

JAPAN SMALL CAPS AS AN ASSET ALLOCATION VEHICLE

March 2019

2018 was a challenging market environment for small caps globally as market participants priced in fears of a global slowdown and tighter liquidity conditions. Even in the US where economic growth was likely around 3% and corporate profits grew about 20%, an environment where US small caps would be expected to outperform, the Russell 2000 lagged the S&P 500 by over 600 basis points (bps).

Historically robust small cap premium and small value premium in Japan

In Japan, 2018 was the first year since 2013 that small caps lagged large caps (as measured by the MSCI Indices), and the first year since 2007 that small caps lagged large caps when the MSCI Japan Index experienced a negative calendar year return.

Over the period of live performance for the WisdomTree Japan SmallCap Dividend Index (WTJSC), Japanese small caps have outperformed large by 117 bps annually on average. In addition to the strong performance of the small-cap premium, dividend-weighted small caps, as measured by WTJSC, have had even better performance. Using dividends as a measure of value, small-cap value had excess returns of 278 basis points annually on average going back to 2006.

More recent 3, 5, and 10-year periods have been even stronger.

FIGURE 1: ANNUALISED RETURNS OF JAPANESE FACTORS

Index	Annualised Returns (June 2006 - December 2018)				
	1 Year	3 years	5 years	10 Years	Analysis Period
WisdomTree Japan SmallCap Dividend	-16.56%	7.43%	7.61%	8.55%	4.07%
MSCI Japan Small Value	-15.64%	5.80%	5.83%	8.06%	3.58%
MSCI Japan Small	-15.99%	5.85%	6.36%	8.04%	2.46%
MSCI Japan Small Growth	-16.46%	5.78%	6.78%	7.94%	2.07%
MSCI Japan Value	-12.67%	2.64%	2.50%	4.92%	1.76%
MSCI Japan	-12.88%	3.41%	3.06%	5.33%	1.29%
MSCI Japan Growth	-13.09%	4.15%	3.60%	5.68%	0.71%
Small-Cap Premium (MSCI Japan Small Cap - MSCI Japan)	-3.11%	2.44%	3.30%	2.71%	1.17%
Small-Cap Value Premium (WTJSC - MSCI Japan)	-3.68%	4.02%	4.55%	3.22%	2.78%

Source: WisdomTree, Zephyr StyleAdvisor, 1 June 2006 to 31 December 2018. 1 June 2006 was the inception date of the WisdomTree Japan SmallCap Dividend Index (WTJSC). **Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.**

Over the past 12 calendar years, small caps and small cap value (as measured by WTJSC) have outperformed (beat on figure 2 below) MSCI Japan 58% of the time, with average and median excess returns of greater than 200 bps.

FIGURE 2: SMALL-CAP PREMIUM AND SMALL-CAP VALUE PREMIUM

Based on Calendar Year Returns (2007 - 2018)	Count	# Beat	% BEAT	Mean Excess Return	Median Excess Return
Consistency of Small-Cap Premium	12	7	58.3%	2.34%	4.03%
Consistency of Small-Cap Value Premium	12	7	58.3%	3.44%	2.78%

Source: WisdomTree, Zephyr StyleAdvisor, 1 January 2007 to 31 December 2018. Small cap Premium is the excess return of the MSCI Japan Small Cap Index relative to the MSCI Japan Index. Small cap Value Premium is the excess return of the WisdomTree Japan SmallCap Dividend Index relative to the MSCI Japan Index. **Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.**

Given the sector composition of a dividend-weighted strategy, this excess return has also been achieved at lower risk: standard deviation of 13.59% compared to 14.68% for MSCI Japan, and a beta of just 0.82. These returns resulted in a Sharpe Ratio of 0.22 for WTJSC relative to 0.02 for MSCI Japan. Note that the WisdomTree Index had the lowest standard deviation of all the below indexes.

