# Global Diversification in Our Model Portfolios

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## Key Takeaways

- U.S. equities have dominated since the global financial crisis, but market leadership is cyclical.
- Abandoning international stocks in hopes of continued U.S. outperformance assumes this cycle is permanent—a risky assumption in investing.
- International diversification remains a key risk management tool. Global equity markets don’t move in perfect sync, offering potential downside protection when U.S. markets stumble.
- Within our international equity allocations, we are particularly focused on Japan within international developed markets and India within emerging markets.
- Currency hedging in developed markets makes strategic sense, as it can reduce volatility, provide exposure to the U.S. dollar as a hedge against market downturns and enhance returns via interest rate differentials.

In investing, it's easy to let recency bias dictate our decisions. The past decade-plus of U.S. equity dominance has been remarkable, leading many investors to question the need for international diversification. But history tells us that markets move in cycles.

## Why We Still Believe in International Diversification

While our Model Portfolios maintain an over-weight allocation to U.S. equities, we continue to see strategic value in international diversification.

- **Market Leadership Is Cyclical**—The U.S. has dominated international equities since the global financial crisis (GFC), but this is just one chapter in a longer story. In prior decades, international stocks have held extended periods of outperformance, often when the U.S. faced headwinds. Betting that this cycle will continue indefinitely is a risky assumption.

- **Diversification Benefits**—Different regional equity markets do not move in tandem. Less-than-perfect correlations between international and U.S. stocks mean that adding global exposure can reduce portfolio risk, providing a buffer when U.S. markets hit turbulence.
- **U.S. Equity Concentration Risk**—The S&P 500 is now overwhelmingly weighted toward a handful of mega-cap technology firms. While these companies have driven returns, concentration risk is increasing. Diversifying internationally means accessing sectors and geographies that may offer different growth drivers.
- **Corporate Domicile Is Increasingly Arbitrary**—The concept of a company's "home country" is blurring. Many U.S.-listed companies derive a significant portion of their revenues from international markets, while many non-U.S. companies are deeply embedded in the global economy. Looking beyond the U.S. gives investors exposure to the full breadth of global growth.

## Positioning within International Equities

Within our international equity allocations, two countries stand out—Japan in developed markets and India in emerging markets.

## Japan: A Compelling Valuation Story

Japan is often overlooked by investors, but we see it as an attractive opportunity:

- **Earnings Yield Advantage**—Japanese equities offer strong earnings yields relative to global peers, creating a valuation cushion.
- **Corporate Reform Momentum**—Japan's corporate governance reforms, including capital efficiency measures and focusing on shareholder returns, are creating a more attractive investment environment.
- **Geopolitical Tailwinds**—In an era of shifting supply chains, Japan is a key player benefiting from geopolitical realignments.

Within our Japan exposure, we prefer to have a tilt toward export-oriented companies. Exporters are a key component of the WisdomTree Japan Hedged Equity Fund (DXJ), which offers investors access to Japan's global market presence while mitigating currency risk.

## India: A Structural Growth Powerhouse

If Japan is the value play, India is the long-term growth engine:

- **Demographics and Workforce Expansion**—With a young and expanding working-age population, India is primed for sustained economic expansion.
- **Massive Infrastructure Investments**—The government's commitment to roads, rail and digital infrastructure is laying the foundation for decades of growth.
- **Financial Sector Growth and Digital Revolution**—Increased access to credit, digital banking advances and the rise of fintech are accelerating economic activity.

- **Corporate-Friendly Reforms**—Recent tax cuts and incentives for manufacturing and technology make India an increasingly attractive destination for capital.

A potential obstacle to an over-weight allocation to India is its elevated valuations compared to other emerging markets. The WisdomTree India Earnings Fund (EPI) addresses this concern through its earnings-weighted methodology, inherently incorporating valuation sensitivity into its strategy. This approach often results in lower valuation metrics compared to market cap-weighted approaches. Notably, EPI's estimated price-to-earnings (P/E) ratio is currently below that of the S&P 500 Index.

## The Case for Currency Hedging in Developed International Markets

When U.S. investors allocate internationally, they often do so without hedging against currency risk, leaving their portfolios vulnerable to fluctuations in foreign exchange rates. This unhedged approach effectively places a bet against the U.S. dollar's strength. We advocate for hedging at least 50% of currency risk in our developed international equity portfolios. Here's why:

- **Reducing Uncompensated Risk**—Currency fluctuations can add unnecessary volatility to a portfolio without offering a long-term return premium.
- **U.S. Dollar as a Hedge against Market Stress**—Historically, the U.S. dollar has been negatively correlated with equity market downturns, making it an effective hedge in times of global volatility.
- **Carry Trade Advantage**—With U.S. interest rates higher than those in Europe and Japan, currency hedging can actually add to returns due to the positive interest rate differential.

## Final Thoughts

It's tempting to believe that U.S. equity dominance will last forever. But history suggests otherwise. International allocations provide portfolio diversification, access to different growth stories and a hedge against concentrated U.S. market risks.

While we maintain an over-weight allocation to U.S. equities, our Model Portfolios continue to embrace international diversification—not because it's the consensus view, but because long-term investors should prepare for what comes next, not just what's worked in the past.

## Important Risks Related to this Article

WisdomTree Model Portfolio information is designed to be used by financial advisors solely as an educational resource, along with other potential resources advisors may consider, in providing services to their end clients. WisdomTree's Model Portfolios and related content are for information only and are not intended to provide, and should not be relied on for, tax, legal, accounting, investment or financial planning advice by WisdomTree, nor should any WisdomTree Model Portfolio information be considered or relied upon as investment advice or as a recommendation from WisdomTree, including regarding the use or suitability of any WisdomTree Model Portfolio, any particular security or any particular strategy.

There are risks associated with investing, including the possible loss of principal. Please read the Fund's prospectus for specific details regarding the Fund's risk profile. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty

**DXJ:** The Fund focuses its investments in Japan, thereby increasing the impact of events and developments in Japan that can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile and may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. Due to the investment strategy of this Fund it may make higher capital gain distributions than other ETFs. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

**EPI:** This Fund focuses its investments in India, thereby increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in emerging, offshore or frontier markets such as India are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. As this Fund has a high concentration in some sectors, the Fund can be adversely affected by changes in those sectors. Due to the investment strategy of this Fund it may make higher capital gain distributions than other ETFs.