Global Equities: International Diversification within Our Model Portfolios

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Andrew Okrongly, CFA
Director, Model Portfolios

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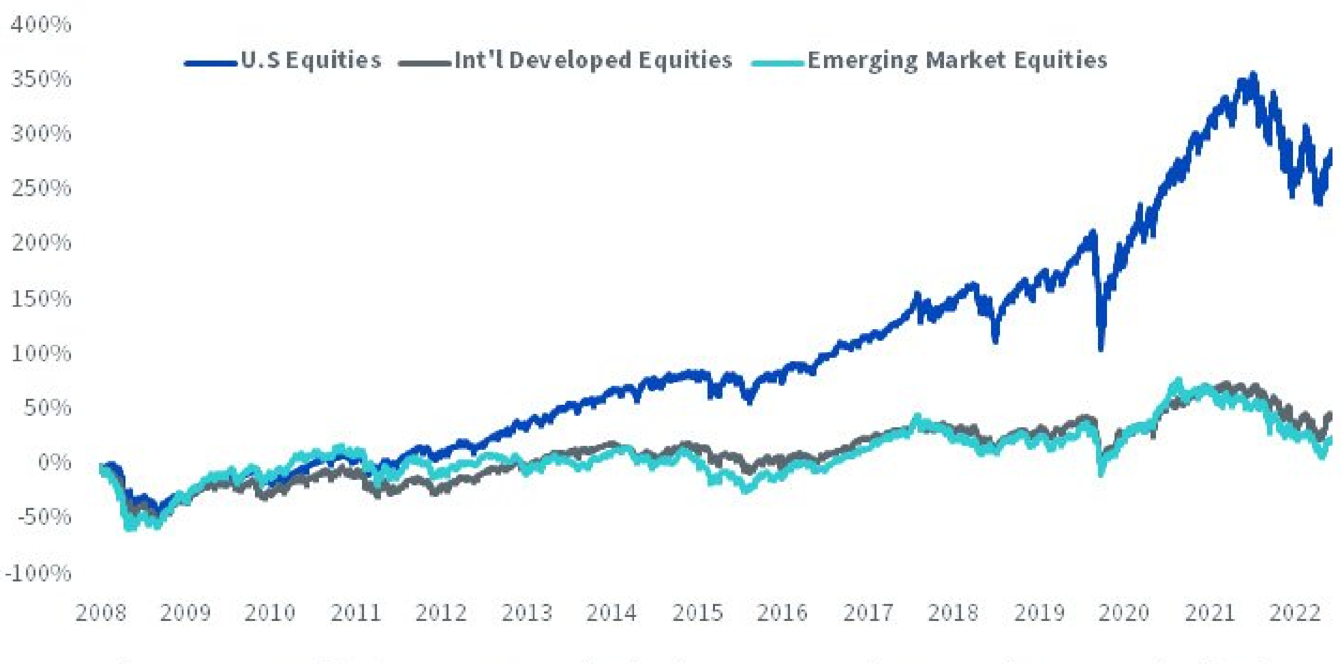
In the 10+ years following the great financial crisis, U.S. companies with high growth potential dominated global equity markets.

This was largely due to the prevailing macro environment, as steady economic growth, muted inflation and ultra-low interest rates facilitated the continued multiple expansion of U.S. stocks.

As a result, the more cyclical and value-oriented universe of stocks outside the U.S. lagged. From June 2008 to December 2022, the cumulative underperformance of international versus U.S. equities amounted to more than 200%.

Cumulative Returns in USD (June 2008–December 2022)



Sources: WisdomTree, FactSet, as of 9/30/22. U.S. Equity returns based on the MSCI USA Net Total Return USD Index. International Developed Equity returns based on the MSCI EAFE Net Total Return USD Index. Emerging Market Equity returns based on the MSCI Emerging Markets Net Total Return USD Index. Past performance is not indicative of future results. You cannot invest directly in an index.

Any diversification away from large U.S. growth stocks over this period generally detracted from overall returns. Some U.S. investors have responded by reducing or even eliminating their exposure to international stocks.

At WisdomTree, we believe this era of "deworsification" has come to an end. With an evolving macro backdrop and a renewed focus on balance sheet strength, margin resilience and the ability to return capital via dividends, diversification across both regions and factors may once again prove critical in generating enhanced returns.

