ARE YOU TAKING ON TOO MUCH RISK IN YOUR SMALL CAP ALLOCATIONS?

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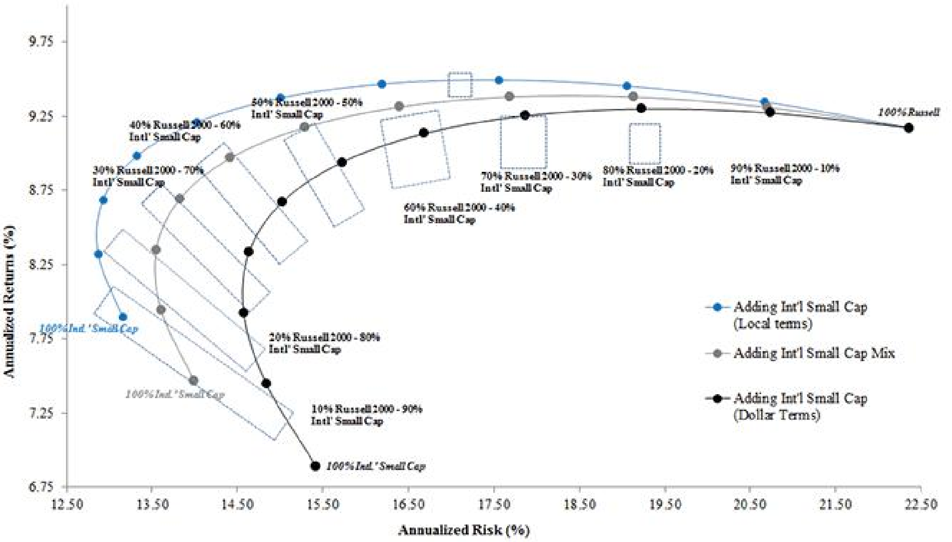
Prior to the popularization of currency-hedged equity strategies, equity investments outside the United States included two trades:

1. The equities, which in most cases were the primary focus
2. The currency, which was a secondary exposure, which some investors were unaware of

One of the most widely held rationales for owning international currencies was the diversification potential, namely how currency volatility, when combined with the rest of the assets in a portfolio, would actually lead to *lower* overall volatility. **How Global Small-Cap Allocations Reduced Risk of the Russell 2000** Starting from a base of the Russell 2000 Index, a common benchmark for U.S. small-cap equity performance, we added developed international equities in 10% increments to the picture to see what would happen. Two primary questions warranted testing:

1. Did adding international exposure improve the risk/return profile?
2. Did adding international equity exposure combined with currency further improve the risk/return profile as compared to adding international equities alone?

Adding International Small Caps to U.S. Small Cap Allocations- Last Ten Years (4/30/2005-4/30/2015)



Index Blend	Adding Int'l Small Cap (local terms)		Adding Int'l Small Cap (mix)[1]		Adding MSCI EAFE Small Cap (dollar terms)	
	Ret (%)	Risk (%)	Ret (%)	Risk (%)	Ret (%)	Risk (%)
100% Russell	9.17	22.36	9.17	22.36	9.17	22.36
50% Russell 2000; 50% International Small Cap[2]	9.37	15.00	9.18	15.29	8.94	15.72
100% International Small Cap[2]	7.90	13.15	7.46	13.99	6.89	15.42

Sources: WisdomTree, Matlab, Bloomberg, with data from 4/30/05 to 4/30/15. Past performance is not indicative of future results. You cannot invest directly in an index. [1]Mix is a 50-50 split of allocations to international small caps in local returns and in U.S. dollar returns. [2]International Smalll Cap is MSCI EAFE Small Cap Index.

• Northwest Is

Best: Within the chart, anything that pulls the data points upwards and to the left (in other words, “northwest”) is offering a greater risk/return trade-off compared to anything positioned further downwards and to the right. Adding international small caps in local terms consistently pulled the data points the furthest toward the northwest corner over the examined period. • **Lower Risk Than the Russell 2000 Index:** Over the 10-year period shown, the Russell 2000 Index had average annual volatility of about 22.4%. International small caps with currency risk had 15.4%, or 7% less, average annual volatility over the same period. Taking away the currency risk brought the average annual volatility to 13.2%—more than 9% below that of the Russell 2000 Index. • **The 50–50 Foreign-U.S. Blend:** The U.S. represents just 50% of the global equity opportunity set[1]. A 50–50 U.S.-foreign allocation, regardless of whether one hedged currency risk, had significant risk-reduction properties. Volatilities of the 50–50 U.S.-foreign blends ranged from 15.0% to 15.7%, down from 22.36% for just the Russell 2000 by itself. The lowest risk profile of these three 50–50 blends was having international wholly represented by small caps without the currency risk. • **Importance of the International Small-Cap 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 international small-cap exposure that were 50% in local terms (without currency) and 50% in U.S. dollar terms (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. [1]Source: Bloomberg; refers to the MSCI ACWI Index universe, with data measured as of 5/22/15.

Important Risks Related to this Article

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DEFINITIONS

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

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

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

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.

MSCI ACWI Index : A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.