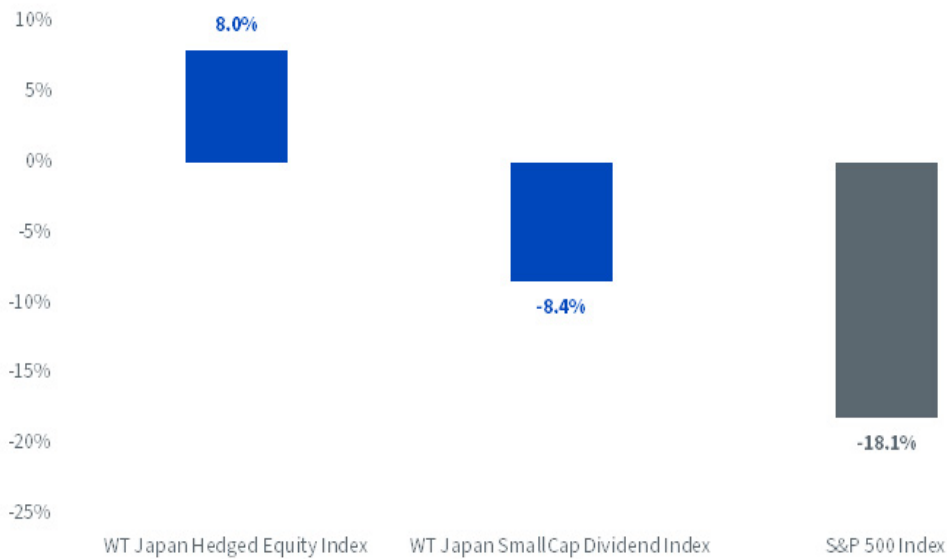
The Japan Hedged Equity Index is [value](#)- and [quality](#)-tilted, and many of its constituents have low valuations.

The [WisdomTree Japan SmallCap Dividend Index](#) is another Japan-focused WisdomTree strategy that provides exposure to the [small-cap](#) universe of dividend-paying Japanese equities without the currency hedge.

The result of the dividend-weighting employed by the Index is a basket of securities on

which the effects of the TSE reform may be especially magnified.

2022 Total Returns



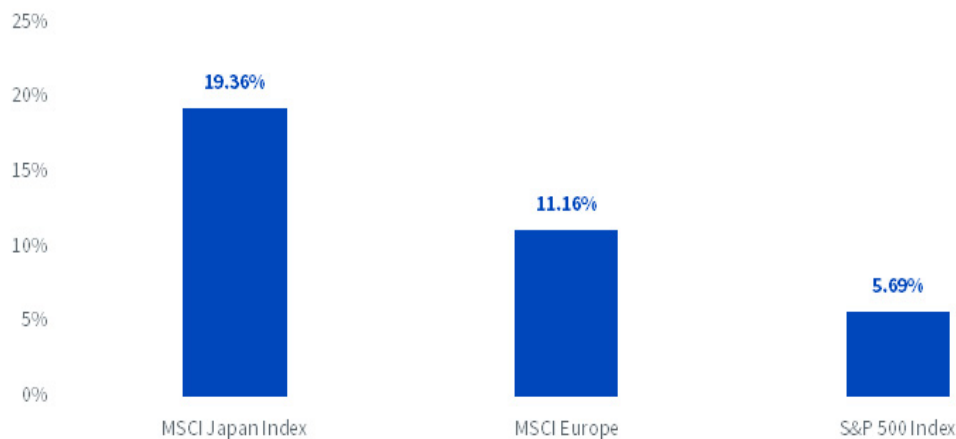
Sources: WisdomTree, S&P, 12/31/21–12/31/22. You cannot invest directly in an index. Past performance is not indicative of future returns.

According to the TSE, all Japanese exchange-listed companies are required to meet the inclusion requirements of the market segments for which they are listed by 2025 or risk being labeled as securities under supervision or even delisting.

This means many historically cash-heavy Japanese companies face increasing pressure to improve their numbers, possibly by funneling historically high excess cash reserves into increased [buybacks](#) or dividends.

