LOOKING PAST THE NARRATIVE ON JAPAN INTO FUNDAMENTALS

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One of the markets caught up in global trade fears that continues to perplex investors is Japan. The Japanese markets are trading near their lowest valuation levels in the last 30 years, supported by increased profitability, better returns on capital and improving profit margins. A recent article in The Wall Street Journal by Mike Bird summarizes sentiment and the environment nicely:

> *"Something strange is going on with corporate Japan: Profits have soared. . . . Yet foreign investors, by and large, aren't that interested. . . . After decades of stagnation, profitability has soared under Prime Minister Shinzo Abe's economic revival program, dubbed Abenomics. Profit margins at nonfinancial firms hit a record 7.7% in the second quarter. This ratio, which compares earnings before interest payments and taxes with sales, rarely topped 4% until a few years ago."*[1]

While Japan tends to trade with its currency and global macro sentiment, this market behavior masks some strong underlying trends in corporate governance and profitability.

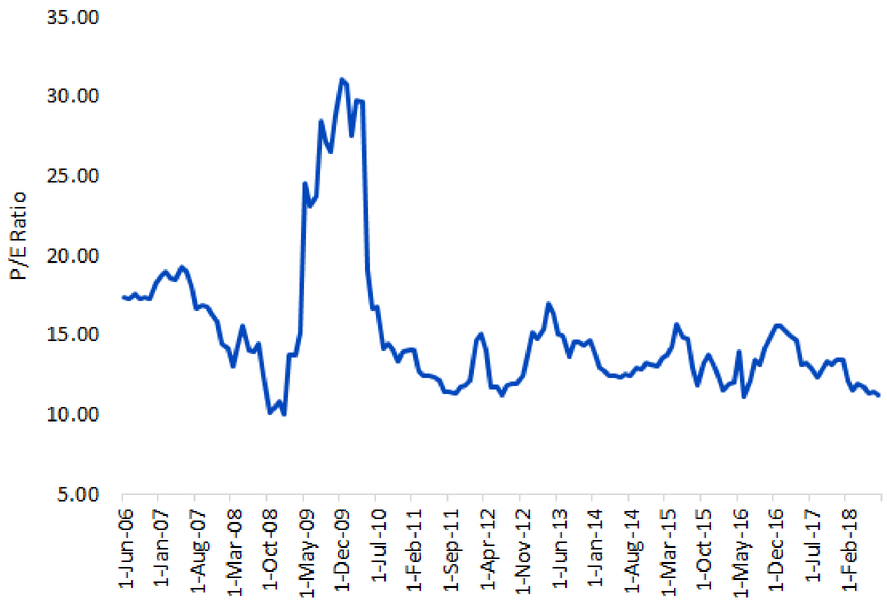
One element of Abenomics involved the creation of new stock indexes that encouraged a focus on return on equity (ROE). Companies have responded, increasing both dividends and buybacks and better managing the cash on the "bloated balance sheets" (which are often cited as a reason to stay away from corporate Japan).

Below, I review some of the key fundamental attributes of the WisdomTree Japan Dividend Index (which also serves as the underlying for the WisdomTree Japan Hedged Equity Index) to show how globally oriented Japanese companies are trading on valuation and a multiple basis.

The median price/earnings (P/E) ratio over the last 12 years was 13.9x, and the latest P/E ratio was 11.8x, a 20% discount to the median. These valuation levels are similar to the depression during the financial crisis 10 years earlier, before earnings collapsed.

The P/E ratio has only been lower in these 12 years less than 4% of the time—meaning that Japan is in the 96% range for inexpensiveness on P/E ratio valuation in the last 12 years.

WisdomTree Japan Dividend Index–P/E Ratio Excluding Negative Earnings

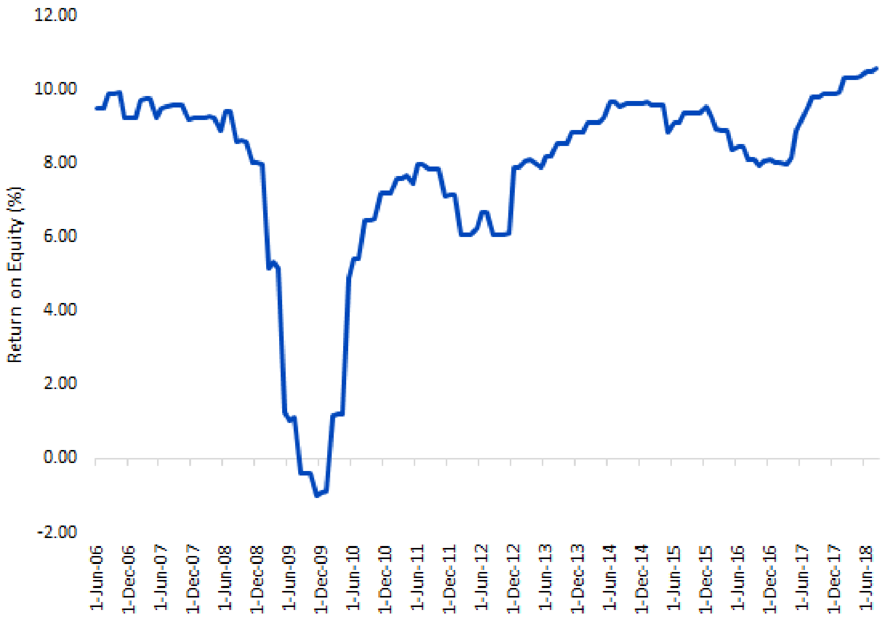


Sources: WisdomTree, FactSet. Data for the period 1/1/06–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

These low valuations come despite the broad improvement in one of WisdomTree's preferred "quality" metrics: ROE. In the 12 years we have been calculating it for the WisdomTree Japan Dividend Index, there had never been a ROE figure greater than 10%—in 2006, when we launched the Index, it was close to those levels, but it dropped sharply during the financial crisis and has been building back slowly ever since.

