HOW TO BEST DIVERSIFY FROM THE S&P 500 INDEX

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It's quite possible that the S&P 500 Index is the most widely followed benchmark index on earth. Therefore, strategies for constructing portfolios around the S&P 500 that enhance risk/return trade-offs could be of great interest, and this is actually one of the reasons people look at stocks outside the United States. **To Hold or Not to Hold Currency with Foreign Equities?** This is a recent question, given that classic international exposures did not even view this as a choice. Since there were limited, if any, cost-effective means to separate currencies from international equities, many simply held the two in tandem. This has changed with the proliferation of currency-hedged exchange-traded funds (ETFs) in the last four to five years. One of the common rationales for layering currency risk on top of equities was that holding the currency–itself a source of uncertainty–actually enhanced the risk/return trade-offs of the broader portfolio. Simply put, holding international currency on top of equities is often thought to improve portfolio diversification. **Debunking the Diversification Myth** Data over the last 10 years calls into question whether currency risk really provides meaningful benefits–as it unquestionably has increased the risk profile of global portfolios. The analysis below starts with the S&P 500 and blends 10% increments of a portfolio to either:

- The MSCI ACWI ex-US Index in U.S. dollars – which has foreign currency risk

- The MSCI ACWI ex-US Index in local currency–which has no foreign currency risk

- Evenly between the MSCI ACWI ex-US Index in U.S. dollars and in local currency

If currency did in fact add diversification over the period, then the blends that added incremental weight to the MSCI ACWI ex-US Index in U.S. dollars should show the best risk/return trade-offs. **Blending MSCI ACWI ex-US to S&P 500- Last 10 Years** *04/30/2005 - 04/30/2015*

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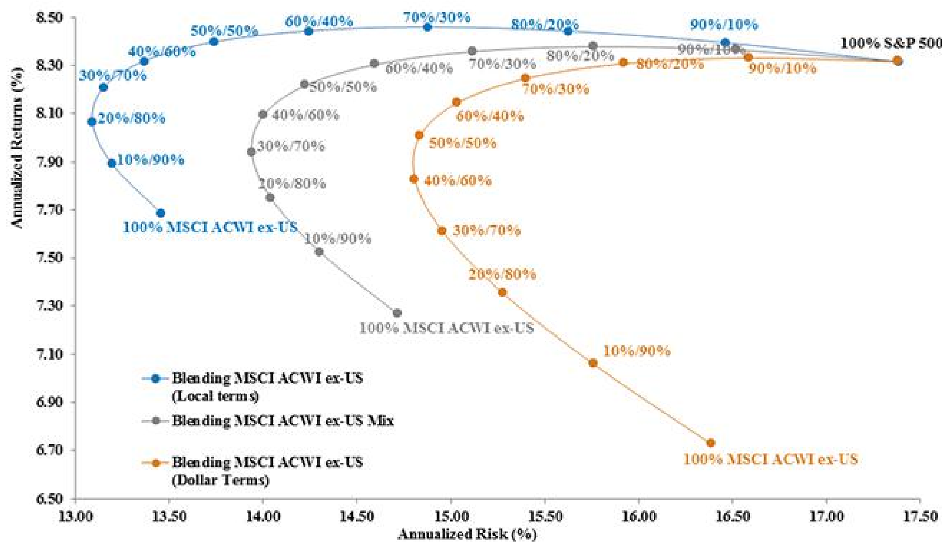

Index Blend	Blending MSCI ACWI ex-US (local terms)		Blending MSCI ACWI ex-US Mix[1]		Blending MSCI ACWI ex-US (Dollar Terms)	
	Ret (%)	Risk (%)	Ret (%)	Risk (%)	Ret (%)	Risk (%)
100% S&P 500	8.32	17.38	8.32	17.38	8.32	17.38
50% S&P 500; 50% MSCI ACWI ex-US[2]	8.40	13.73	8.22	14.22	8.00	14.83
100% MSCI ACWI ex-US	7.69	13.45	7.27	14.72	6.73	16.39

Sources: WisdomTree, Bloomberg, Matlab, with data from 4/30/05 to 4/30/15. [1]Mix is a 50-50 equal weighted blend of MSCI ACWI ex-US in Local returns & in USD returns. 2MSCI ACWI ex-US is MSCI AC World ex-US Total Return Index.

- **Lower Risk than the S&P 500 Index:** Over the 10-year period shown, the S&P 500 Index had average annual volatility of about 17.4%. The MSCI ACWI ex-US Index (in U.S. dollars) had a 16.4% average annual volatility over the same period. Taking away the currency risk brought the average annual volatility down to 13.5%—almost 4% lower than that of the S&P 500 Index.
- **Importance of the 50/50 Mix:** We recognize that currencies tend to move in waves and that this 10-year period might be one in which foreign currency exposures faced a particular headwind. Therefore, an interesting baseline could involve looking at mixes of the MSCI ACWI ex-US Index that were 50% in local terms (i.e., without currency) and 50% in U.S. dollar terms (i.e., with currency). This would minimize the risk of being fully exposed or unexposed to fluctuating exchange rates, given that there is no way to know precisely how they might behave in the future.
  - Notably a 50/50 blend of the S&P 500 and foreign equities reduced the volatility of equities from over 17.38% for the S&P 500 to just 14.22%.
  - Risk can be reduced even further if one concentrated on just the local equities without the currency risk. The 50/50 blend of S&P 500 and MSCI ACWI ex-US Index (in local currency) had a volatility of 13.73%.

If the last 10 years are any guide, the real diversification of international exposures comes not from holding currency on top of equities but rather from just the equities themselves. With many investors questioning the valuations in U.S. equity markets, now is a very natural time to be looking at foreign allocations that are priced at lower valuation multiples than the U.S. markets. But a big question is whether one should take foreign currency risk when going overseas. Many feel the dollar has strengthened already and they missed the opportunity to hedge their currency risk. But this long-term analysis shows why hedging can be an important part of strategic allocations to foreign markets to achieve a lower risk profile for global portfolios.

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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.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

MSCI ACWI ex-U.S. Index : A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets excluding companies based in the United States.

Volatility : A measure of the dispersion of actual returns around a particular average level. .