This is reflected across our suite of strategic and outcome-oriented Model Portfolios, which incorporates globally diversified equity allocations with:

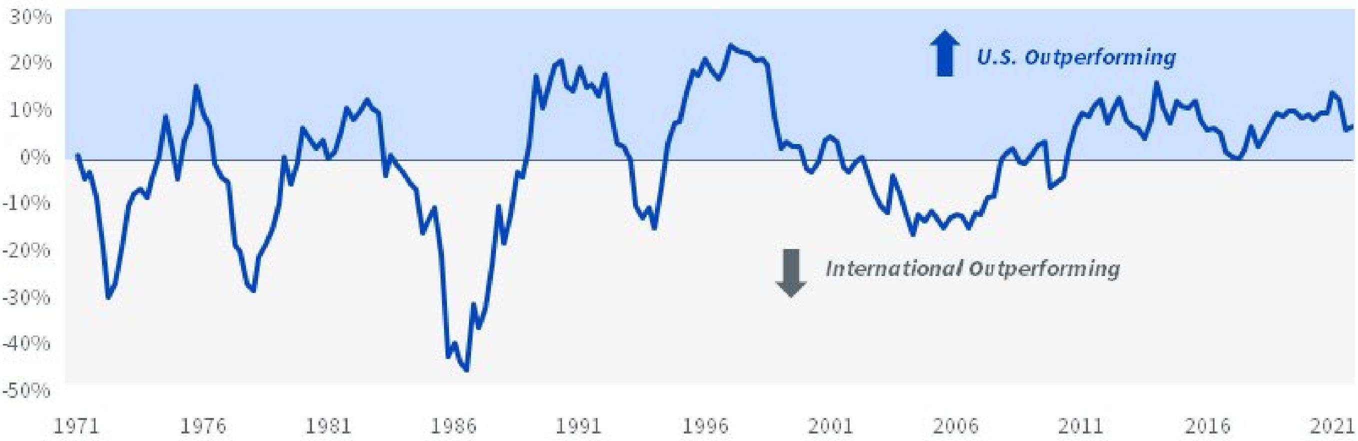
- Regional weights roughly aligned with the MSCI All-Country World Index (ACWI)
- Strategic tilts toward value, quality and dividend factors

Below, we outline the logic behind our conviction in global diversification and why valuation-focused investors might find international stocks particularly attractive in today's market environment.

The Benefits of Global Diversification

First, it is important to view the most recent example of U.S. outperformance in a historical context, as it only represents one period in what has historically been a cyclical relationship. There are numerous examples of European, Japanese and emerging markets having their own "moments in the sun."

Rolling 2-Year Annualized Relative Returns of U.S. vs. International Equities (1969–2022)



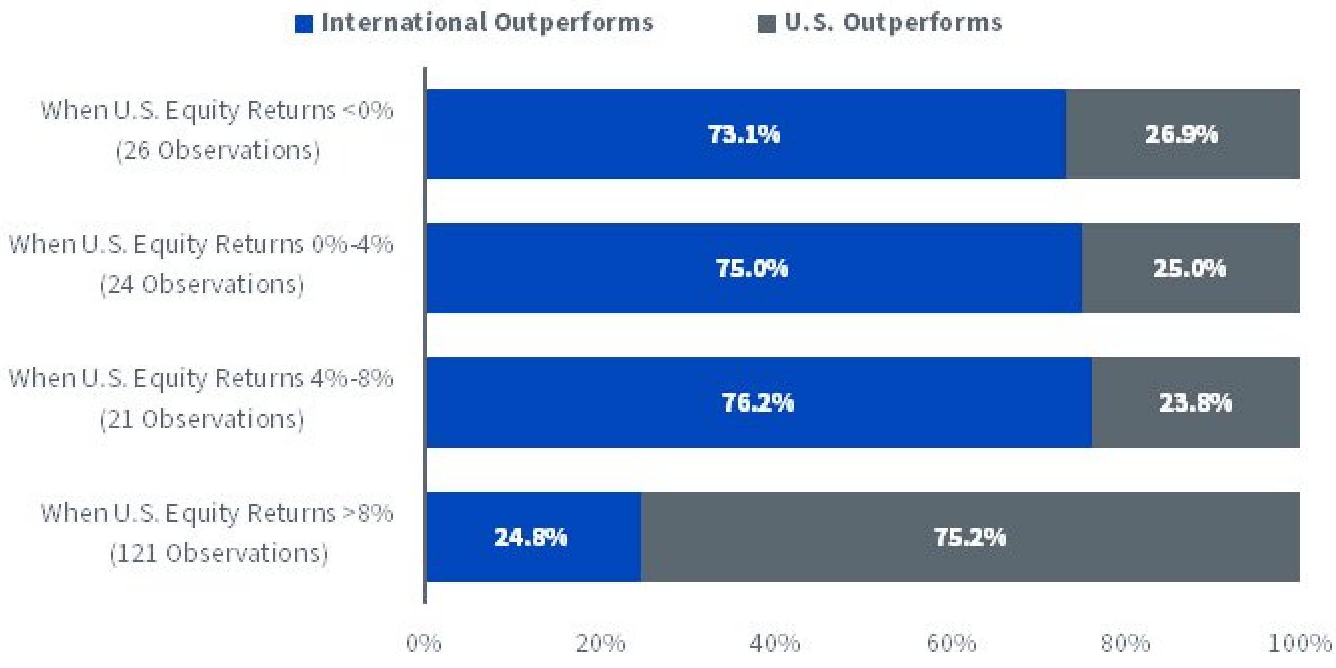
Sources: WisdomTree, FactSet, as of 9/30/22. U.S. Equity returns based on the MSCI USA Net Total Return USD Index. International Equity returns based on the MSCI EAFE Net Total Return USD Index from 1969–1998 and the MSCI ACWI Ex USA Net Total Return USD Index from 1999–2022. Past performance is not indicative of future results. You cannot invest directly in an index.