Showing the relative profitability figures and better management of corporate balance sheets, we saw this figure go past 10% in 2018. We also see room for further improvement given the broad increase in shareholder returns and still-high cash levels on balance sheets that are starting to get paid out. ROE figures for a similar U.S. index are closer to 15%—and as Japan tries to attract more global capital, being good stewards of capital should keep pushing ROEs higher.

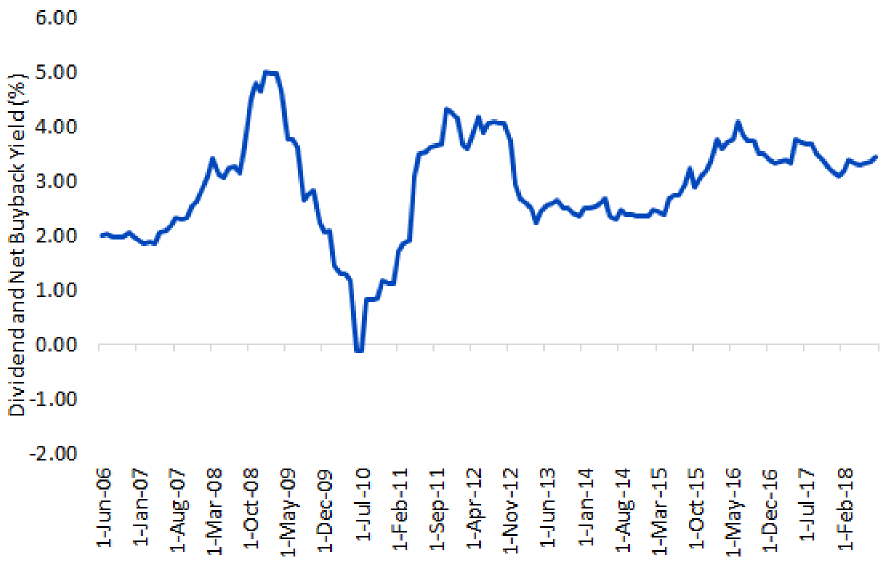
WisdomTree Japan Dividend Index—Return on Equity



Sources: WisdomTree, FactSet. Data for the period 1/1/06–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

The [dividend yield]() on our Index is 2.7%, and the net buyback yield was 0.7% at the end of August, giving a total dividend and net buyback yield of 3.4%. The median of this ratio over the last 12 years has been 2.9%. In general, the broad increase in this ratio ever since the end of 2012 shows that corporate Japan has been driven by rising dividends and buybacks and not just rising prices—that was also reflected in the declining P/E ratios presented earlier.

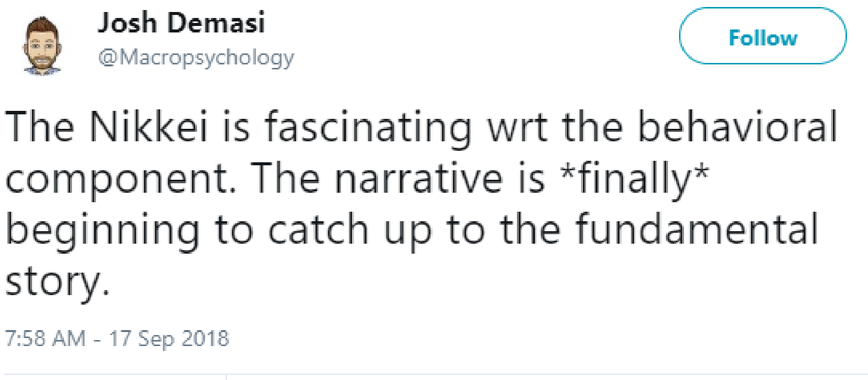
WisdomTree Japan Dividend Index–Dividend and Net Buyback Yield



Sources: WisdomTree, FactSet. Data for the period 1/1/06–8/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

In early 2018, Japan traded down largely with global sentiment on trade fears and uncertainty associated with U.S. policy—not for some decrease in its fundamental measures of value. While many believe Japan will always be a "value trap," we see good evidence that corporate payouts are favoring more shareholder-friendly actions and see quality metrics and margins improving.

On September 17, Josh Demasi tweeted something that I think summarizes the situation quite well:


Josh Demasi
@Macropsychology
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The Nikkei is fascinating wrt the behavioral component. The narrative is *finally* beginning to catch up to the fundamental story.

7:58 AM - 17 Sep 2018

For most of this year, the narrative was that Japan is going to be hurt by trade wars and perhaps a peaking in global growth and slowdown in China. Improved trade dynamics between Japan and China might be one outcome of the U.S-China spat that many are not factoring into their models. We like Japan as an underowned value opportunity.

[1]Mike Bird, “Profits Jump at Japanese Companies, but Foreign Investors Don’t Bite,” The Wall Street Journal, 9/9/18.

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You cannot invest directly in an index.

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.

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.

Macro : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

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

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

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

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.

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.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

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 tim.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.