LOOKING PAST THE NARRATIVE ON JAPAN INTO FUNDAMENTALS

Wisdomtree EU
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Global trade fears continue to confuse investors about Japan. The Japanese markets are trading near their lowest valuation levels in the last 30 years[1], supported by increased profitability, better returns on capital and improving profit margins[2]. A recent Wall Street Journal article by Mike Bird summarizes sentiment and the environment nicely[3].

"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."

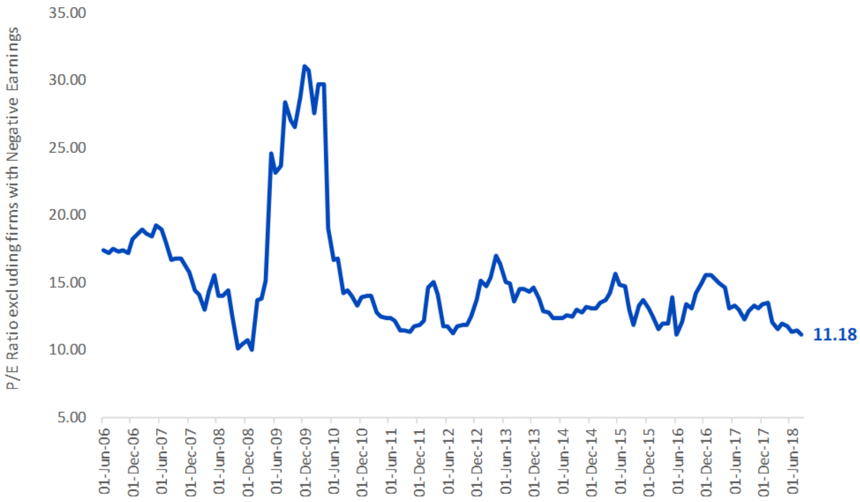
While Japan tends to trade with its currency and global macro sentiment, this market behavior masks some strong underlying trends in corporate governance and profitability.

One element of Abenomics involved the creation of new stock indexes that encouraged a focus on return on equity[4]. Company managements 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 (that also serves as the underlying for the WisdomTree Japan Hedged Equity Index) to show how globally oriented Japanese companies are trading on valuation and multiple basis[5]:

- The median Price/Earnings (P/E) ratio over the last 12 years was 13.9 and the latest P/E ratio was 11.8, 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 Japan is in the 96% range for cheapness on P/E ratio valuation in the last 12 years.

Figure 1: WisdomTree Japan Dividend Index P/E ratio with impact of negative earnings excluded



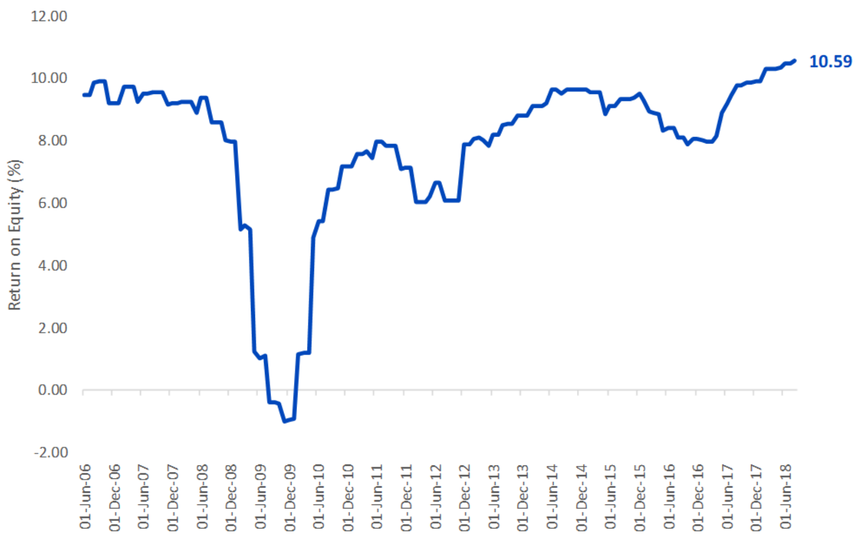
Source: Factset. Data is from 1 June 2006 to 31 August 2018. You cannot invest directly in an Index.

Historical performance is not an indication of future performance and any investments may go down in value.

