

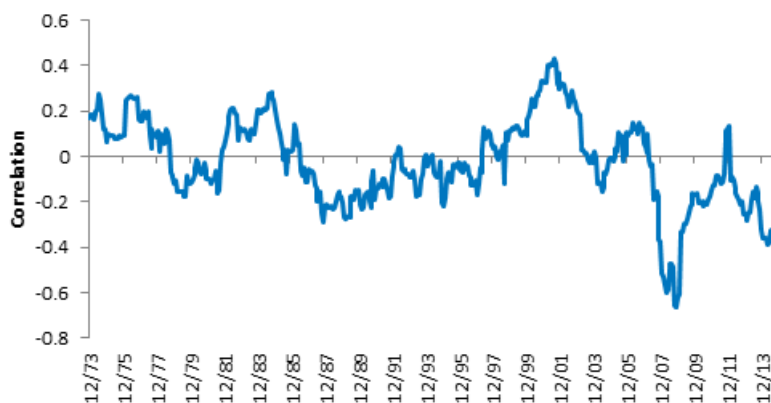
DIVERSIFYING WITH THE YEN? NOT IF JAPANESE EQUITIES ARE INVOLVED

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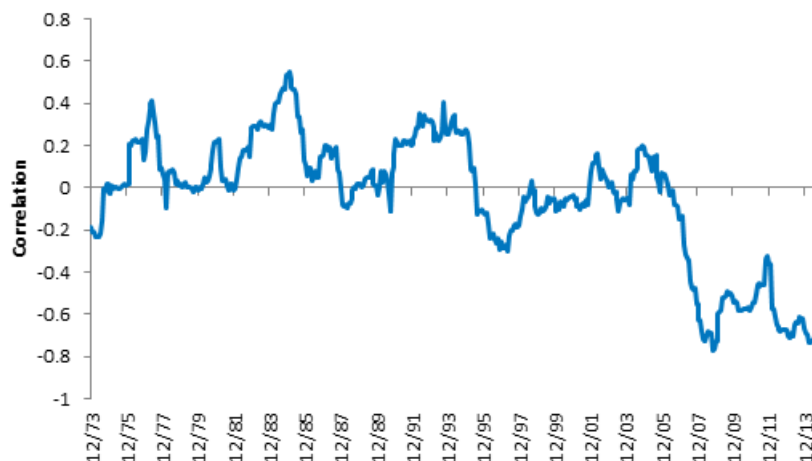
As a leading sponsor of [currency-hedged](#) exchange-traded funds, we engage in a fair amount of discussion regarding the “currency bet,” that is, the added [risk](#) investors layer on top of equity returns when they invest internationally. One reason often cited is that it helps diversify exposure to the U.S. equity markets (defined here as the [S&P 500 Index](#)). The Japanese yen, for example, looks like an interesting asset class to achieve this, as the yen has displayed a negative [correlation](#) to the S&P 500 over the last 40 years, with a sharper negative correlation in more recent years. However, there are two sides to the coin. While the yen correlates negatively to U.S. equities, it is also negatively correlated to the Japanese equity market (as measured by the [MSCI Japan Index](#)). In fact, the negative correlation in Japan is even higher than that of the U.S., which means that Japanese stocks will take a significant hit in a rising yen environment. Consider that the three-year correlation of the S&P 500 and the yen was -0.33, but the three-year correlation of the yen and the MSCI Japan Index (in yen) was -0.74. If investors wanted a hedge for a [bearish](#) scenario in the U.S. equity markets, the historical correlation data would suggest the yen could serve that choice as a standalone investment, but not if not packaged with Japanese equities.

Figure 1: Three-Year Correlation of Yen vs. S&P 500 Index



Sources: WisdomTree, MSCI, 12/31/73-7/31/14.

Figure 2: Three-Year Correlation of Yen



Sources: WisdomTree, MSCI, 12/31/73–7/31/14.

Figure 3: MSCI Japan Table

vs. MSCI Japan Index

Japan	Returns			Volatility				Correlation			
Index:											
	Japan w/ Yen	Japan No Yen	Yen	Japan w/ Yen	Japan No Yen	Yen	S&P 500	Japan w/ Yen	Yen	Japan No Yen	Correlations to MSCI Japan
12/31/69-7/31/14	9.1%	6.1%	2.8%	21.3%	18.6%	11.1%	15.3%	0.37	(0.02)	0.42	(0.06)
Abe Period	35.6%	69.1%	-19.8%	13.3%	17.6%	7.8%	8.6%	0.33	(0.38)	0.42	(0.68)
3-Year	6.6%	17.3%	-9.1%	14.2%	19.2%	7.8%	12.2%	0.54	(0.33)	0.53	(0.74)
5-Year	6.5%	8.1%	-1.5%	13.8%	18.7%	9.4%	13.2%	0.57	(0.20)	0.52	(0.70)
10-Year	3.9%	3.1%	0.8%	15.7%	19.2%	9.4%	14.7%	0.67	(0.23)	0.65	(0.60)
20-Year	0.1%	0.4%	-0.3%	18.3%	18.1%	11.0%	15.2%	0.53	(0.01)	0.54	(0.30)

Sources: WisdomTree, MSCI, 12/31/69–7/31/14. Japan w/ Yen refers to the MSCI Japan Index priced in USD. Japan no Yen refers to the MSCI Japan Index priced in the local currency. Yen refers to the underlying currency exposure of the Yen against the U.S. dollar. Abe period is from 11/30/12–7/31/14 and references the approximate period Shinzo Abe has been Prime Minister of Japan. Past performance is not indicative of future results. You cannot invest in directly an index.

Diversification vs. Risk

The discussion of [currency-hedged strategies](#) has shaken some of the core beliefs of investors. Traditional investment vehicles that package equity risk plus a secondary currency risk on top of the equity risk have been referred to as the traditional “plain vanilla” exposure because they were the first to the market, and it is what investors have been using for so long. The yen is a currency that looks like a portfolio diversifier, as it has a negative correlation to U.S. equities. But when the yen is packaged on top of Japanese equities, which have an even stronger negative correlation to the yen, that diversification benefit is compromised and ultimately becomes nothing more than added risk. Japan was a market that highlighted the benefits of a currency-hedged approach in 2013 as the yen sank and stocks performed very well¹. Increasingly, investors will come to look at currency-hedged products as more strategic options for international allocations, as they continue to question the diversification benefit of layering currency risk on top of international equities. ¹Source: Bloomberg, 12/31/12–12/31/13; references the yen weakening more than 17% against the U.S. dollar while the MSCI Japan Local Index was up more than 54%. Past performance is not indicative of future results.

Important Risks Related to this Article

Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Diversification does not eliminate the risk of experiencing investment losses.

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.

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You cannot invest directly in an index.

DEFINITIONS

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

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.

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.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

MSCI Japan Index : A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.