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# A QUALITY DECADE FOR INTERNATIONAL EQUITIES

**Matt Wagner — Associate Director, Research**  
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[Growth](#) has outperformed [value](#) globally for the last decade. It's been a significant headwind for rules-based ("quant") strategies targeting less expensive stocks.

During this rough period, quants have paid increasing attention to "quality" companies.

Quality has a variety of definitions—as should all robust factors—but typically includes measures of profitability and [leverage](#).

By screening profits, quality is closely related to growth, providing a good hedge to value or an attractive overlay to a value-tilted strategy<sup>1</sup>.

Due to the strong performance of quality strategies—and the resilience of the factor during times of market [volatility](#)—capital has flowed into quality-focused funds this year.

WisdomTree has been an industry leader: Our [currency-hedged](#) approach to quality in broad developed international ranks in the top 5% of its Morningstar category since its inception.<sup>2</sup>

## Quality Outperformance in Developed International Markets

A lot of factor discussions are U.S.-centric, but quality has had a significant performance advantage in developed international markets.

Below, we chart the performance of the first and fifth quintiles of constituents from the [MSCI EAFE Index](#) scored by a combination of [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#). ROE is a good measure of the profits generated on the capital provided by common stockholders, while including ROA provides a check on the leverage financing that may be juicing ROE.

The highest quality quintile outperformed the lowest by nearly 500 [basis points \(bps\)](#) annualized, and at 274 bps of lower volatility.

## MSCI EAFE Quintiles of Return on Equity and Return on Assets (5/31/09-5/31/19)



|                   | 1st Quintile | 5th Quintile | Differential |
|-------------------|--------------|--------------|--------------|
| Annualized Return | 8.41%        | 3.50%        | 4.91%        |
| Annualized Risk   | 14.02%       | 16.75%       | -2.74%       |

Sources: WisdomTree, FactSet. Quintiles are market cap-weighted and semi-annually rebalanced at the end of June and December using trailing one- to three-year ROE and ROA. Past performance is not indicative of future results. You cannot invest directly in an index.

A [cap-weighted](#) index gives no consideration to [fundamentals](#) like profitability in its composition. The Financials sector dominates the MSCI EAFE Index, with nearly a 19% weight, due to the market having over 100 mid-sized national banks that are fighting for market share and profitability.

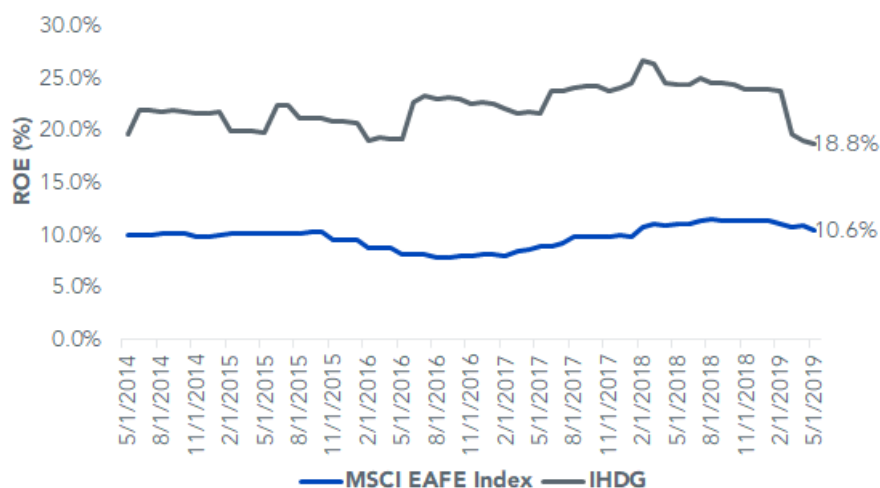
| MSCI EAFE Index        |              |       |        |
|------------------------|--------------|-------|--------|
| Sector                 | Index Weight | ROA   | ROE    |
| Financials             | 18.97%       | 0.49% | 8.19%  |
| Industrials            | 14.66%       | 3.83% | 11.59% |
| Consumer Staples       | 11.96%       | 5.62% | 15.45% |
| Health Care            | 11.05%       | 5.96% | 14.69% |
| Consumer Discretionary | 10.94%       | 4.11% | 12.26% |
| Materials              | 7.24%        | 6.15% | 13.93% |
| Information Technology | 6.60%        | 5.46% | 11.23% |
| Energy                 | 5.64%        | 4.29% | 9.91%  |
| Communication Services | 5.56%        | 3.20% | 9.86%  |
| Real Estate            | 3.73%        | 3.58% | 6.68%  |
| Utilities              | 3.65%        | 2.09% | 9.05%  |

Sources: WisdomTree, FactSet. Data as of 5/31/19. Green shading indicates higher ROA or ROE and red shading indicates lower ROA or ROE for respective sectors. Weights subject to change.