Even after this recent prolonged cycle of U.S. outperformance, long-term cumulative dollar returns across global regions do not differ significantly. Put simply, we don't believe global diversification sacrifices long-term return potential.

However, imperfect correlations of returns across regions can help protect portfolios on the downside, particularly in periods of poor

U.S. equity returns.

Rolling 5-Year Returns, U.S. vs. International (1970–2022)



Sources: WisdomTree, FactSet, as of 11/30/22. Based on quarterly observations of rolling five-year returns. U.S. Equity returns based on the MSCI USA Net Total Return USD Index. International Equity returns based on the MSCI World Ex-USA Net Total Return USD Index. Past performance is not indicative of future results. You cannot invest directly in an index.

This was the case in 2022, as international equities, as measured by the MSCI All-Country World Ex-USA Index, were down approximately -16.0% compared to the -18.5% return on the S&P 500 Index. Local returns of international equities were even more resilient, with the MSCI EAFE and MSCI Emerging Markets (Local) Indexes down only -7.0% and -15.5%, respectively.1

A global approach to equity investing can also help enhance sector diversification.

Even with several large, tech-focused U.S. firms now in the Communication Services (Meta, Alphabet) and Consumer Discretionary (Tesla, Amazon) sectors, U.S. equities are still much more concentrated in the Technology sector than international indexes.

