# JAPAN IS RALLYING, AND FOREIGN INVESTORS ARE (FINALLY) NOTICING

**Matt Wagner,**

## VALUATION

- The Nikkei 225 Index broke three-decade highs, but Japanese valuations are still attractive versus the U.S.
- The S&P 500 forward price-to-earnings (P/E) ratio of 21.2x is 33% higher than the 15.9x P/E of the MSCI Japan Index.

## DIVERSIFICATION

- The three decades of negative returns for Japanese equities are a cautionary tale for investors heavily over-weight in U.S. equities that are at elevated valuations—returns for a broad index can be negative for much longer than anyone expects.

## FOREIGN INVESTOR INTEREST

- Value investors are following Bu□ett into Japan. Since late August 2020, when Bu□ett's investments in five Japanese trading houses became public, returns of 185% to 402% have far outpaced the S&P 500 return of 53%.
- Shi□ing investments from China—an almost symmetrical picture has emerged for these two markets over the last three years, with Japanese equities up 52% and Chinese equities down 53%.

## TOKYO STOCK EXCHANGE REFORMS

- In 2022, the Tokyo Stock Exchange (TSE) instituted its biggest overhaul in 60 years to reinvigorate enthusiasm for Japanese equities.
- The TSE announced that about half of its listed companies had a price-to-book ratio below 1x. It said that these companies needed to disclose their policies and specific initiatives for improving valuations.

## DIVIDEND/SHARE BUYBACK GROWTH AND EARNINGS GROWTH

- Tangible evidence of corporate governance improvements, with dividend and share buyback growth.
- Earnings have tripled over the last decade, well ahead of U.S. earnings growth.

## WEAKER YEN AND CURRENCY HEDGING

- Currency hedging has outperformed unhedged Japanese equities due to a weakening yen and positive carry from higher USD rates versus JPY rates.

## WISDOMTREE IS A LEADER IN OFFERING JAPAN ETFS FOR MORE THAN 15 YEARS

- WisdomTree Japan Hedged Equity Fund (DXJ)
- WisdomTree Japan SmallCap Dividend Fund (DFJ)
- WisdomTree Japan SmallCap Hedged Equity Fund (DXJS)

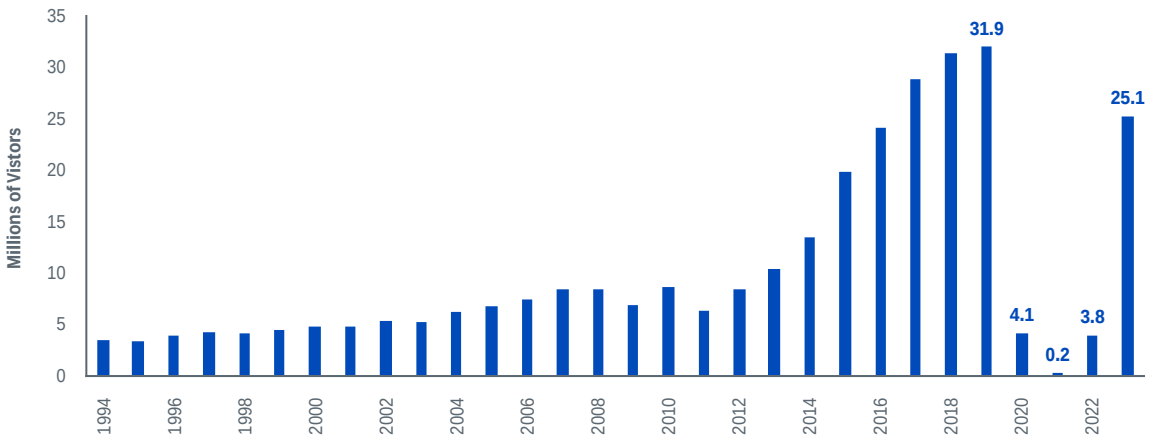
Your Instagram feed isn't deceiving you— it appears everyone *really* is going to Japan.

Well, not everyone.

A□er several COVID-19-disrupted years, tourism bounced back in 2023. The 25 million visitors were below 2019 levels but an encouraging rebound.

