DOES CURRENCY HEDGING MAKE SENSE FOR INDIA?

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Recently, we saw a Twitter conversation with participants expressing a need for a currency hedging exchange-traded fund (ETF) for India, out of fears weakness in the rupee could eat away at India's equity market returns. The core investment proposition: India stands to be one of the great growth stories of the coming decades. It has the world's largest populations that are likely to "catch up" on a relative basis to the developed world, and the growth in consumption from India's middle class should be one of the great growth stories in the coming years. But does India's high inflation erode the value of the rupee such that returns for U.S. investors buying Indian equities will be hurt by a perpetually falling exchange rate? The problem, in our view, with offering an Indian rupee-hedged ETF is that the cost to hedge the rupee is quite high, and we believe it outweighs the benefits over the longer run. In the short run, of course, hedging would help if the rupee depreciates by more than the costs. But the investment thesis for Indian growth driven by demographics is by nature, over the long run. So does hedging the rupee over the long run work? Some investors familiar with our currency-hedged approach to Europe and Japan have questioned why we don't employ a similar strategy for Indian equities. **Why Europe and Japan Are Different: Currently the Cost to Hedge Is *Negative*; You're Paid to Hedge** First, let me review why we believe Europe and Japan are different from India. In the developed world, WisdomTree has argued that currency often poses uncompensated risk—there is no reason to believe currencies like the euro and yen should always appreciate in value versus the U.S. dollar. So why should investors always bet on these currencies appreciating? It is also inexpensive to hedge in these regions. The primary cost of currency hedging is based on short-term interest rate differentials between the foreign market and the home market. A surprising truth: In the developed world, U.S. investors have been "paid" to hedge currency risk over the last 30 years on average. Currently, the European Central Bank (ECB) has an interest rate of negative 40 basis points (bps), and the Federal Reserve (Fed) has a positive interest rate close to 40 basis points—so by using forward contracts, a key tool of our hedging mechanism, an investor is paid those relative differentials (more than 80 basis points). In Japan, with Bank of Japan (BOJ) rates at negative 10 basis points, an investor is also being paid to strategically hedge the yen. These negative rate differentials—in finance terms, the "carry"—are why I call currency hedging a "better than free option," because U.S. investors can hedge their currency risk from equities with a potential for this interest rate income. **Rupee Hedging Costs Are High because India Interest Rates Are Quite High** However, rates for India are much higher than the U.S., and an investor must pay the interest rate differential. Short-term interest rates in India are currently at 6.5%. The differential in interest rates between India and the U.S. is thus currently greater than 6 percentage points. Could the rupee depreciate by more than 6% a year? That is how much it has to fall for an investor just to break even on the cost to hedge. The below chart illustrates the difference between the spot return of the rupee and the total return from investing in long rupee forward contracts. Note: This is the exact opposite of what an investor would have experienced hedging (i.e., how much someone would have paid to hedge). Over the last 10 years, the cumulative spot return for the rupee was negative 31.8%, but the total return for being long rupee forward contracts was a positive 53.6%. This is because interest rate differentials (7%+ per year on average) more than compensated for the decline in the rupee's value. On an average annual basis, the differential over 10 years was as follows: The rupee lost 3.8% per year, but the total return of going long rupees was 4.4% per year. This means hedging the rupee would have cost investors *4.4% per year*, despite being correct that the rupee would have depreciated over the period.

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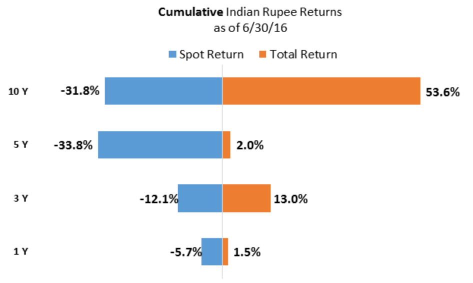

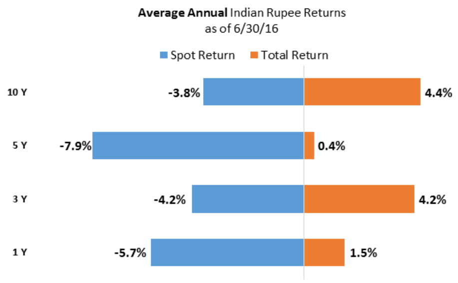

Source: Bloomberg, as of 6/30/16. Past performance is not indicative of future results.

WisdomTree argues that strategic investors may rather have the potential to collect the higher interest rate in India's local markets. That is why we created the WisdomTree Indian Rupee Strategy Fund (ICN), which seeks to benefit from high short-term interest rates available to investors in India. This Fund goes long Indian rupee nondeliverable forward contracts to collect the interest rate premium, instead of paying it, as an investor would need to do to hedge the exposure. The forward contracts in the Fund are also collateralized by U.S. cash investments. The combination of interest from the U.S. cash instruments with the interest rate premium approximates the local money market rates in India, which is how the strategy seeks to accomplish its objective. While there certainly would have been a volatility reduction for investing in India while hedging the rupee, the returns would have been lower over the last 1, 3, 5 and 10 years, all periods when the rupee depreciated. Many emerging market (EM) currencies offer the potential for excess returns through a couple of factors. First is the convergence to long-term purchasing power. EM currencies are often valued at a discount compared to their long-term purchasing power. As these countries develop, the discount gradually fades as their productivity outstrips productivity in more mature economies. Second, as we discussed, these countries have higher interest rates or carry that attracts capital inflows. In addition, higher carry compensates investors for greater uncertainty in inflation expectations as well as the volatility of spot movements. For these reasons, we still see the cost to hedge the rupee as an impediment to the long-term returns from rupee-hedging Indian equities. ***Unless otherwise noted data source is Bloomberg, as of June 30, 2016.***

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DEFINITIONS

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

Inflation : Characterized by rising price levels.

Interest Rate Differentials : The Difference between the 2 Year interest rate swaps of the United Kingdom vs. the United States.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Basis point : 1/100th of 1 percent.

Forward contracts : Agreements to buy or sell a specific currency at a future date at an agreed upon rate.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Spot return : return generated from changes in spot price.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Non-deliverable forward currency contract : An agreement to buy or sell a specific currency at a future date at an agreed-upon rate that is settled in U.S. dollars.

Interest rate premium : Refers to the difference between short-term interest rates in different domiciles.

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