

THINKING INTERNATIONAL: SECTOR EXPOSURES COMPLEMENT (AND COMPLETE) THE ECONOMIC CYCLE

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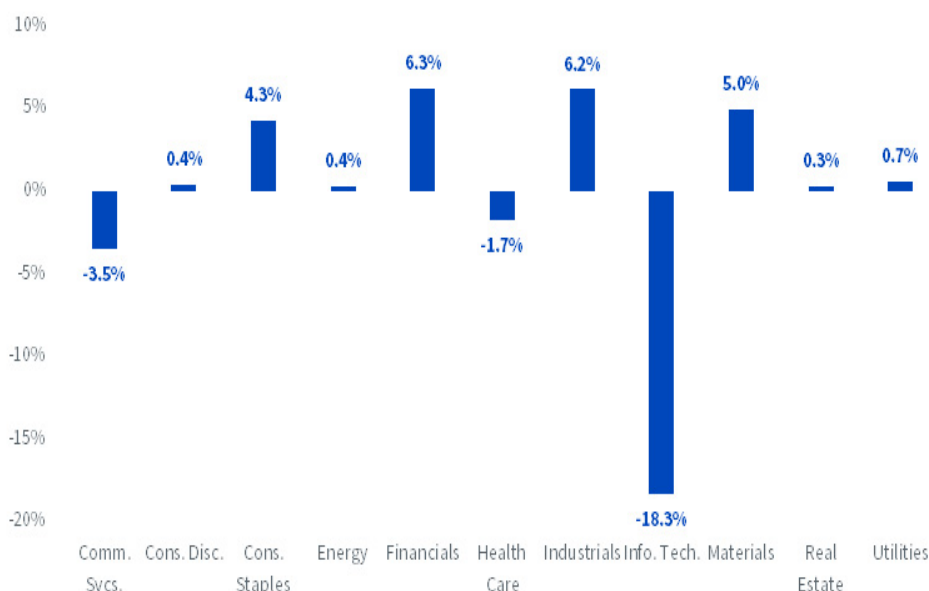
This blog is the first installment of a four-part series that examines the tactical and strategic case for investing internationally despite a multi-year period of U.S. equity outperformance.

Over the past several months, we've fielded a series of questions from advisors about why they should EVER allocate outside of the U.S. For the last decade, U.S. equities have handily outperformed, meaning that any allocations apart from U.S. [large-cap](#) exposure have probably cost investors returns. However, we feel this comparatively short-sighted period of performance-chasing misses a key consideration of prudent investing.

A major part of international equities' appeal is that they provide sector exposures dissimilar to what U.S. investors are familiar with. In style investing parlance, we often categorize developed equity markets as [value](#)-focused (and cyclical, from an economic standpoint) while the U.S. is [growth](#)-centric.

These tendencies materialize through notable industry tilts between the U.S. and developed market equity universes. Over the past several years, international equities maintained over-weight exposures to the Financials, Industrials and Materials sectors, all of which are cyclical economic bellwethers. These exposures almost entirely come at the expense of Information Technology and (to a lesser extent) Communication Services, two sectors that have come to define U.S. equity investing due to mega-cap heavyweights like Apple, Amazon, Microsoft, Alphabet and more.

Avg. Sector Over-/Under-Weights: MSCI EAFE vs. MSCI USA



Sources: WisdomTree, MSCI, as of 6/30/23. Average sector comparison dates to the beginning of our available data history in early 2017. You cannot invest directly in an index.

Though U.S. equities have led international stocks for more than 20 years now, their outperformance has not been broad-

based. It's important to decompose the outsized impact some of these companies have had on a domestic portfolio. During the 2010–2020 decade, the [S&P 500](#) outperformed the [MSCI EAFE Index](#) by 7.5% per year, annualized in U.S. dollar terms.¹ The MANAMA cohort (Meta, Apple, Netflix, Amazon, Microsoft and Alphabet) alone contributed 1.68% toward that advantage, or roughly a quarter of overall annual outperformance.

S&P 500 MANAMA Attribution vs. MSCI EAFE (2010–2020)

| Stock | Total Attribution Impact | % of Total Performance |
|---|--------------------------|------------------------|
| Apple Inc. | 0.66% | 8.70% |
| Microsoft Corporation | 0.38% | 5.10% |
| Amazon.com, Inc. | 0.31% | 4.10% |
| Meta Platforms Inc. Class A | 0.15% | 2.05% |
| Alphabet Inc. Class A | 0.12% | 1.54% |
| Netflix, Inc. | 0.06% | 0.78% |
| Total | 1.68% | 22.28% |
| Total S&P 500 Outperformance over MSCI EAFE | 7.55% | |

Sources: WisdomTree, FactSet, MSCI, as of 12/31/19. Past performance is not indicative of future results. You cannot invest directly in an Index.