This isn't a travel piece. But foreign tourism statistics help contextualize the rebound in economic growth in Japan coinciding with foreign interest in the country.

**Figure 1: Foreign Tourism to Japan**



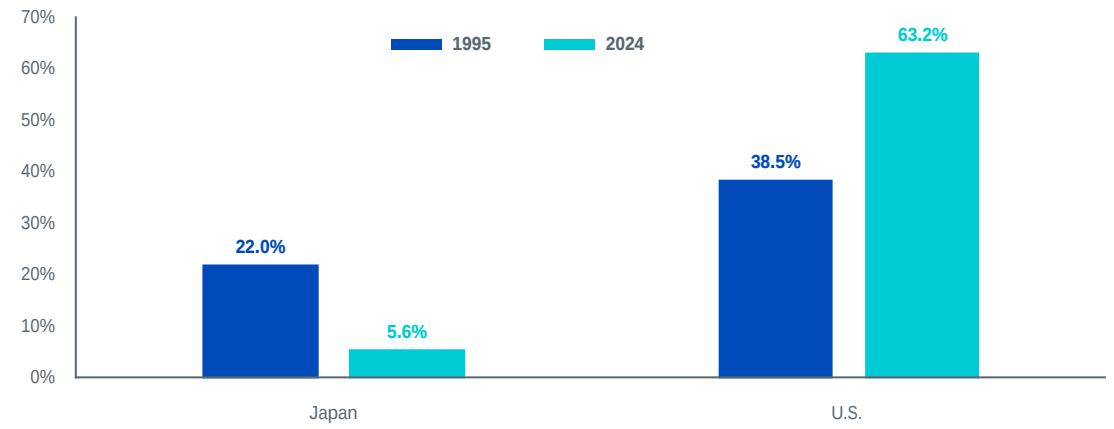

## THE "RIGHT" WEIGHT TO JAPAN IN PORTFOLIOS

Investors are forgiven if they haven't focused on Japanese equity allocations in some time. In the mid-1990s, Japan made up more than one-fi□h of the MSCI All Country World Index (ACWI). It now accounts for less than 6%. The U.S. influence on the benchmark grew from under 40% to 63%.

Many portfolio exposures to U.S. equities are even higher, considering common behavioral biases like home country bias and recency bias—and a belief in American exceptionalism.

Consistent U.S. outperformance over the last 15 years reinforced the notion global diversification is overrated. The experience of Japanese equities over the last three decades is o□en contrasted as the cautionary tale for this thinking.

**Figure 2: Country Weights in the MSCI All Country World Index (ACWI)**




Though a "buy-the-dip" mentality has worked well for U.S. growth allocations in the post-global financial crisis era, Japanese equities should remind investors of the "risk" aspect of the equity risk premium.

In the late 1980s, a decade of roaring economic growth in both the U.S. and Japan, investor enthusiasm for Japanese assets—both equities and real estate—was wildly overdone.

Growth rates couldn't keep pace with lo□y expectations. Over the next three decades, up until November 2020, Japanese equities remained below their December 1989 peak. At its lowest point in 2003, the Index was down 68% from its high.[1]