FIGURE 3: SINCE INCEPTION: RISK/ RETURN

Index	Return (%)	Std Dev (%)	Downside Risk (%)	Beta vs. Market	Alpha vs. Market (%)	Sharpe Ratio
WisdomTree Japan SmallCap Dividend	4.07	13.59	10.04	0.82	3.02	0.22
MSCI Japan Small	2.46	14.32	10.54	0.86	1.43	0.10
MSCI Japan Small Value	3.58	13.96	9.98	0.85	2.52	0.18
MSCI Japan Small Growth	2.07	14.90	11.10	0.87	1.12	0.07
MSCI Japan Growth	0.71	15.49	11.87	1.03	-0.51	-0.02
MSCI Japan Value	1.76	14.67	10.59	0.97	0.52	0.05
MSCI Japan	1.29	14.68	10.98	1.00	0.00	0.02

Source: WisdomTree, Zephyr StyleAdvisor, 1 June 2006 to 31 December 2018. 1 June 2006 was the inception date of the WisdomTree Japan SmallCap Dividend Index (WTJSC). **Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.**

Over the past 3 years, the beta of WTJSC has increased to 1.02 and the risk of the Index was about 100 bps greater than the broad MSCI Index. However, this incremental risk for WTJSC was accompanied by outperformance of over 400 bps relative to the MSCI Japan Index and a Sharpe Ratio of 0.51 versus 0.21.

With that being said, the beta of the strategy has increased as of late and may have been a contributor to the recent underperformance as the market trended down in 2018.

FIGURE 4: TRAILING 3-YEAR RISK/RETURN

Index	Return (%)	Std Dev (%)	Downside Risk (%)	Beta vs. Market	Alpha vs. Market (%)	Sharpe Ratio
WisdomTree Japan SmallCap Dividend	7.43	12.69	9.84	1.02	3.92	0.51
MSCI Japan Small	5.85	12.69	10.01	0.99	2.54	0.38
MSCI Japan Small Value	5.80	11.81	9.01	0.95	2.51	0.41
MSCI Japan Small Growth	5.78	14.81	11.77	1.02	2.63	0.32
MSCI Japan Growth	4.15	12.89	10.04	1.04	0.72	0.25
MSCI Japan Value	2.64	12.11	9.11	0.96	-0.57	0.14
MSCI Japan	3.41	11.74	9.07	1.00	0	0.21

Source: WisdomTree, Zephyr StyleAdvisor, 1 January 2016-31 December 2018. **Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.**

It's always important to recognize the importance of Japan small caps as an asset allocation vehicle. Japanese small-caps represent one of the lowest correlation equity markets to US equities, as measured by the S&P 500. The historical correlation of 0.54 for WTJSC compares to .71 for MSCI Japan. This lower correlation helps construct a more diverse portfolio higher up on the efficient frontier.

FIGURE 5: LOW CORRELATION TO US EQUITIES

Correlation Matrix (June 2006 - December 2018)								
	1	2	3	4	5	6	7	8
1) WisdomTree Japan SmallCap Dividend	1.00							
2) MSCI Japan Small	0.98	1.00						
3) MSCI Japan Small Value	0.98	0.97	1.00					
4) MSCI Japan Small Growth	0.94	0.98	0.91	1.00				
5) MSCI Japan Growth	0.87	0.88	0.85	0.88	1.00			
6) MSCI Japan Value	0.86	0.84	0.88	0.78	0.90	1.00		
7) S&P 500	0.54	0.56	0.55	0.55	0.74	0.64	1.00	
8) MSCI Japan	0.89	0.88	0.89	0.85	0.97	0.97	0.71	1.00

Source: WisdomTree, Zephyr StyleAdvisor, 1 June 2006 to 31 December 2018. 1 June 2006 was the inception date of the WisdomTree Japan SmallCap Dividend Index (WTJSC). **Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.**

Industry Attributions

Over the past year, WTJSC has lagged the MSCI Japan Index by about 400 bps. Capital Goods, an industry the Index is overweight by about 5%, was the largest drag on returns versus the benchmark in the last year. This industry contributed about 75 bps to underperformance. Interestingly, Capital Goods was a top 5 contributor to excess returns over the 3- and 5-year windows.

