# DO FACTORS WORK IN INTERNATIONAL EQUITIES?

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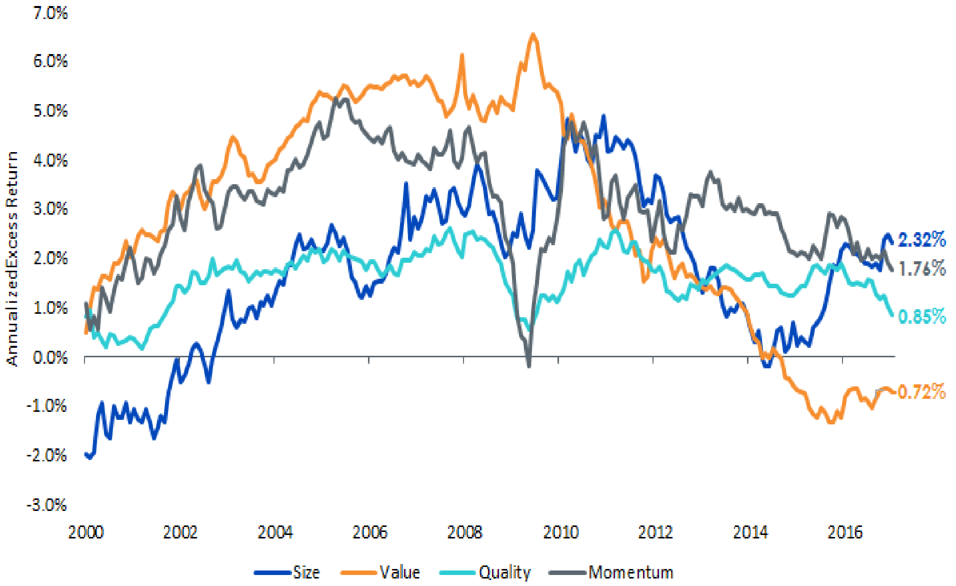
A few weeks ago, we looked at the current state of affairs in smart beta factors in the U.S. markets. With flows into U.S. smart beta stock ETFs in recent years, we found that there was a reduced, but not eliminated, effectiveness with a factor-based approach.

Many investors see international equity markets as generally less efficient than U.S. markets, and as such, we wanted to see if factors have a greater propensity to outperform the broad market outside the U.S.

**Rolling 10-Year Annualized Excess Returns vs. MSCI EAFE**




Sources: WisdomTree, Bloomberg, Kenneth French Data Library, with data for 10/31/1990 through 10/31/2017. Past performance is not indicative of future results. You cannot invest directly in an index. Size refers to an equal split of the SMALL LoBM and SMALL HiBM portfolios. Value refers to the BIG HiBM portfolio. Quality refers to the BIG HiOP portfolio. Momentum refers to the BIG HiPRIOR portfolio. SMALL LoBM: Small low book to market. SMALL HiBM: Small high book to market. BIG HiBM: Big high book to market. BIG HiOP: Big high operating profitability. BIG HiPRIOR: Big high prior momentum.

*For definitions of the terms in the graph please visit our glossary.*

**International Factors: Larger Excess Performance than U.S. Factors**

Over the last 10 years, the size, quality and momentum factors have generated strong excess returns compared to the MSCI EAFE Index. Echoing what we saw in the U.S., the value factor is in the midst of its worst relative performance in its (albeit shorter) history.

An important takeaway we found was that for the international size, value and momentum factors, their excess performance over the last 10 years was greater than what we found from their U.S. counterparts (and the international quality factor, although having slightly less robust outperformance than the U.S. quality factor, still managed to outperform the MSCI EAFE Index on every rolling 10-year time frame).

To us, this has massive implications: that a factor-based approach may be even more effective at outperforming [cap-weighted](#) indexes in international markets than in U.S. markets.