**Figure 3: Rolling Drawdown: Japan Three Decades Underwater**

## JAPAN RELATIVE VALUE DISCOUNT

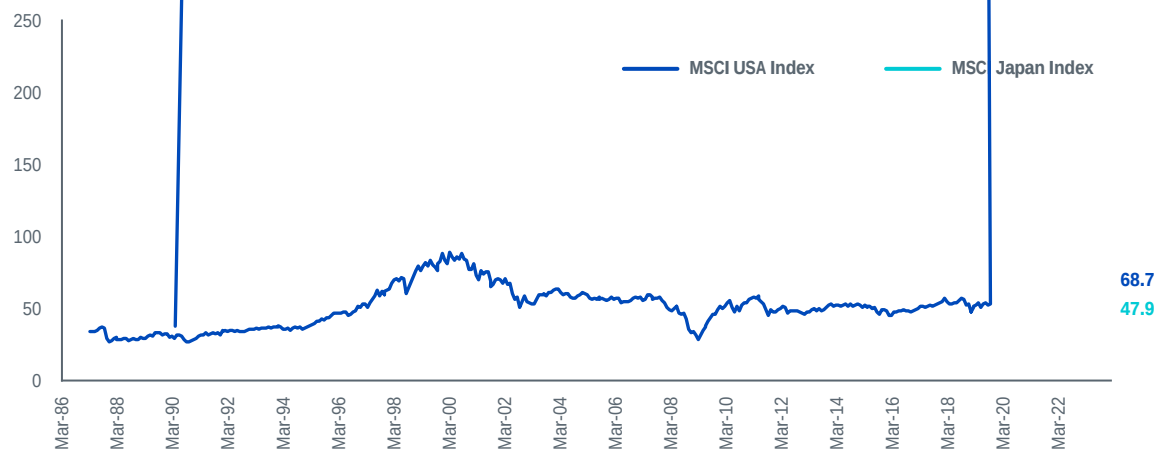
You will hear some market participants compare the Japanese asset price bubble to the current U.S. equity market. To be clear, we do not see U.S. equities at a level anywhere close to where Japan was in the late 1980s and early 1990s.

Comparing the price-to-dividend (the reciprocal of the dividend yield) of U.S. equities to that period, current U.S. valuations look far more reasonable.

We do, however, believe there is value to be had outside the U.S. and many investors would be well-served to consider mitigating U.S. over-weights that likely exist in portfolios.

Interestingly, despite sustained underperformance from Japanese equities, it has only been in the last six years that its valuations on the price-to-dividend ratio have been consistently below the U.S. (the dividend yield of Japan > U.S.).

**Figure 4: Japan Price-to-Dividend vs. U.S. Price-to-Dividend**



Price-to-earnings ratios also confirm the relative valuation discount of Japan versus the U.S. As the U.S. equity market continues to become increasingly more concentrated in a handful of high-growth tech-enabled companies, its multiples have become more stretched compared to Japan.

