

THE RIGHT TIME FOR DYNAMIC FX HEDGING

Jeremy Schwartz — Global Chief Investment Officer

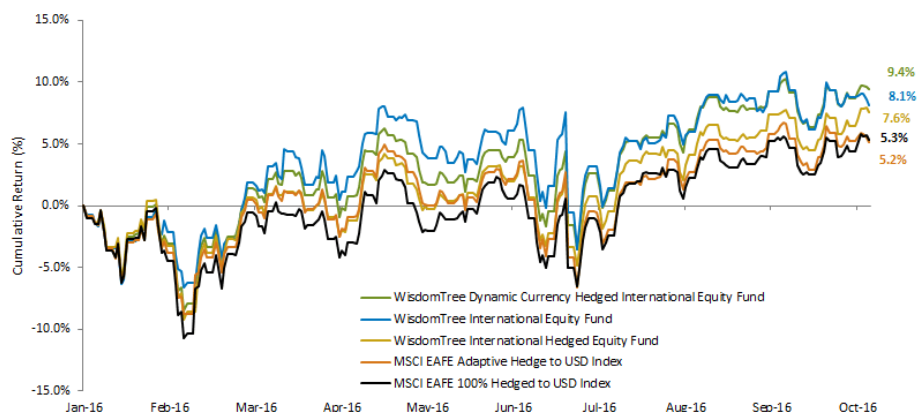
10/11/2016

In early January 2016, WisdomTree launched a set of Funds that we consider to be the future of international equity portfolio management: a family of exchange-traded Funds (ETFs) that incorporate a dynamic element to the management of currency risk. For as far back as we can remember, investors in the U.S. have primarily defaulted to accepting currency risk when investing in *equities* abroad. For developed world fixed income, sure, the [volatility](#) is so large that many, if not most, default to [hedge](#). But interestingly, in equities, which often have higher volatility, investors have tolerated the higher risk that comes along with [unhedged](#) currency exposure. The volatility we've seen in currency markets this year re-emphasizes why currency hedging is of *strategic* importance to portfolios, in our view. In a period of months, the British pound (GBP) dropped from a value of GBP1.50 to the dollar to below GBP1.30¹ to the dollar because of political uncertainty following the UK's [Brexit](#) decision. What happened to UK stocks? They outperformed European markets substantially on the premise that a weaker currency would support their company profits.² Having UK stock market exposure—to diversify risk of U.S. equities being an expensive equity market—was quite valuable thus far this year. Having GBP risk, not so valuable. But over the long run, there is no logical reason to bet the GBP will always and forever be appreciating versus the U.S. dollar, or that it should always add value to U.S. investors (as assumed in unhedged UK strategies). The only real case, in my opinion, to add developed world currency risk is if you have a viewpoint on those currencies appreciating more tactically. It is easy to look backward and say one should not have taken on this British pound risk this year.

Looking Forward: A Factor Approach to Dynamically Adjust Hedges But how can you proactively determine whether you want that currency risk looking *forward*? WisdomTree developed a family of [dynamic strategies](#) that incorporates important factors and determinants of exchange rate movements. Those three factors are [interest rate differentials](#), [momentum](#) and [value](#). You may have heard the phrase “value and momentum everywhere.” In our view, those two factors help explain currency moves. Our Index process, developed in conjunction with Record Currency Management, added interest rate differentials (or [carry](#)) to value and momentum, as interest rates are also known to drive currency gains. At the very least, by not hedging currencies that are expensive to hedge due to a high carry cost (as is now the case in Australia), you can potentially turn the cost of hedging from paying carry and into your favor by hedging only when you are paid, through positive interest rate differentials, to do so (as you are today in the euro, yen and Swiss franc).

How'd Dynamic Hedging Do in Real Time? The Results Are Encouraging Now that we have nine months of real-time results for this international family of dynamically hedged ETFs, we can evaluate how they've done during a period of perplexing currency moves and volatility. Last year was a very strong dollar period in which currency-hedged strategies took in meaningful assets and foreign exchange (FX) hedging added significant value. In the first half of 2016, the yen and euro were surprisingly strong, so unhedged strategies saw a tailwind that led to outperformance compared to hedged strategies. But below we show the results for the [WisdomTree Dynamic Currency Hedged International Equity Fund \(DDWM\)](#) compared to a fully hedged and adaptively hedged index from MSCI since the inception of DDWM, along with fully hedged and unhedged versions of the same WisdomTree strategy. The real-time results show an impressive start for the WisdomTree dynamic FX approach.