These low valuations come despite the broad improvement in one of WisdomTree's preferred 'quality' metrics: return on equity (ROE). In the 12 years we have been calculating it for our Japan Dividend index, there had never been a greater than 10% ROE figure – 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. As Japan tries to attract more global capital, being good stewards of capital should keep pushing ROEs higher.

Figure 2: Return on equity for WisdomTree Japan Dividend Index



Source: Factset. Data is from 1 June 2006 to 31 August 2018. You cannot invest directly in an Index.

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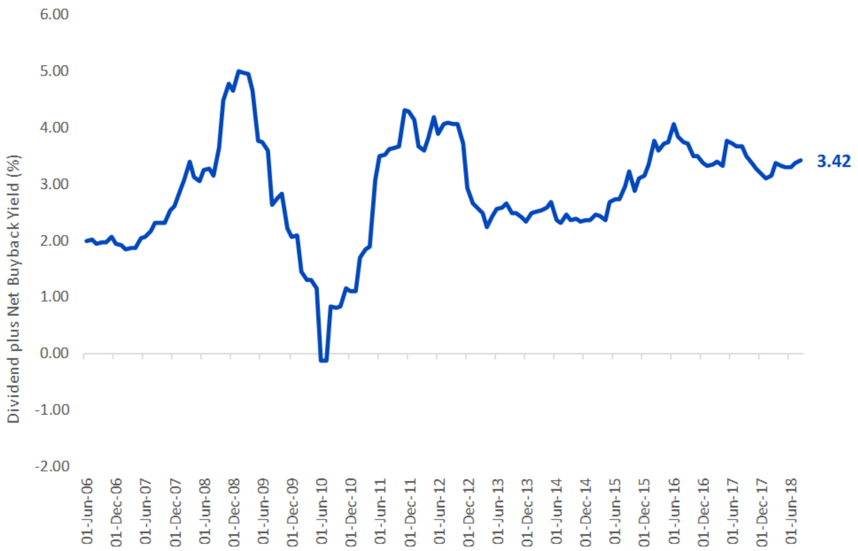
The dividend yield on our index was 2.7% and the net buyback yield was 0.7% at the end of August, giving a total dividend and net buyback yield of 3.4%. The median of this ratio over the last 12 years has been 2.9%. In general, the broad increase in this ratio ever since the end of 2012 shows that corporate 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.

Figure 3: Total shareholder yield for WisdomTree Japan Dividend Index



Source: Factset. Data is from 1 June 2006 to 31 August 2018. You cannot invest directly in an Index.

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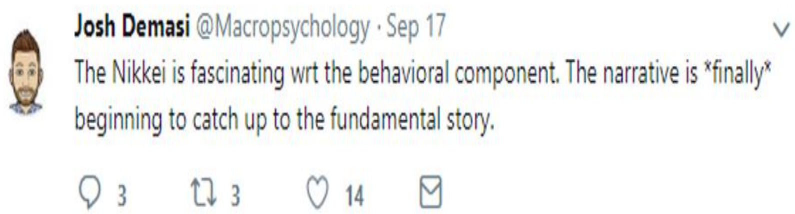
In early 2018 Japan traded down largely with global sentiment on trade fears and uncertainty associated with US policy–not for some decrease in its fundamental measures of value. While many believe Japan will always be a 'value trap,' we see good evidence that corporate payouts are favoring more shareholder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

On 17 September 2018, emerging markets analyst Josh Demasi tweeted something that summarizes the situation quite well:



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 US-China spat that many are not factoring into their models. We like Japan as an under-owned value opportunity, potentially appealing to the more contrarian amongst investors out there.

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Source

1 MSCI. Data measures the price to dividend ratio (1 / dividend yield) from 31 December 1970 to 31 August 2018. Outside of the 2008-09 Global Financial Crisis period and a period during 2012, one has to look back to 29 October 1982 to see valuations of Japan's equities relative to dividends close to these levels. Universe is MSCI Japan Index.

2 Bloomberg, with data measured as of 31 August 2018.

3 Bird, Mike. "Profits Jump at Japanese Companies but Foreign Investors Don't Bite." Wall Street Journal. 9 September 2018.

4 Refers to the JPX Nikkei 400 Index, which requires constituents to showcase high return on equity and other qualitative signals of commitment to good corporate governments in order to gain inclusion. This index began live calculation 6 January 2014.

5 Factset. Data measured from 1 June 2006 to 31 August 2018.

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