**Figure 5: Forward Price-to-Earnings**

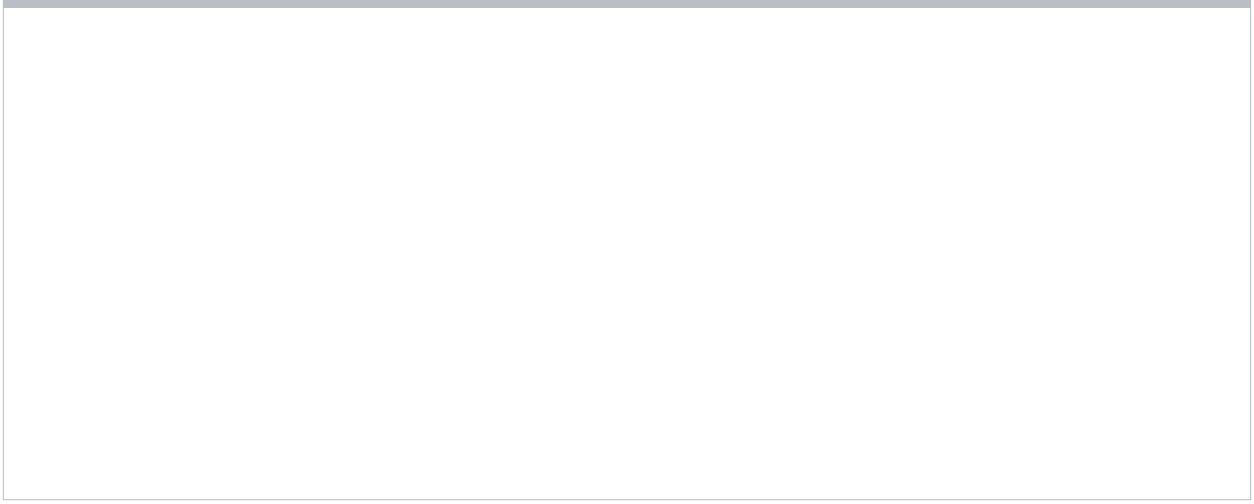
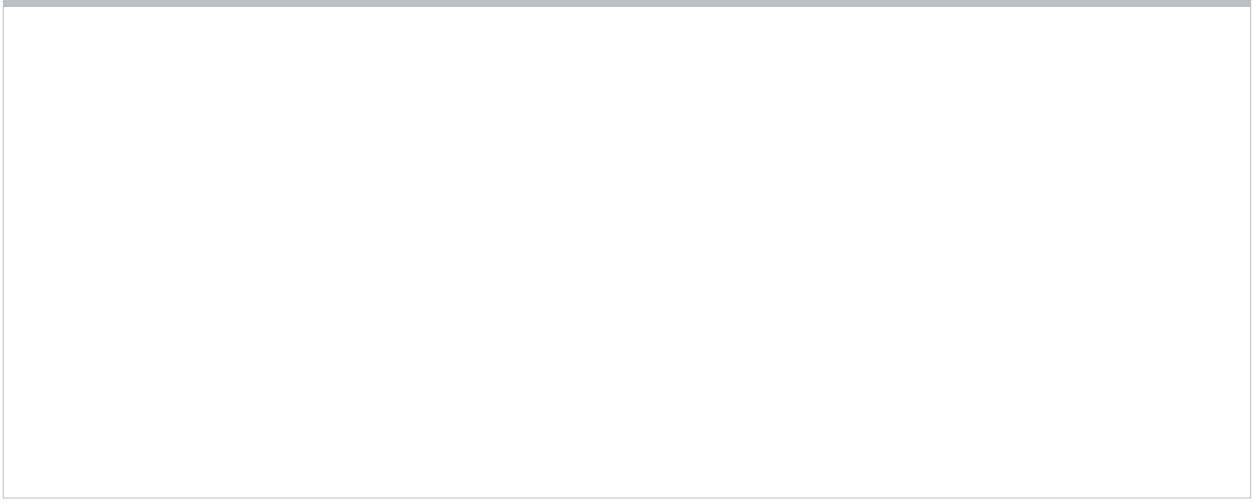