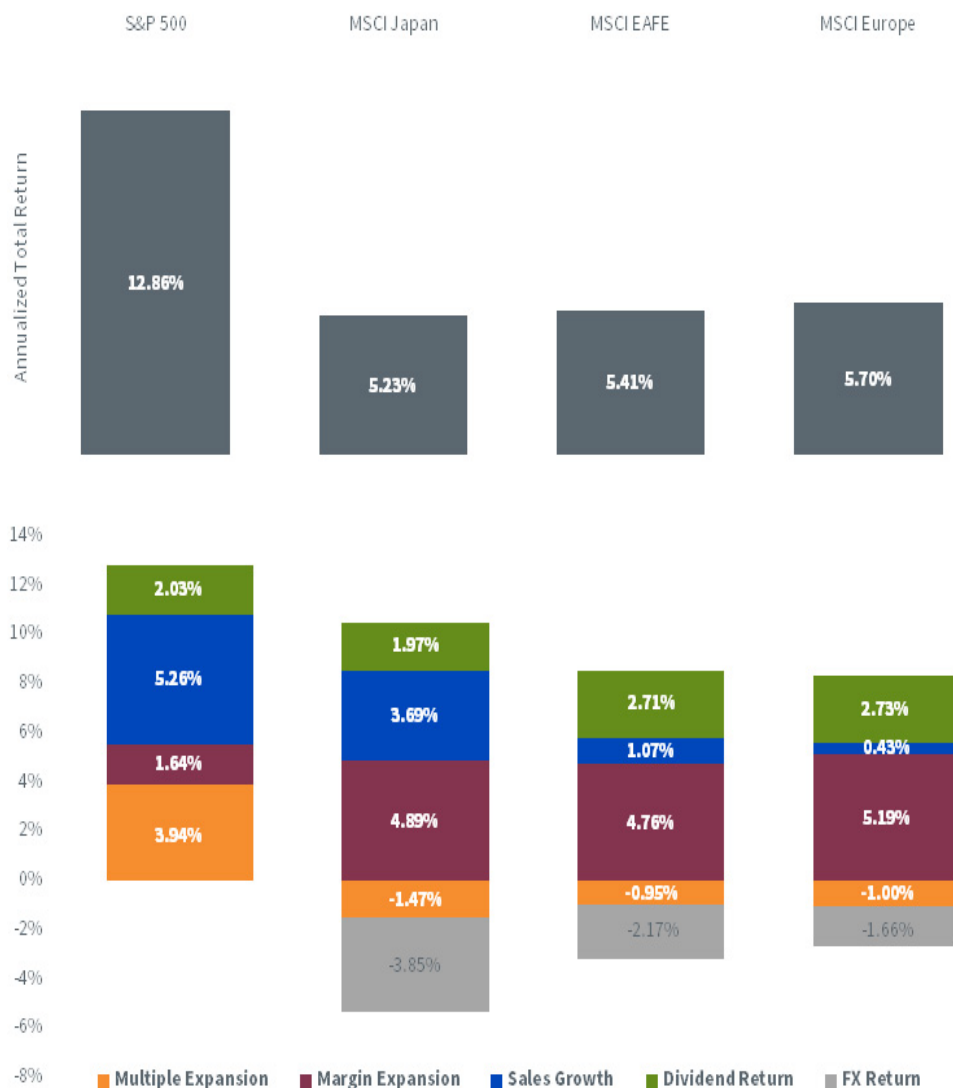
Broader sector effects were similar. Information Technology, the largest over-weight exposure in the U.S. relative to developed international, contributed 2.3% of the 7.5% annualized outperformance per year, or about 30% of the advantage.

Through this lens, the extent of the U.S.'s success seems like an anomaly more than a foregone conclusion. The absence of a similar Information Technology and Communication Services footprint overseas, therefore, is advantageous for U.S. investors because it helps provides exposure to the complete economic cycle while avoiding overconcentration. A global portfolio can potentially generate higher returns from anchor positions in U.S. growth, while participating in market rotations to value stocks and other cyclical beneficiaries.

Digging Deeper

Over the past 10 years, U.S. outperformance has been predicated on steady support from valuation changes, fundamental drivers and positive currency effects. If previous market cycles are any indication, it appears unlikely that every driver of returns will continue to favor the U.S. versus the rest of the developed world.

Return Attribution (Trailing 10-Year)



Source: WisdomTree, FactSet, MSCI, as of 6/30/23. Past performance is not indicative of future results. You cannot invest directly in an index.

Roughly half of the S&P 500's 12.9% annualized return from June 2013 through June 2023 is attributable to business successes at the top and bottom lines. Over 5% came from sales growth, while operational efforts to grow earnings relative to costs added another 2% through margin expansion. Dividends delivered another 2%, while dollar strength relative to other currencies weighed on returns overseas.

