

# PRICE RETURNS, TOTAL RETURNS AND CURRENCY HEDGED EQUITY ETFS

Luciano Siracusano — Chief Investment Strategist

02/09/2016

One of the big stories in the exchange-traded fund (ETF) industry in 2015 was the [WisdomTree Europe Hedged Equity Fund \(HEDJ\)](#), which led the entire ETF industry in net inflows, taking in nearly \$14 billion for the year.<sup>1</sup> Although WisdomTree launched HEDJ in 2009, most of the interest in the Fund came in the last two years as many investors became more interested in protecting their international equity allocations from the decay of depreciating foreign currencies. Given how widely owned this WisdomTree ETF now is, let me summarize some of the frequently asked questions we field related to HEDJ and to [currency-hedged](#) equity funds generally. **Performance** We are often asked how WisdomTree's approach to hedging currency in Europe has performed compared to similar [cap-weighted](#) indexes in that region. When discussing the performance of currency-hedged equity indexes, an investor should evaluate returns not just compared to a broad index of European stocks, but to an index of European stocks that [hedges](#) or mitigates the impact of foreign currency movements. When we do so below, we notice that the [WisdomTree Europe Hedged Equity Index](#), which HEDJ tracks before fees and expenses, has outperformed two major cap-weighted European hedged equity indexes since its inception in July 2012. It also generated annualized returns that were more than 5 percentage points greater than the unhedged [MSCI EMU Index](#) over the same period.

Index Name	WT Index Inception Date	Average Annual Returns as of 12/31/2015				
		3- Month	1-Year	3-Year	5-Year	Since WT Index Inception
WisdomTree Europe Hedged Equity Index	7/2/2012	6.90%	6.15%	11.43%	N/A	15.22%
MSCI Europe US Dollar Hedged Index		5.23%	4.61%	10.08%	7.13%	12.14%
MSCI EMU 100% Hedged to USD Index		6.28%	8.88%	12.23%	7.78%	15.20%
MSCI EMU Index		3.60%	-1.42%	5.20%	3.04%	10.14%

Sources: Bloomberg, WisdomTree, as of 2/4/16. Past performance is not indicative of future results. You cannot invest directly in an index. 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.

For definitions of indexes in the chart, visit our [glossary](#). WisdomTree did underperform one European hedged index in calendar year 2015. That can occur when you have different country and sector weights compared to the “[beta](#)” benchmarks. But those variations can also turn in your favor. Thus far in 2016, WisdomTree's Europe Hedged Equity Index has already generated more than 150 [basis points \(bps\)](#) of excess return relative to this [MSCI EMU 100% Hedged Index](#)—so that trailing one-year performance differential is closing. **Price Returns vs. Total Returns** WisdomTree, like most ETF managers, provides return data on its website ([click here to see standardized returns for HEDJ](#)). Regrettably, many investors (and some financial reporters) use data from vendors that show returns based only on the ETF's price movement in the market. This can cause confusion. To make meaningful fund comparisons, investors should use the total return of an ETF, which can include reinvested [dividends](#), interest and capital gains distributions. Investors who look at Yahoo Finance or their own brokerage screens may not see the full performance picture if they only view the “price” return of the fund. HEDJ, for example, generated a total return of 6.7% at [Net Asset Value \(NAV\)](#) in the fourth quarter of 2015. But the capital gains distributions and the dividends it paid in that quarter totaled \$4.00 per share—or roughly 7% of the fund's NAV. If you were looking at a screen that did not include those distributions, you could mistakenly conclude that HEDJ lost money over the final three months of 2015. It didn't. To the contrary, it literally put money in investors' pockets. **Capital Gains on Currency-Hedged Equity Funds** Many equity ETFs can go many years before ever paying a capital gains distribution to shareholders. [This tax efficiency is one of the benefits of the ETF structure](#). However, currency-hedged equity funds that generate positive returns through the use of [forward contracts](#) do typically generate capital gains distributions. This was

the case for HEDJ in 2015. WisdomTree generated zero capital gains on the equity portion of the portfolio. But HEDJ did make a large capital gains distribution in December because the Fund succeeded in doing exactly what it was designed to do: It mitigated the impact of the euro. The Fund does this each month by entering into forward contracts to establish a [short position](#) in the euro. This is intended to hedge the impact of being “[long](#)” the euro by owning European stocks. Because most of the euro’s depreciation in 2015 occurred earlier in the year, and because HEDJ has a different fiscal year than other European hedged ETFs,<sup>1</sup> HEDJ produced a larger capital gains distribution on its currency forward contracts—both in absolute dollar terms and as a percentage of NAV.<sup>2</sup> In any given year, the size of capital gains distributions can vary; next year it could easily reverse. **Costs of Trading Currency-Hedged ETFs** Another misperception around currency-hedged ETFs relates to the cost of hedging and the cost of trading the ETF in the marketplace. The cost of hedging typically is determined by the differential in [interest rates](#) between the foreign currency and the U.S. dollar. Right now that cost is nil. With [short-term interest rates](#) in Europe below zero as of June 2014, that differential actually represents a source of return for U.S. investors. In addition to the management fee, the other costs incurred by ETF investors relate to brokerage commissions and the [bid/ask spread](#) to buy the ETF on an exchange. The cost to [create or redeem](#) an ETF can vary, but that is a cost borne by large institutions that transact with the Fund and is not necessarily a cost that investors buying on an exchange incur directly. It is fair to say that the cost of assembling the basket of stocks within an ETF is typically reflected in the bid/ask spread in the ETF. But in ETFs that are actively traded, that cost can dissipate with strong two-way flow in the [secondary market](#). HEDJ is one of those actively traded ETFs. It traded an average of more than 5 million shares per day over the last three months, or roughly five times the average daily dollar volume of its closest competitors over that period.<sup>3</sup> Because of that two-way flow, HEDJ typically trades a penny wide between the bid and ask price. If you trade a penny wide at \$50, the cost per trade is 2 basis points, excluding commission costs. That compares to 4 basis points for funds trading a penny wide at half of HEDJ’s price.<sup>4</sup> For many investors, the all-in cost of owning and trading an ETF—as well as its total return over time—is what really matters.

<sup>1</sup>Source: Morningstar, as of 12/31/15. <sup>2</sup>Source: WisdomTree, as of 1/29/16. <sup>3</sup>Source: Bloomberg. <sup>4</sup>Source: ETF.com.

#### Important Risks Related to this Article

Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

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. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. 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. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund’s prospectus for specific details regarding the Fund’s risk profile.

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](http://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

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

**Market capitalization-weighting** : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

**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.

**MSCI EMU Index** : A free float-adjusted market capitalization-weighted index designed to measure the performance of the markets in the European Monetary Union.

**Beta** : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

**MSCI EMU 100% Hedged Index** : Achieves an index return very similar to the MSCI EMU Index but with the addition of hedging its currency exposures.

**Dividend** : A portion of corporate profits paid out to shareholders.

**Net Asset Value (NAV)** : The calculated assets minus liabilities divided by shares outstanding. NAV is the straightforward account of the actual assets in the fund.

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

**Short (or Short Position)** : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

**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).

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

**Short-term rates** : the rate of interest on a debt instrument maturing in two years or less.

**Bid/Ask Spread** : This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

**Creation and Redemption Process** : The process whereby an ETF issuer takes in and disburses baskets of assets in exchange for the issuance or removal of new ETF shares.

**Secondary market** : A market where investors purchase or sell securities or assets from or to other investors, rather than from issuing companies themselves—exchanges such as the New York Stock Exchange and the NASDAQ—are secondary markets.