**Figure 6: Historical P/E Ratio Relative Valuation**



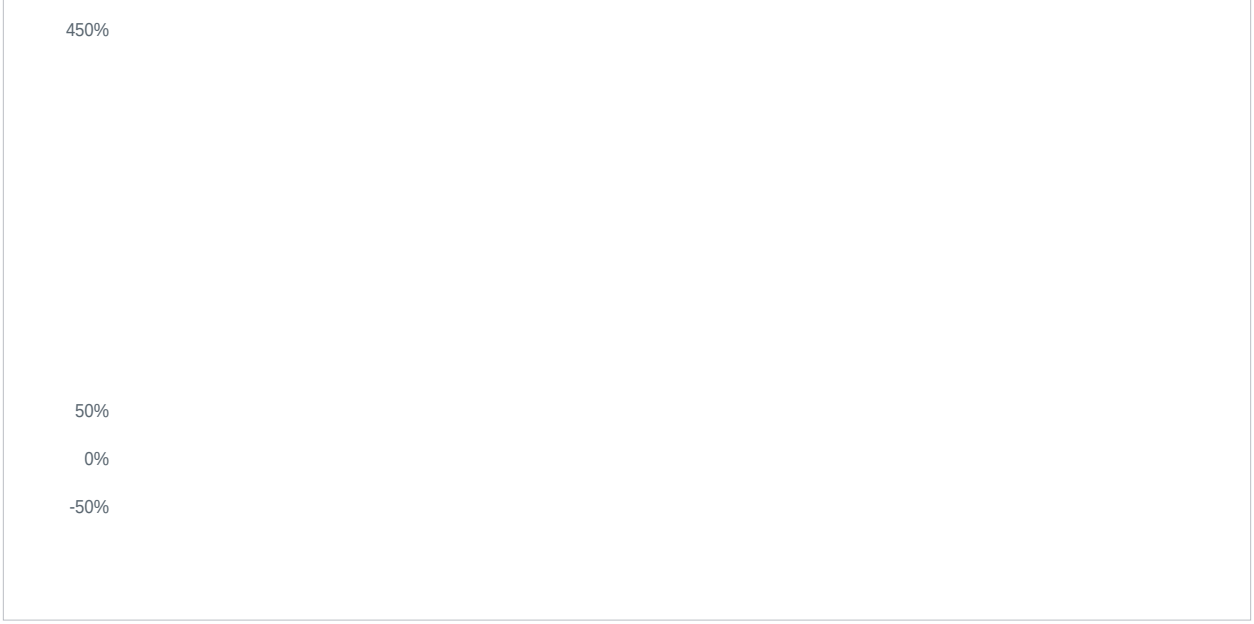
## FOLLOWING BUFFETT INTO JAPAN

Though there are a variety of positive catalysts for investor interest in Japanese equities, it is this valuation discount to the U.S. that enticed the world's most famous value investor—Warren Bu□ett—to make a splash with his investments in Japan in recent years.

Throughout 2019 and 2020, Bu□ett's Berkshire Hathaway amassed 5% stakes—that he increased to just under 10%—in five Japanese general trading firms, known as "sogo shosha."

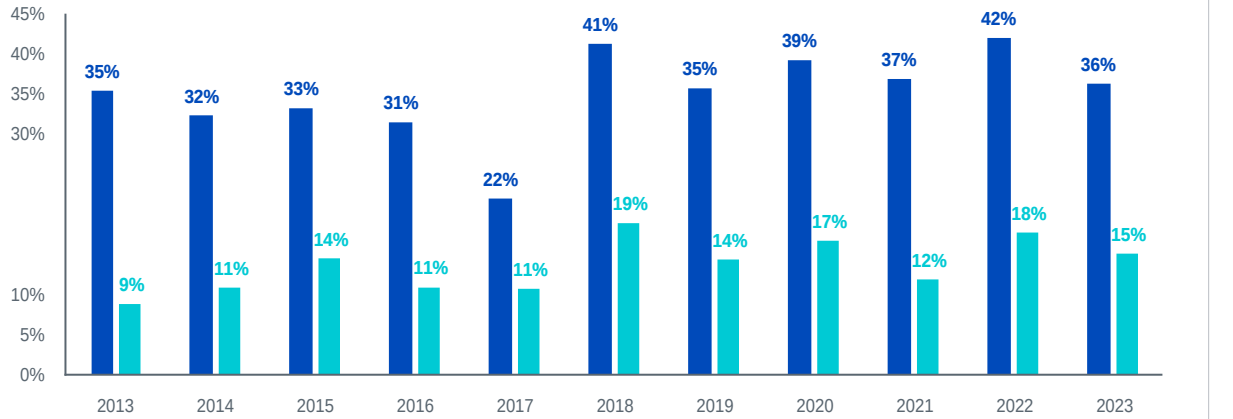
Since late August 2020, when Bu□ett's investments in the five trading houses became public, his investments have far and away beaten the returns of the S&P 500. The S&P 500 returns of 53% pale in comparison to the returns for these companies, ranging from 185% to 402%

**Figure 7: Buffett's Japanese Trading Houses Investments**



In 2022, the Tokyo Stock Exchange (TSE) instituted its biggest overhaul in 60 years to reinvigorate enthusiasm for Japanese equities. The TSE announced that about half of its listed companies had a price-to-book ratio below 1x. It said that these companies needed to disclose their policies and specific initiatives for improving valuations.

**Figure 8: Percentage of Companies with Price-to-Book Less than 1**




Bu□ett's investments highlight the new sources of capital flowing into Japan, looking to take advantage of the low valuations. There are also capital inflows with shi□ing allocations from China. An almost symmetrical picture emerges for these two markets over the last three years—Japanese equities are up 52%, while Chinese equities are down 53%.

Japan is a logical alternative to China, as many Japanese companies sell to China but don't have the political risks associated with directly investing in China.