International Equity Cumulative



Sources: WisdomTree, Bloomberg. You cannot invest directly in an index.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

Return (1/7/16–10/7/16)

Click each ticker for standardized performance: [DDWM](#), [HDWM](#), [DWM](#). For definitions of indexes in the chart visit our [glossary](#). **Where Dynamic Hedging Added Value** In a year when being unhedged has often outperformed hedged strategies, the broad dynamic hedged strategy from WisdomTree, which has consistently averaged over a 50% hedge ratio in aggregate positioning throughout 2016, has outperformed the unhedged strategies through October 7th. How can this be? It's because of a process that hedged the right currencies more and had lower hedge ratios on currencies that appreciated. A key attribution point comes with the British pound (GBP) and yen. **Hedged GBP:** Our hedge ratio on GBP has been 83.3% since December 28, 2015, and this helped protect returns following the GBP collapse post-Brexit. Why did the dynamic process have an 83.3% hedge for GBP heading into Brexit? The momentum and interest rate signals have both suggested to hedge the GBP since the U.S. [hiked rates](#) in December and U.S. investors were being paid a marginal amount to hedge the GBP, while the [value signal](#) has suggested a half-hedge. The GBP's fall in 2016 was one of its larger falls in history, and it is important to see that our hedging process was able to blunt its decline quite effectively—the exact goal of a dynamic hedging strategy. **Gains in Currencies Such as the Yen:** While passive currency-hedged strategies would have been better served by being 100% hedged on the GBP instead of 83.3% as done in the dynamic model, dynamic hedging outperformed these hedged strategies in 2016, in large part because the yen has appreciated this year and dynamic hedging incorporated a 50% hedge ratio on the yen since late 2015, when the yen's momentum rolled over. **Trend toward FX Hedging Equities Still in Early Innings** In WisdomTree's view, developed world currencies offer higher expected risk levels with no expected return enhancement. Why should you desire these higher risk levels, unless you are good at timing when you want currency risk to be unhedged? Adopting a dynamic approach with WisdomTree moves you away from subjective calls and into a disciplined, "[smart-beta](#)" and factor approach to currency risk management. We believe our factors (carry, value and momentum) have potential to outperform both hedged and unhedged strategies over time by rotating currency hedges with their cycles. So far in 2016, the signals are showing promising added value in a year of large currency moves. Note that our signals currently suggest being roughly half-hedged for the total FX exposure in a broad international strategy. We believe this is a great current guide and also suggest (based on assets under management levels of unhedged international funds) that investors take on too much unnecessary risk when they invest abroad.

{{unknown}}

¹Source: Bloomberg, from 12/16/15 to 7/7/16. ²Refers to the MSCI United Kingdom Index relative to the MSCI EMU Index and MSCI Europe Index, from 12/16/15 to 7/7/16.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Fund invests in derivatives in seeking to obtain a dynamic currency-hedge exposure. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. Derivatives used by the Fund may not perform as intended. A Fund that has exposure to one or more sectors may be more vulnerable to any single economic or regulatory development. This may result in greater share price volatility. The composition of the Index underlying the Fund is heavily dependent on quantitative models and data from one or more third parties, and the Index may not perform as intended. 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. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

No WisdomTree Fund is sponsored, endorsed, sold or promoted by Record Currency Management ("Record"). Record has licensed certain rights to WisdomTree Investments, Inc., as the index provider to the applicable WisdomTree Funds, and Record is providing no investment advice to any WisdomTree Fund or its advisors. Record makes no representation or warranty, expressed or implied, to the owners of any WisdomTree Fund regarding any associated risks or the advisability of investing in any WisdomTree Fund.

Foreside Fund Services, LLC, is not affiliated with the other entities mentioned.

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.

For more investing insights, check out our [Economic & Market Outlook](#)

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

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

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Brexit : an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Dynamic Hedge : Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of time.

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

Momentum Factor : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

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.

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

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Value Signal : Signal using purchasing power parity (PPP), an academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences in order to contribute to a view as to whether a currency might be under or overvalued.

Smart Beta : A term for rules-based investment strategies that don’t use conventional market-cap weightings.