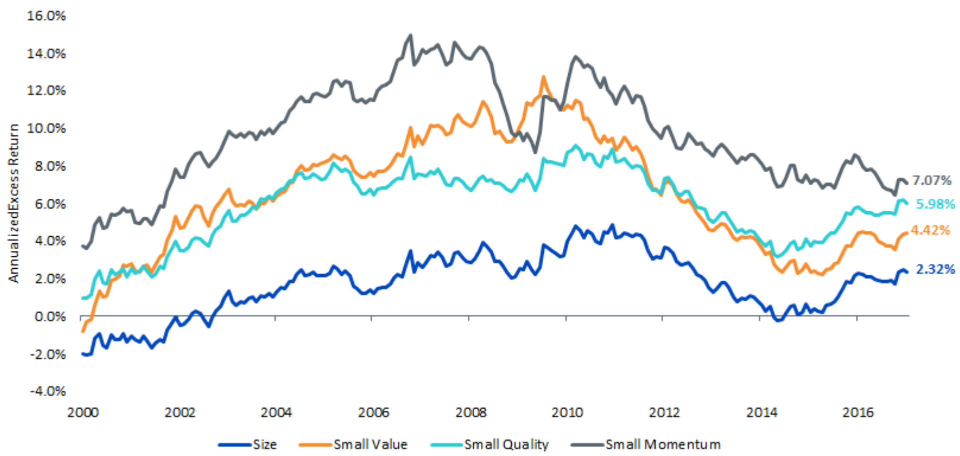
### Size on the Rise

Interestingly, the size factor has seen its excess performance spike upward in recent years. When we review investors' portfolios, we typically see many who already allocate to U.S. [small caps](#). However, it is far less frequent that we find international small caps, from either developed or emerging markets. Given how much value small caps can add to a portfolio, we fully advocate for their inclusion where appropriate. That said, when it comes to small caps, we always prefer a discretionary approach.

### Not All Small Caps Will Suffice

AQR wrote an influential paper in 2015 about the need to take an additional step beyond market cap when analyzing and investing in small caps.[1] While many small companies can be lower in quality, when those are removed from the equation, the size factor becomes much more robust in efficacy. The paper focused on U.S. markets, so we wanted to see if the additional layer of scrutiny held up in international markets as well.

### Rolling 10-Year Annualized Excess Return vs. MSCI EAFE

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### Size Is Good, But Size and Something Else Is Better

On every single rolling time frame, the combination of size and one additional factor outperformed the standalone size factor. Further, outside of a three-month period in 2000, each of the "size-plus" portfolios outperformed the broad MSCI EAFE Index as well.

Therefore, we can conclude that investors allocating to international small caps may outperform the market—but those allocating *within* small caps may do even better.

## Dividend Weighting in Small Caps: 3 Factors in 1

Launched in 2006, the WisdomTree International SmallCap Dividend Fund (DLS) takes our dividend-weighted approach and applies it to small-cap companies in the international developed markets. In addition to the obvious size factor, we've found that DLS also regresses strongly to the value and quality factors (mirroring the results of our U.S. dividend-weighted strategies). This combination has provided a potent multifactor approach in generating significant excess returns compared to cap weighting, along with an income boost to boot.

With U.S. investors starting to pivot portfolio flows into internationally focused strategies, we believe it makes a lot of sense to consider small caps—particularly those that implement a factor-based approach.

[1]Source: Clifford S. Asness et al., "Size Matters, if You Control Your Junk," AQR, 1/15 (first draft).

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You cannot invest directly in an index.

## DEFINITIONS

**Smart Beta** : A term for rules-based investment strategies that don’t use conventional market-cap weightings.

**Factor-based** : Strategies that focus on groups of firms thought to share common attributes, be it in terms of their fundamentals or their share price behavior.

**Size** : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

**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.

**Momentum** : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

**MSCI EAFE Index** : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

**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 tim.

**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.

**Small caps** : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

**Dividend weighted** : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.