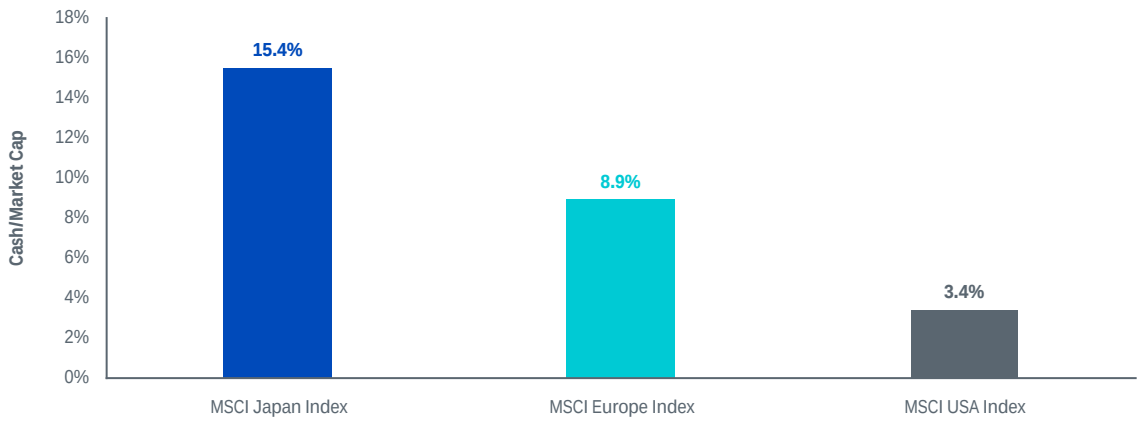
**Figure 9: Growth of $100: Japan vs. China**

## RETURNING CASH TO SHAREHOLDERS

One way Japanese companies focused on increasing price-to-book ratios was by reducing the high degree of cash on balance sheets with increases in dividends and share buybacks.

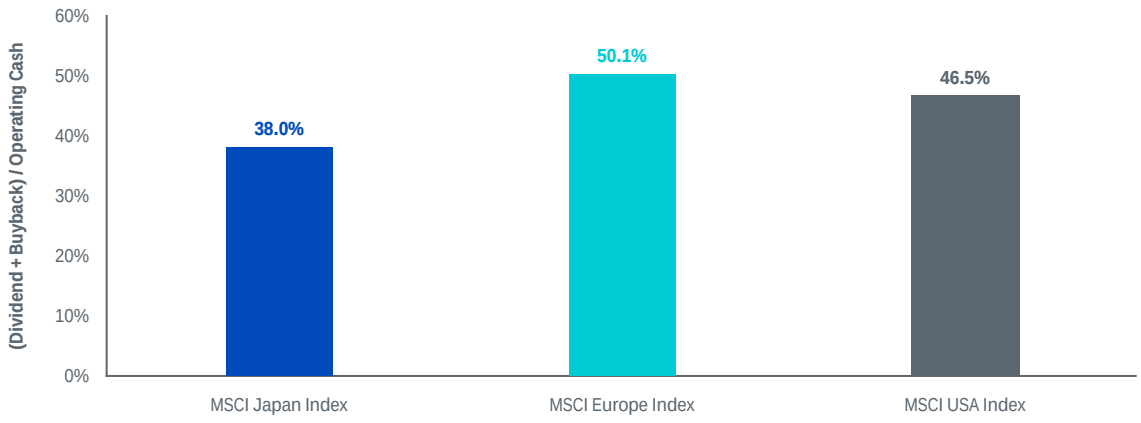
Though companies cannot control the numerator (price) of the price-to-book ratio, returning cash to shareholders does lower the book value of assets, shrinking the denominator.

**Figure 10: High Cash-to-Market Cap Ratio**




The reason for high cash hoards is that Japan, Inc., is notoriously conservative with payouts. Dividends and buybacks make up just 38% of operating cash flow for Japan as opposed to 50% for Europe.

**Figure 11: Low Payout Ratios**



## EARNINGS GROWTH AND YEN SENSITIVITY

Payouts are just part of the story of improving fundamentals. Dividend growth is being funded by significant rebounds in earnings. Japanese earnings have nearly tripled since 2012.

