

What Works in Non-U.S. Equities? High Quality

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Key Takeaways

- U.S. investors have largely ignored international equities in favor of domestic large caps, resulting in significant under-weighting in international investments despite a desire for global diversification.
- Historical data shows that high-quality companies with high operating profitability consistently outperform low-quality companies both in the U.S. and internationally.
- Our International Hedged Quality Dividend Growth Index focuses on high-quality international equities to enhance risk-adjusted returns.

For the past two decades, international investing has been largely disregarded by U.S. investors. The opportunity cost for every dollar invested in international equity was to miss the return potential of domestic large caps, which climbed relentlessly higher with minimal interference.

As a result, many U.S. investors are hesitant to invest abroad and remain under-weight in international equities despite ostensibly wanting a globally diversified portfolio. There's indifference as well. Most are unconcerned by all-time highs in the S&P 500 yet are simultaneously unaware that the MSCI EAFE also reached all-time highs in July.

To break the international equity stigma, we believe that investors need to have confidence in strategies that have historically been successful, and many would prefer to frame their international allocations similarly to U.S. positions.

Fortunately, early factor research in international markets presents one interesting return driver that has had similar success in the U.S.: **operating profitability**, which we colloquialize as "quality" at WisdomTree.

A Brief History of Quality in the U.S.

In their seminal research on investment factors, Eugene Fama and Ken French segmented the U.S. equity market into groups based on operating profits, with the most profitable companies in the top quintiles and deciles and the least profitable ones at the bottom. Return calculations across the profitability scale provided a valuable insight: Companies with high operating profitability dramatically outperformed those with low operating profitability over time. **In other words, high-"quality" companies (those with efficient**

operations that generate larger, consistent profits relative to their capital structure) tended to outpace low-quality companies over medium- to long-term periods.

Within the U.S., the performance trend since the beginning of the Fama-French data series in 1963 is compelling. Among rolling three-year return observations, high-quality outperformed low-quality 70% of the time. Across rolling 5- and 10-year returns, high-quality's outperformance frequency improved to 77% and 84%, respectively.

Rolling 10-Year Excess Returns: High- vs. Low- Quality U.S. Stocks



Source: Ken French Data Library, as of 5/31/24, which represents the latest available data. Rolling 10-year excess return is calculated by using the return differential of the first (Hi 20) and fifth (Lo 20) quintiles of U.S. stocks segmented by operating profitability.

More notably, high-quality had prolonged success over the past 40 years. Low-quality companies have not outperformed their more profitable peers on a 10-year annualized return basis since the mid-1980s. Even during periods of market history characterized by wild speculative investing, when low-quality companies would theoretically benefit the most, their success was neither large nor prolonged enough to upset high-quality as a long-term alpha generator.

Quality Works Abroad, as Well

The international factor research history is a bit shorter, beginning in 1990, but quality's results so far prove even more enticing. Among large-cap companies from the developed ex-U.S. region, high-quality outpaced low-quality in more than 80% of rolling three-year return observations and 89% of rolling five-year intervals.

Across 10-year periods, however, high-quality outperformed 100% of the time. **To date, there has never been a 10-year interval where the least profitable companies in the large-cap developed ex-U.S. universe beat the most profitable.**

Rolling 10-Year Excess Returns: High- vs. Low- Quality Large Cap Dev. Ex-U.S. Stocks



Source: Ken French Data Library, as of 5/31/24, which represents the latest available data. Rolling 10-year excess return is calculated by using the return differential of the BIG HiOP and BIG LoOP value-weighted portfolios of developed ex-U.S. stocks, which represent large-cap companies with high and low operating profitability, respectively. BIG HiOP and BIG LoOP refer to the names of the portfolios within the Fama-French database.

For most of the past two decades, high-quality led low-quality by more than 2% per year, on average, and never by a margin less than 1%.

Obviously, past is not prologue, and return relationships can and *do* change as global markets evolve, but we think there's legitimacy to quality's relationship with overseas equity markets. After all, investing in profitable, efficient companies seems intuitive as the foundation for a portfolio. [Warren Buffet actually prefers it.](#)

This thesis led us to launch the WisdomTree International Hedged Quality Dividend Growth Index and WisdomTree International Quality Dividend Growth Index in December 2013, where the only difference

is that the latter is not currency-hedged like the former. These Indexes are tracked by the [WisdomTree International Hedged Quality Dividend Growth Fund \(IHDG\)](#) and the [WisdomTree International Quality Dividend Growth Fund \(IQDG\)](#), respectively.

Their methodologies are anchored by the quality factor and aim to select the top 300 stocks from the dividend-paying developed international equity universe based on measurements of return on equity (ROE), return on assets (ROA) and estimated earnings growth.

This results in a predominantly large-cap equity allocation that has beaten the MSCI EAFE Index by more than 1.2% per year since inception. If we assume the MSCI EAFE Index represents the average quality profile of the developed ex-U.S. equity market, then our Index's outperformance margin is consistent with the average excess return of high-quality versus low-quality factor portfolios over the past 10 years.

