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

Bradley Krom – U.S. Head of Research,Lonnie Jacobs – Associate Director, Research Content,Brian Manby – Associate, Investment Strategy
09/25/2023

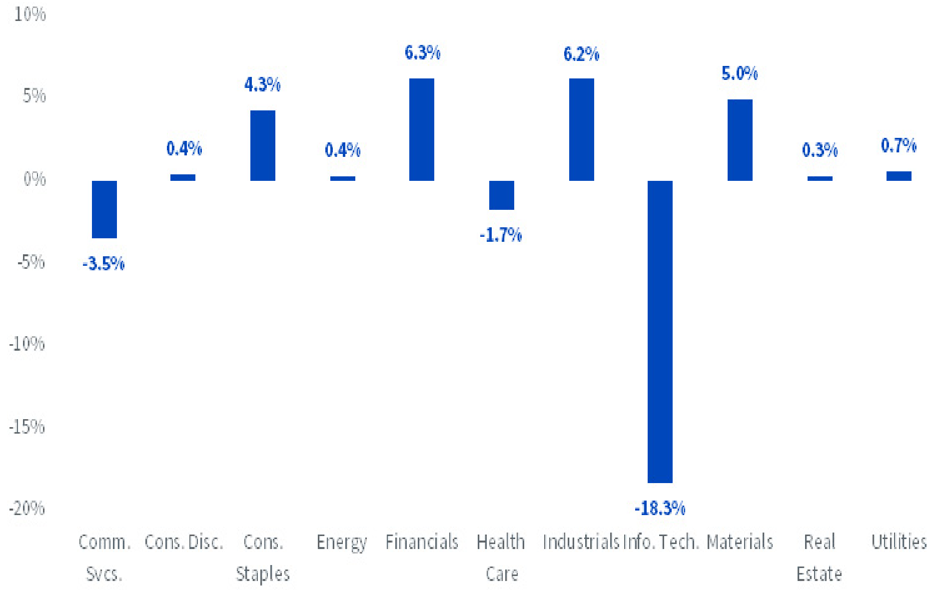
This blog is the first installment of a four-part series that examines the tactical and strategic case for investing internationally despite a multi-year period of U.S. equity outperformance.

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.

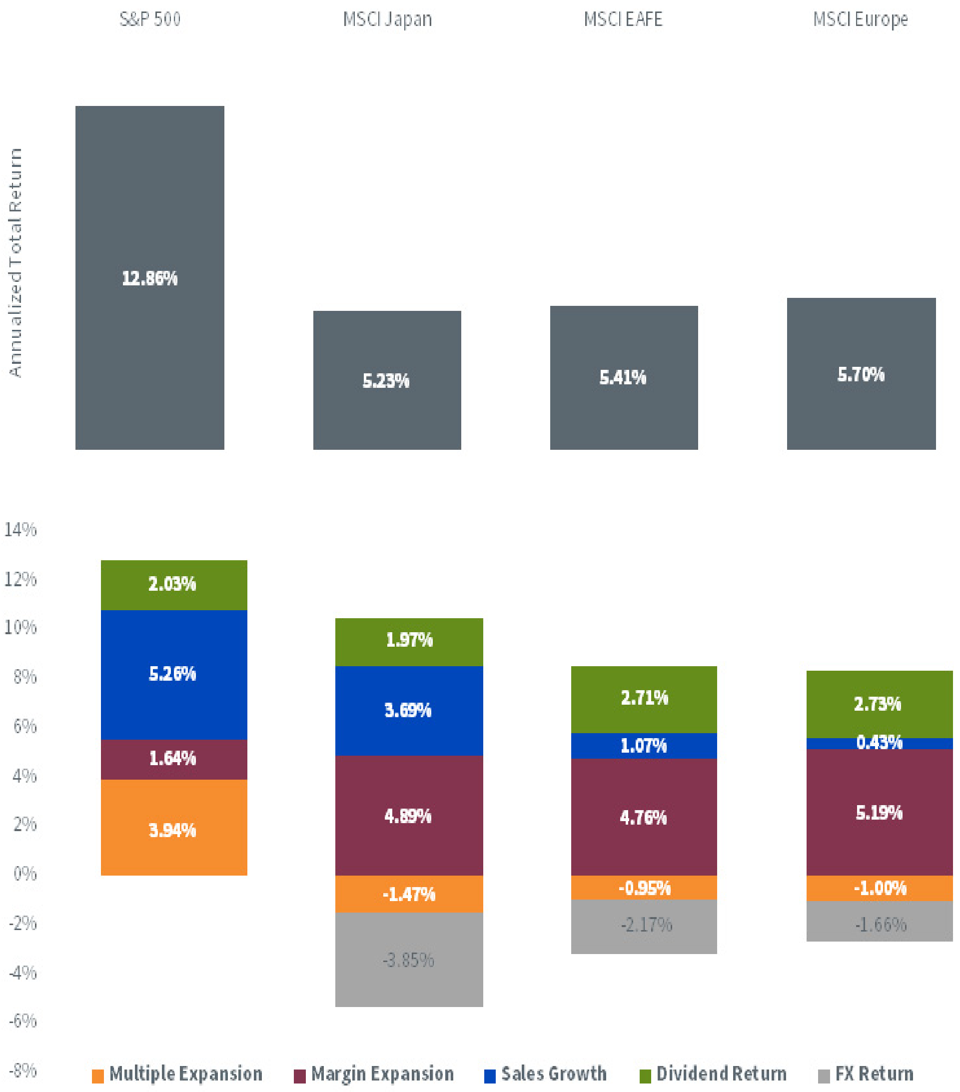
Through this lens, the extent of the U.S.'s success seems like an anomaly more than a foregone conclusion. The absence of a similar Information Technology and Communication Services footprint overseas, therefore, is advantageous for U.S. investors because it helps provides exposure to the complete economic 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.