**Figure 14: Japan's Earnings Nearly Triple since 2012**

In part, this earnings growth was fueled by a more competitive currency. Japan is an export-heavy economy, relying on the physical export of goods as well as the "export" that comes from its rebounding tourism economy (see our first chart!).

Toyota Motors, for example, has stated every ¥1 depreciation against the dollar boosts earnings 34 (arnin6 thjvains4u1 /CS0 6JETEMC .)-35Vi.2 6.

## CURRENCY HEDGING

Over the last several calendar years, the yen weakened heavily versus the dollar. For a foreign investor, investing in Japanese equities without a currency hedge would mean being fully exposed to the weakening yen, wiping out strong gains in the returns of the companies themselves.

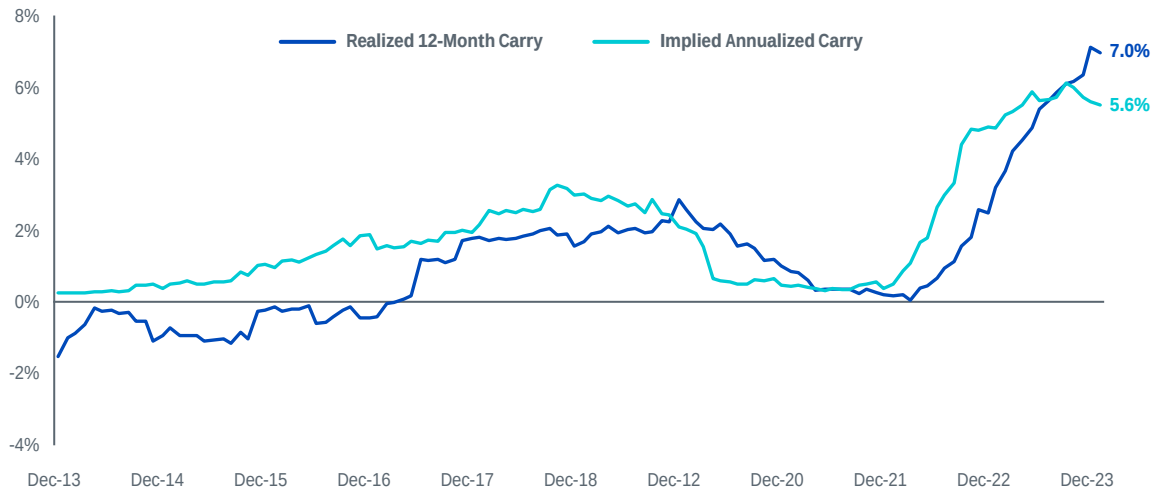
Figure 16: Getting Currency Wrong Can Wipe out Gains

One underappreciated aspect of currency hedging, particularly with the current market backdrop, is the carry of hedging yen exposure for USD-based investors.

Because of higher interest rates in the U.S. than in Japan, investors who are hedging yen exposure are "paid" to hedge based on the interest rate differential—currently a 5.6% implied annualized carry.

Over the last 12 months, the realized carry—the difference in the returns of the hedged index and local currency index—was 7%.

**Figure 18: Getting "Paid" to Hedge Japanese Yen: Positive Carry**



## JAPAN FOR THE NEXT DECADE

In his book *Stocks for the Long Run,*

## THE ALLOCATION DECISION: WISDOMTREE JAPAN ETFS

WisdomTree has been a leader in o□ering Japanese equity exposures in the ETF structure for more than 15 years. There are three distinct options for accessing Japanese equities, with each Fund outperforming its respective benchmark over the standard 1-year, 3-year, 5-year and 10-year periods.

Each Fund weights constituents by a measure of fundamental value—dividends—to create a repeatable and consistent value discipline that can keep investors exposed to Japanese equities while mitigating valuation risks like those experienced in the 1980s and 1990s.