ROE Quintile Attribution of WisdomTree International Quality Dividend Growth Index vs. MSCI EAFE

Category	Attribution Components				Average Category Weight			Category Performance	
	Allocation	Stock Selection	Interaction	Total Attribution	Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
1st Quintile (Highest ROE)	0.35%	0.26%	0.35%	0.96%	65.50%	25.25%	40.25%	6.42%	5.51%
2nd Quintile	-0.01%	-0.41%	0.07%	-0.35%	20.09%	21.36%	-1.27%	3.79%	6.01%
3rd Quintile	0.12%	-0.01%	0.05%	0.15%	8.10%	19.08%	-10.99%	3.55%	3.73%
4th Quintile	0.23%	0.18%	-0.21%	0.20%	2.70%	16.71%	-14.00%	3.62%	3.16%
5th Quintile (Lowest ROE)	0.04%	0.98%	-0.82%	0.21%	1.45%	12.45%	-11.00%	9.78%	3.47%
Negative Return	0.04%	0.28%	-0.29%	0.02%	0.22%	4.05%	-3.84%	2.75%	1.19%
N/A	0.05%	0.05%	-0.05%	0.05%	1.95%	1.10%	0.85%	3.12%	4.63%
Total	0.81%	1.33%	-0.90%	1.24%	100.00%	100.00%	0.00%	5.94%	4.70%

Sources: WisdomTree, FactSet, MSCI, for the period 12/31/13–6/30/24. **Past performance is not indicative of future results. You cannot invest directly in an index.**

The advantage of the high-quality equity basket is evident in performance attribution as well. The first quintile of companies by ROE contributed about three-quarters of the annualized outperformance due to

allocation and stock selection effects. Over-weighting in that quintile by more than 40% on average since inception, combined with the success of the individual companies held within it, explains virtually all the alpha over the past decade.

The remaining alpha is attributed to under-weighting in the remaining quintiles. While the second quintile detracted from performance due to negative stock selection effects, this headwind was entirely offset by under-weights in the third, fourth and fifth quintiles, representing the mid- to low-quality groups.

Overall, this framework demonstrates the benefit of owning high-quality companies in the developed ex-U.S. universe for return generation, but there are volatility advantages as well.

As expected, the low-quality Fama-French portfolio provided 18.8% annualized volatility since 1990, which was 2.4% more volatile than the 16.4% figure from the high-quality portfolio. The excess return, coupled with reduced volatility, more than doubled the risk-adjusted returns.

Dev. ex-U.S. Large Cap Quality Portfolios: July 1990–May 2024

Portfolio	Annualized Return	Annualized Volatility	Sharpe Ratio
Low-Quality	2.9%	18.7%	0.15
High-Quality	6.3%	16.3%	0.38

Source: Ken French Data Library, as of 5/31/24, which represents the latest available data. Annualized returns and volatilities are calculated using the monthly returns of the BIG HiOP and BIG LoOP value-weighted portfolios of developed ex-U.S. stocks, which represent large-cap companies with high and low operating profitability, respectively.

[WisdomTree's Index \(WTIDGTR\)](#) produced a similar effect against the MSCI EAFE Index, which represents the average quality profile of the developed ex-U.S. region. It produced an additional 1.2% annualized return versus the broader index with sub-1% incremental volatility. More importantly, the alpha generation outweighed the volatility pickup to enhance risk-adjusted returns.

WisdomTree Quality Solution: December 2013–June 2024

Portfolio	Annualized Return	Annualized Volatility	Sharpe Ratio
WTIDGTR	5.9%	15.6%	0.38
MSCI EAFE (USD)	4.7%	14.9%	0.31

Sources: WisdomTree, MSCI, as of 6/30/24. WTIDGTR = WisdomTree International Quality Dividend Growth

Total Return Index. **Past performance is not indicative of future results. You cannot invest directly in an index.**

Overseas, Think Quality for the Long Term

Breaking the international equity stigma requires nuanced ways to invest abroad and potentially obtain better risk-adjusted returns. Though the factor's investment research is still in development, early insights look promising and consistent with performance trends observed in the U.S. High-quality allocations, in particular, have proven to reward over the long term compared to low-quality ones with complete consistency over three decades. They have had strong success versus mid-quality broad market allocations as well.

As investors begin to rethink their international under-weights and consider reallocating, we believe they should use high-quality non-U.S. positions like the [WisdomTree International Quality Dividend Growth Fund \(IQDG\)](#) to enhance risk-adjusted returns in a market that sorely needs them.

1 "High Quality" refers to companies with efficient operations that consistently generate larger profits relative to their capital structure, as measured by metrics like return on equity (ROE), return on assets (ROA), and estimated earnings growth. These companies are characterized by stability and long-term outperformance in both U.S. and international markets. "Low Quality" refers to companies with less efficient operations, lower profitability, and inconsistent performance, often resulting in higher volatility and weaker long-term returns compared to high-quality companies.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. To the extent the Fund invests a significant portion of its assets in the securities of companies of a single country or region, it is likely to be impacted by the events or conditions affecting that country or region. Heightened sector exposure increases the Fund's vulnerability to any single economic, regulatory or other development impacting that sector, which may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile, and these investments may be less liquid than other securities and more sensitive to the effects of varied economic conditions.

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