Sector Exposures—U.S. and International Equity Indexes

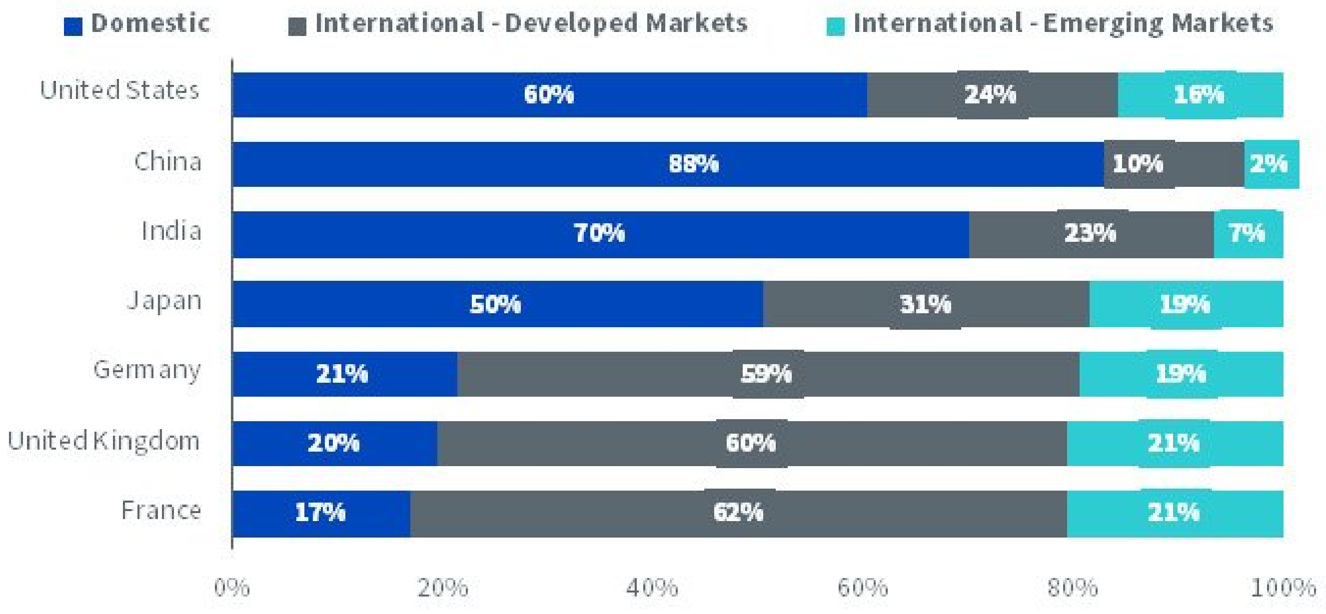
Sector	S&P 500 Index	MSCI EAFE Index	MSCI Emerging Markets Index
Communication Services	7.50%	4.50%	9.30%
Consumer Discretionary	10.40%	11.40%	13.40%
Consumer Staples	7.00%	10.50%	6.30%
Energy	5.10%	5.10%	5.10%
Financials	11.60%	18.00%	22.20%
Health Care	15.20%	13.40%	4.00%
Industrials	8.40%	15.20%	6.00%
Information Technology	26.40%	8.20%	19.60%
Materials	2.70%	7.70%	9.10%
Real Estate	2.70%	2.60%	2.10%
Utilities	3.00%	3.40%	3.00%

Sources: WisdomTree, FactSet, as of 11/30/22. U.S. Equity exposures based on the S&P 500 Index. International Equity exposures based on the MSCI EAFE Net Total Return USD Index and MSCI Emerging Markets Net Total Return USD Index (as labeled). You cannot invest directly in an index.

We also believe a regionally diversified equity portfolio is necessary to gain exposure to today's global economy.

Despite calls for the "end of globalization," U.S. annual imports have only accelerated in recent years,2 and U.S. companies in the MSCI USA Index now generate approximately 40% of their revenues from overseas.3

Geographic Revenue Exposure for MSCI Country Indexes



Sources: WisdomTree, FactSet, as of 11/30/22. United States data based on MSCI United States Index. China data based on MSCI China Index. India data based on MSCI India Index. Japan data based on MSCI Japan Index. Germany data based on MSCI Germany Index. United Kingdom data based on MSCI United Kingdom Index. France data based on MSCI France Index. You cannot invest directly in an index.

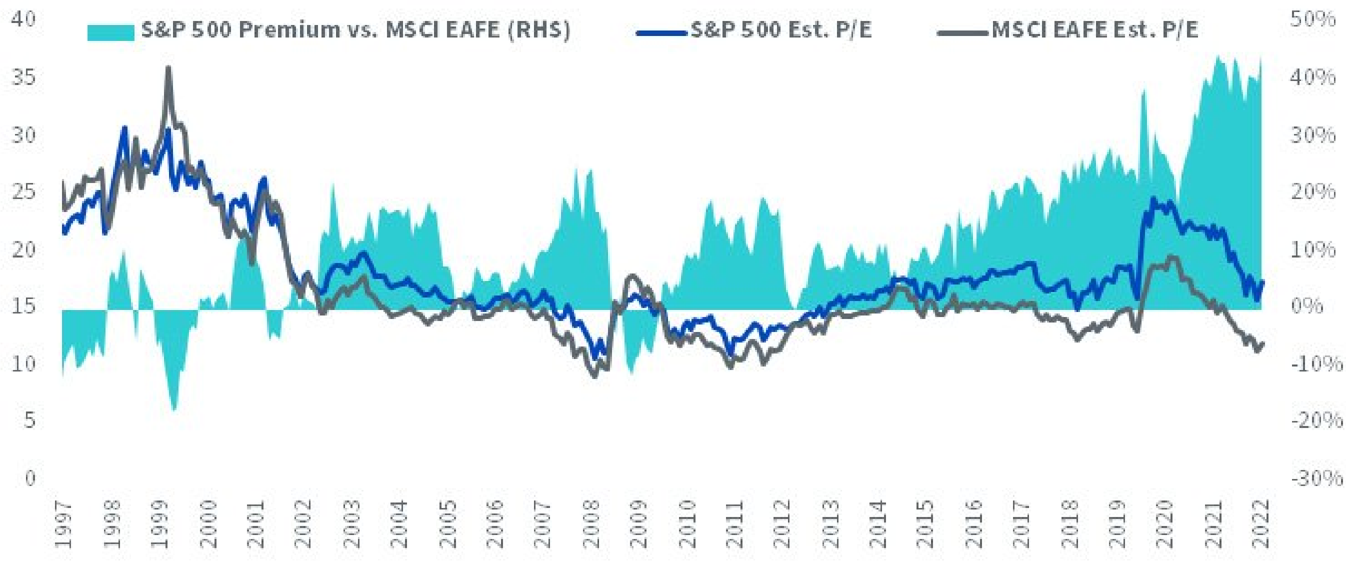
Senior Investment Strategy Advisor to WisdomTree, Professor Jeremy Siegel, and Global CIO Jeremy Schwartz argue in the latest edition of *Stocks for the Long Run* that the current definition of a company's domicile based on the location of its headquarters may become increasingly arbitrary in today's globally interconnected world.4