## The WisdomTree Quality Approach

Five years ago, WisdomTree launched the [WisdomTree International Hedged Quality Dividend Growth Fund \(IHDG\)](#). It screens for quality [dividend](#)-paying companies. The main measures for quality are trailing three-year ROE and three-year ROA. The result is a Fund that has had, on average, about twice as high a ROE than the MSCI EAFE Index.

## Return on Equity (5/31/14 – 5/31/19)



Sources: WisdomTree, FactSet. Inception date for IHDG was 5/7/14. Past performance is not indicative of future results. You cannot invest directly in an index.

As of May 31, 2019, the Fund held just under 4% of its weight in Financials. Its biggest sector over-weights are in Consumer Discretionary, Industrials, Health Care, and Information Technology.

Since its inception, IHDG has outperformed the average returns of its peers in the Morningstar Foreign Large Growth Category, as well as both the [MSCI EAFE Local Currency](#) and MSCI EAFE Indexes.

Part of this outperformance is explained by its currency hedge during a strong dollar environment—evident by the outperformance of the MSCI EAFE Local Currency Index over the unhedged MSCI EAFE Index. But it has also benefited from its over-weight to quality companies.

| Name/Category                                   | 5-Year Annualized |         |         |                    |              |
|---|-------------------|---------|---------|--------------------|--------------|
|   | 1 year            | 3 years | 5 years | Standard Deviation | Sharpe Ratio |
| WisdomTree Intl Hdgd Qual Div Gr ETF (NAV)      | -1.25%            | 7.28%   | 6.57%   | 10.90%             | 0.53         |
| Morningstar Foreign Large Growth Category (NAV) | -5.11%            | 7.14%   | 3.19%   | 11.82%             | 0.20         |
| MSCI EAFE Local Currency Index                  | -2.32%            | 6.90%   | 5.01%   | 11.06%             | 0.38         |
| MSCI EAFE Index                                 | -5.75%            | 5.82%   | 1.27%   | 12.02%             | 0.04         |

Sources: WisdomTree, Zephyr StyleADVISOR. Inception date for IHDG was 5/7/14. Returns from 5/31/14-5/31/19. Past performance is not indicative of future returns. You cannot invest directly in an index.

For definitions of terms in the chart, please visit our [glossary](#).

## Conclusion

Many U.S. investors actively monitor factor exposures for their domestic equity allocations, but then default to an unhedged market cap-weighted allocation or unhedged [active manager](#) for their international exposure.

[We have long argued the merits of at least partial hedging in international equities](#), in order to improve the risk-return profile by mitigating some of the embedded currency bet. And just as investors are familiar with harvesting the quality risk-premium in U.S. equities in a rules-based ETF, we would argue investors should consider doing so in developed international markets as well.

| Name/Category                              | Ticker | Exp. Ratio | Inception Date | Annualized Returns as of 3/31/2019 |         |         |          |                 |
|--|--------|------------|----------------|------------------------------------|---------|---------|----------|-----------------|
|  |        |            |                | 1 year                             | 3 years | 5 years | 10 Years | Since Inception |
| WisdomTree Intl Hdgd Qual Div Gr ETF (NAV) | IHDG   | 0.58%      | 5/7/14         | 4.99%                              | 8.97%   | N/A     | N/A      | 7.18%           |
| WisdomTree Intl Hdgd Qual Div Gr ETF (MP)  | -      | -          | -              | 4.61%                              | 9.16%   | N/A     | N/A      | 7.07%           |
| Morningstar Foreign Large Growth Category  | -      | -          | -              | -3.23%                             | 8.17%   | 3.87%   | 9.91%    | 3.58%           |

Sources: WisdomTree, Zephyr StyleADVISOR. Since-inception returns from 5/31/14-3/31/19.

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WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total Returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

<sup>1</sup>Novy-Marx, Robert. (2013). "The Other Side of Value: The Gross Profitability Premium," *Journal of Financial Economics*, 108, issue 1, p. 1-28.

<sup>2</sup>Sources: Morningstar, WisdomTree, 5/31/14-3/31/19. Inception date for IHDG was 5/7/14. There are 320 investments included in peer group for Morningstar Foreign Large Growth. The percentile rank is the funds' total-return percentile rank compared to all funds within the same Morningstar category and is subject to change each month. There are 320 investments included in peer Foreign Large Growth Category , for since inception performance, 5/31/14-3/31/19. For the one year period as of 3/31/19 the fund is in the 7 rank out of 442 funds.

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You cannot invest directly in an index.

## DEFINITIONS

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**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.

**Leverage** : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

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

**Currency hedging** : Strategies designed to mitigate the impact of currency performance on investment returns.

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

**Return on assets (ROA)** : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

**Basis point** : 1/100th of 1 percent.

**Market capitalization-weighting** : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

**Fundamentals** : Attributes related to a company's actual operations and production as opposed to changes in share price.

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

**MSCI EAFE Local Currency Index** : A market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan, with performance measured in local currency term.

**Active manager** : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.