FIGURES 6A, 6B AND 6C: ATTRIBUTION PER INDUSTRY

		1-Year as of 31 January 2019	Average Industry Weights		Cumulative Total Return		Total Attribution
		Industry	WisdomTree Japan SmallCap Dividend	MSCI Japan	WisdomTree Japan SmallCap Dividend	MSCI Japan	
Top 5 Contributors	Media & Entertainment		3.50%	2.48%	-4.21%	-21.90%	0.51%
	Software & Services		2.72%	1.30%	6.63%	-3.28%	0.40%
	Diversified Financials		3.49%	2.15%	-11.82%	-21.77%	0.25%
	Materials		12.70%	5.96%	-15.21%	-22.05%	0.25%
	Semiconductors & Semiconductor Equipment		1.00%	1.41%	-32.85%	-31.60%	0.11%
Top 5 Detractors	Real Estate		3.05%	4.02%	-14.57%	-5.29%	-0.41%
	Automobiles & Components		5.96%	11.21%	-24.68%	-14.10%	-0.51%
	Banks		6.64%	6.81%	-27.28%	-19.18%	-0.55%
	Retailing		6.30%	2.72%	-19.87%	-11.42%	-0.55%
	Capital Goods		19.10%	14.34%	-20.73%	-18.56%	-0.74%
Total			100.00%	100.00%	-15.38%	-11.35%	-4.03%

		3-Year as of 31 January 2019	Average Industry Weights		Cumulative Total Return		Total Attribution
		Industry	WisdomTree Japan SmallCap Dividend	MSCI Japan	WisdomTree Japan SmallCap Dividend	MSCI Japan	
Top 5 Contributors	Materials		12.53%	6.05%	48.79%	32.94%	3.07%
	Food, Beverage & Tobacco		3.63%	4.12%	53.94%	5.78%	2.78%
	Software & Services		2.75%	1.22%	91.88%	53.86%	1.48%
	Transportation		3.32%	5.00%	58.58%	16.12%	1.43%
	Capital Goods		18.88%	13.87%	48.63%	51.47%	1.22%
Top 5 Detractors	Utilities		1.08%	1.98%	15.87%	20.36%	-0.35%
	Pharmaceuticals, Biotechnology & Life Science		2.16%	5.49%	19.58%	25.38%	-0.42%
	Insurance		0.00%	3.02%	0.00%	35.01%	-0.58%
	Telecommunication Services		0.09%	5.60%	24.11%	32.75%	-0.95%
	Banks		7.64%	7.45%	-11.54%	11.54%	-2.08%
Total			100.00%	100.00%	41.56%	29.07%	12.48%

	5-Year as of 31 January 2019	Average Industry Weights		Cumulative Total Return		Total Attribution
	Industry	WisdomTree Japan SmallCap Dividend	MSCI Japan	WisdomTree Japan SmallCap Dividend	MSCI Japan	
Top 5 Contributors	Capital Goods	18.55%	13.66%	54.70%	32.10%	3.66%
	Automobiles & Components	5.58%	13.09%	27.26%	13.80%	3.31%
	Food, Beverage & Tobacco	4.25%	4.03%	117.80%	44.79%	3.20%
	Real Estate	2.10%	4.50%	42.40%	1.24%	2.55%
	Materials	12.25%	5.99%	45.44%	26.09%	1.84%
Top 5 Detractors	Health Care Equipment & Services	2.52%	2.14%	71.01%	88.42%	-0.16%
	Media & Entertainment	3.23%	2.00%	41.72%	51.17%	-0.20%
	Insurance	0.00%	2.88%	0.00%	48.44%	-0.30%
	Consumer Durables & Apparel	5.44%	4.17%	44.98%	55.02%	-0.35%
	Pharmaceuticals, Biotechnology & Life Sciences	2.39%	5.41%	60.88%	59.69%	-0.65%
Total		100.00%	100.00%	54.83%	30.36%	24.47%

Source: WisdomTree, Bloomberg. Total attribution based on cumulative returns. **Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.**

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