Current Valuations Support an Allocation to International Equities

Beyond the strategic arguments for global diversification, current valuations of international equities make a compelling opportunistic case for their inclusion in portfolios.

The price premium on U.S. equities, based on the estimated price-to-earnings (P/E) ratio, is now near an all-time high.

Historical Estimated Price-to-Earnings (P/E) Ratios



Sources: WisdomTree, FactSet, as of 11/30/22. U.S. Equity valuations based on the S&P 500. International Equity valuations based on the MSCI EAFE Net Total Return USD Index. You cannot invest directly in an index.

The relative valuation discounts on international stocks can also be seen in current dividend yields. As of December 31, 2022, the MSCI EAFE and Emerging Markets Indexes offer dividend yields of 3.23% and 3.36%, respectively, versus the 1.69% dividend yield of the S&P 500 Index.5

Relative Strength of the U.S. Dollar

As most U.S. investors do not hedge foreign currency exposure within international equity allocations, another important factor in relative performance versus domestic equities is the strength of the U.S. dollar.

Historically, a stronger USD has generally been associated with U.S. equity outperformance, while a weaker USD has generally been associated with international stocks outperforming U.S. equities.

Rolling 2-Year Annualized Relative Returns

Sources: WisdomTree, FactSet, as of 11/30/22. International Equity returns based on the MSCI EAFE Net Total Return USD Index from 1992–1998 and the MSCI ACWI Ex USA Net Total Return USD Index from 1999–2022. Dollar strength based on the U.S. Dollar Index (USDX). U.S. Dollar Index (USDX) = A measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies. Past performance is not indicative of future results. You cannot invest directly in an index.

While the dollar recently took a breather from the relentless strengthening seen throughout 2021–2022, it is still more than one standard deviation above long-term averages.

U.S. Dollar Index

Sources: WisdomTree, FactSet, as of 11/30/22. Dollar strength based on the U.S. Dollar Index (USDX). You cannot invest directly in an index.

Should this trend of USD weakness continue, it may present an additional tailwind for international stocks.

Conclusion

While recent U.S. equity outperformance has led some investors to question the role of international stocks, we are strong believers in the potential long-term advantages of global equity investing:

Attractive Long-Term Returns	Relative performance between U.S. and international stocks has been cyclical; long-term cumulative returns across regions do not differ significantly.
Diversification	Imperfect correlations between regions can help mitigate volatility. International stocks are much less reliant on high-growth tech companies. Going forward, the current definition of a company's domicile based on headquarters location may become less significant.
Valuations and Fundamentals	International equities are currently priced very attractively across several different measurements of value relative to the U.S. If the U.S. dollar weakens from its current level, history suggests that it could benefit the relative performance of international equities.

1 Sources: WisdomTree, FactSet, as of 12/31/22.

2 Source: Bloomberg, as of 10/31/22.

3 Sources: WisdomTree, FactSet, as of 11/30/22. United States data based on MSCI United States Index.

4 Source: Jeremy J. Siegel with Jeremy Schwartz, Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies (6th ed.), New York: McGraw-Hill.

5 Sources: WisdomTree, FactSet, as of 12/31/22.

Important Risks Related to this Article

Diversification does not eliminate the risk of experiencing investment losses.

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