The conservative cash balances of Japanese equities are also important factors that contribute to lower [volatility](#) amid major [drawdowns](#) in other markets and saw the [MSCI Japan Index](#) outperform other regional indexes through a tumultuous 2022.

Cash as a Percentage of Market Cap



Source: WisdomTree, as of 3/27/23. MSCI Europe refers to MSCI EMU Index. You cannot invest directly in an index. Past performance is not indicative of future returns.

According to an earlier Man Institute report, half the stocks on the [Tokyo Stock Price Index \(TOPIX\)](#) traded below their book values by the end of February.²

Currently, 52% of WisdomTree Japan Hedged Equity Index constituents and 59% of WisdomTree Japan SmallCap Dividend Index constituents trade below their book values.

That is, more than half the companies included in these Indexes will have to improve their corporate governance and shareholder value in the next two years or potentially answer for their performances.

Percentage of Index Constituents with Price-to-Book under 1.0

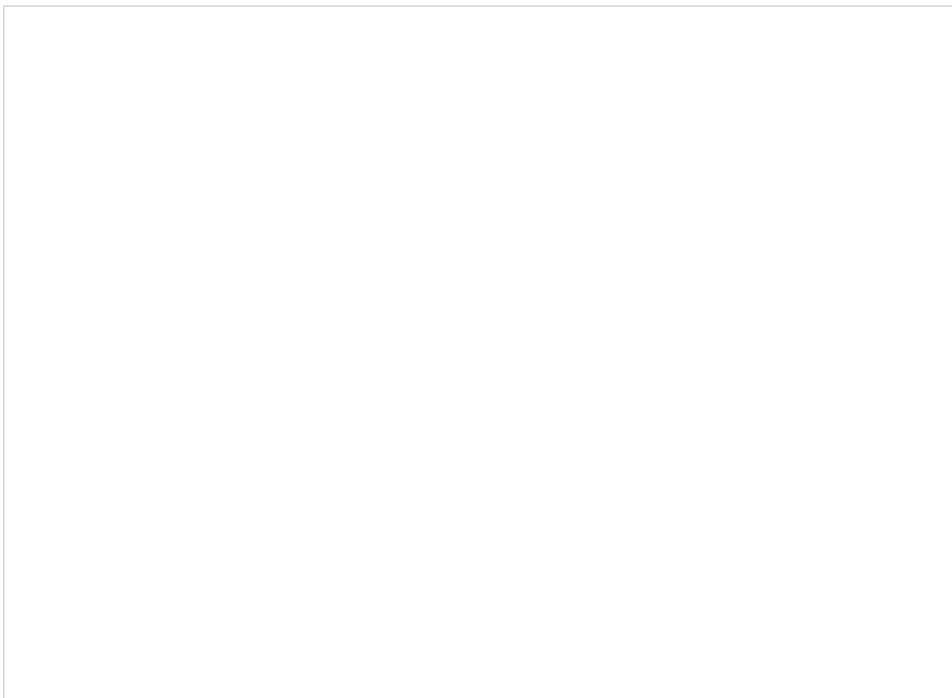


Source: WisdomTree, 6/30/06-2/28/23. You cannot invest directly in an index. Past performance is not indicative of future returns.

It’s an exciting time for Japanese equities.

Under the shadow of an increasingly volatile yen, it’s an even more exciting time for currency-hedged Japanese equities. While the TSE’s initiatives to reform what they see as bloated and stagnating dinosaurs will be painful for managers and executives, shareholders are among the first in line to benefit.

Year-to-Date Total Returns



¹ Eri Sugiura and Leo Lewis, "Overhauled Tokyo Stock Exchange Makes Debut," *The Financial Times*, 4/4/22.

² Badger, Emily, "This Time Is Different: Japan Value and Corporate Governance: Man Institute." *Man Institute* | Man Group, 1 Mar. 2023, <https://www.man.com/maninstitute/this-time-is-different>.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

View the online version of this article [here](#).

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DEFINITIONS

Price-to-book ratio: Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

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.

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

Carry: The amount of return that accrues from investing in fixed income or currency forward contracts.

Value: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Quality: Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

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

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

Volatility: A measure of the dispersion of actual returns around a particular average level.

Drawdowns: Periods of sustained negative trends of return.

MSCI Japan Index: A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.

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.