But the U.S. also received a boost from a speculative component absent in the EAFE (Europe, Australasia and the Far East), European and Japanese equity markets: multiple expansion. U.S. investors happily paid more per dollar of company earnings over the past decade, propelling many S&P 500 constituents higher and adding 4% to the index's annualized return in the process.

Abroad, however, an interesting phenomenon occurred.

Unlike the U.S., the EAFE, European and Japanese markets instead whittled *down* the prices they were willing to pay per unit of earnings, resulting in multiple *contraction* which weighed on returns.

Meanwhile, however, the equity fundamentals of each region surprisingly improved. The combination of margin expansion and strong sales growth contributed over 5% to total returns in EAFE and Europe and nearly 9% in Japan. Dividends between the two regions added 2.7% apiece (and 2% in Japan), resulting in return contributions due to fundamental factors ranging from 8% to 11% across all three regions.

Despite improving fundamentals, overseas multiples contracted, creating an attractive valuation opportunity and potential entry point for developed international equities.

Relative to the U.S., developed equity market multiples remain two standard deviations below their long-term averages

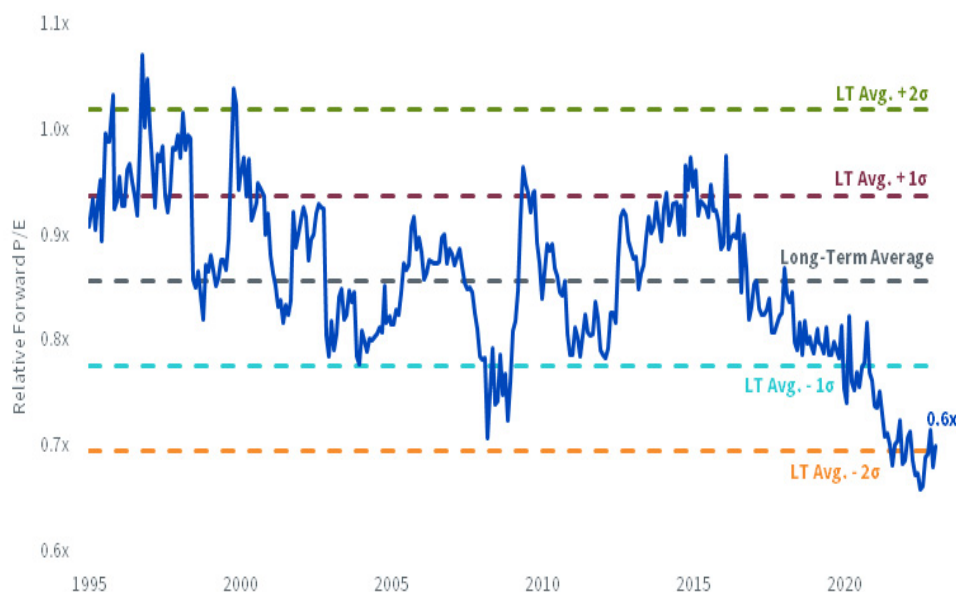
on a forward earnings basis. Both the MSCI EAFE and MSCI Europe indexes currently trade at about 0.7 times the forward P/E of the S&P 500, below their long-term averages of 0.9 times apiece.

MSCI EAFE vs. S&P 500



Source: WisdomTree, FactSet, as of 6/30/23. You cannot invest directly in an index. Subject to change.

MSCI Europe vs. S&P 500



Source: WisdomTree, FactSet, as of 6/30/23. You cannot invest directly in an index. Subject to change.

Both markets' relative valuations steadily declined over the past decade, indicative of the "melt-up" in U.S. equities while overseas investors preferred cheaply valued shares. The trend is similar in Japan, which currently trades at 0.8 times the U.S. [forward P/E](#), well below its 1.3 times long-term average.

The average relative multiples imply that EAFE and Europe historically traded at slight discounts to the U.S., which is reasonable considering that the latter has been the preeminent return driver in global equity markets. Japan, however, historically commands a *premium* to the U.S., which is unusual since it has been mired in a low-growth environment for most of our recent memory.

With current valuations for all three markets comfortably below their long-term averages (and some rejecting historical relationships in the process), the prevailing discounts are compelling when coupled with robust equity fundamentals

fueling long-term returns. For investors looking to increase exposure to EAFE, we believe the [WisdomTree International Quality Dividend Growth Fund \(IQDG\)](#) could be well positioned to capitalize on these market trends.

To access the complete developed international market insight, click [here](#).

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You cannot invest directly in an index.

DEFINITIONS

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

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.

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.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

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.

Median Forward Price-to-Earnings (P/E) Ratio : Ratio of current price per share to estimated earnings per share over the course of the next year. Median refers to the middle observation, meaning that 50% of the dataset is below and 50% is above this value.