### WisdomTree Japan Hedged Equity Fund (DXJ)

- Gain broad equity exposure to Japanese dividend-paying companies with an exporter tilt
- Currency hedge mitigates exposure to fluctuations of the Japanese yen

### WisdomTree Japan SmallCap Dividend Fund (DFJ)

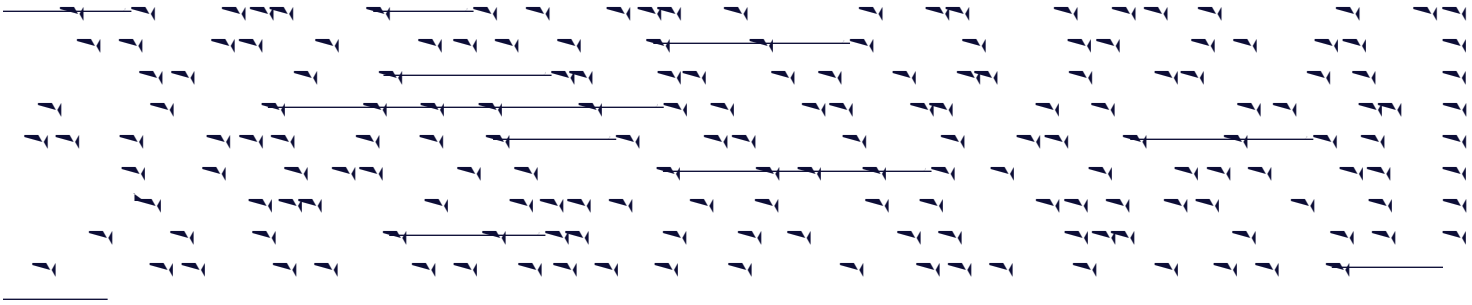
- Gain exposure to Japanese small-cap equity from dividend-paying companies
- Use to complement Japanese exposure, accessing local economic growth

### WisdomTree Japan Hedged SmallCap Equity Fund (DXJS)

- Gain small-cap equity exposure to Japanese dividend-paying companies
- Currency hedge mitigates exposures to fluctuations in the Japanese yen

**Figure 21: Returns as of December 31, 2023**

| | | | | Average Annual Total Returns | | | |
|---|---|---|---|---|---|---|---|
| **Name** | **Ticker** | **Inception Date** | **Expense Ratio** | **1-Year** | **3-Year** | **5-Year** | **10-Year** |
| WisdomTree Japan Hedged Equity Fund NAV Returns | DXJ | 6/16/06 | 0.48% | 40.8% | 21.4% | 16.9% | 10.0% |
| WisdomTree Japan Hedged Equity Fund Market Price Returns | | | | 41.9% | 21.1% | 17.0% | 9.8% |
| MSCI Japan Local Currency Index | | | | 28.6% | 11.7% | 12.4% | 8.1% |
| Excess Return (based on NAV Returns) | | | | 12.2% | 9.7% | 4.5% | 1.9% |
| **Name** | **Ticker** | **Inception Date** | **Expense Ratio** | **1-Year** | **3-Year** | **5-Year** | **10-Year** |
| WisdomTree Japan SmallCap Dividend Fund NAV Returns | DFJ | 6/16/06 | 0.58% | 21.6% | 3.7% | 5.5% | 6.2% |
| WisdomTree Japan SmallCap Dividend Fund Market Price Returns | | | | 21.8% | 3.6% | 5.7% | 6.1% |
| MSCI Japan Small Cap Index | | | | 13.3% | -0.9% | 4.4% | 5.4% |
| Excess Return (based on NAV Returns) | | | | 8.3% | 4.6% | 1.1% | 0.8% |
| **Name** | **Ticker** | **Inception Date** | **Expense Ratio** | **1-Year** | **3-Year** | **5-Year** | **10-Year** |
| WisdomTree Japan SmallCap Hedged Equity Fund NAV Returns | DXJS | 6/28/13 | 0.58% | 36.7% | 17.8% | 13.0% | 10.6% |
| WisdomTree Japan SmallCap Hedged Equity Fund Market Price Returns | | | | 38.1% | 17.6% | 13.2% | 10.4% |
| MSCI Japan Small Cap Local Currency Index | | | | 21.1% | 10.0% | 9.7% | 8.5% |
| Excess Return (based on NAV Returns) | | | | 15.6% | 7.8% | 3.3% | 2.1% |

**Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at wisdomtree.com/investments.**

## GLOSSARY