WISDOMTREE®

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.

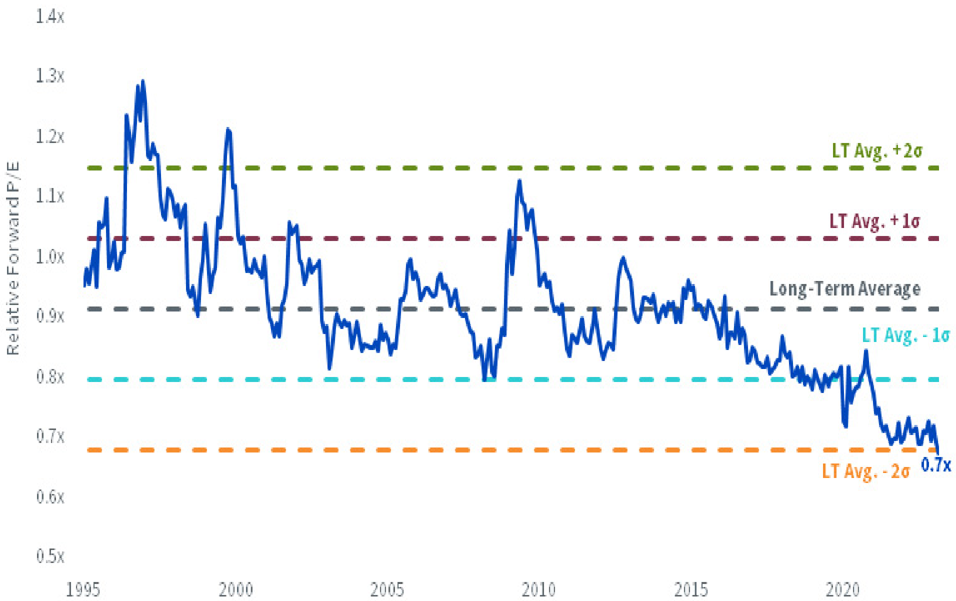
Unlike the U.S., the EAFE, European and Japanese markets instead whittled *down* the prices they were willing to pay per unit of earnings, resulting in multiple *contraction* which weighed on returns.

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.

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. Heightened sector exposure increases the Fund's vulnerability to any single economic, regulatory or other development impacting that sector. This may result in greater share price volatility. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit, and the Fund does not attempt to outperform its Index or take defensive positions in declining markets. 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. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of IQDG please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/equity/iqdg

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Funds

+ WisdomTree International Quality Dividend Growth Fund

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

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 tim.

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.