HOW TO AVOID UNINTENTIONAL CURRENCY BETS

Jeremy Schwartz — Global Chief Investment Officer
09/28/2020

Let's say we erase all legacy biases, start with a clean slate and face the following choice:

Investment A: International Stocks

Investment B: International Stocks plus Currency

The vast majority of investors would likely choose International Stocks only. It seems simpler.

Yet to achieve Investment A, investors must put on a currency hedge that seems exotic. It's like you're being forced to make an active call on the direction of the U.S. dollar in foreign exchange markets.

Perception vs. Reality

The reality is that unhedged international strategies carry a second layer of risk and exposure courtesy of foreign exchange fluctuations. By not hedging currency risk, you are implicitly making a bet on an underlying currency, whether you realize it or not. Currency-hedged strategies have the goal of isolating returns to stock performance in their local markets, with no additional risk or movement from directional changes in local currencies. That is what most stock investors want in the first place, even if they don't realize it.

By utilizing unhedged strategies, most investors inherently express bearish views on the dollar in perpetuity since the source of returns from their unhedged international strategy is attributed to stock and currency performance. That may not be their intention, but that is what they're getting.

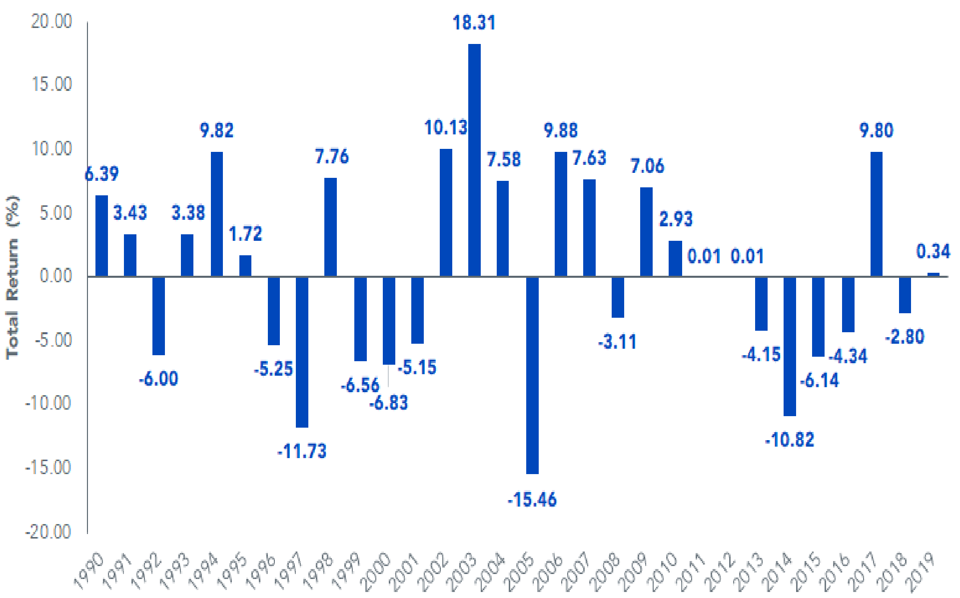
Looking at calendar-year returns of currency exposure in the MSCI EAFE Index, we see over the last 30 years there was approximately a 50/50 chance for currency moves up or down, with the average, absolute change being about 6.7%.

There is widespread agreement that expected returns from currency moves are zero, since conventional wisdom tells us that no one knows what currencies will do. One of the few guarantees of currency bets, however, is that they will add to the expected risk of international investments.

Why do investors insist on doing that?

Some don't, and you don't have to either.

MSCI EAFE Index Calendar Year Returns from Currency



Sources: WisdomTree, Bloomberg, as of 12/31/19. Past performance is not indicative of future results. You cannot invest directly in an index.

Case Study: Buffett in Japan

Warren Buffett recently purchased five Japanese stocks valued at more than $6 billion. When announcing the purchases, Berkshire emphasized how it's the ultimate passive and long-term investor.

While international ETF investors often argue that "currency washes out in the long run" to justify keeping exposure to currencies, Buffett implemented a currency hedge such that a sharply depreciating Japanese yen relative to the dollar cannot offset the gains he makes in the stocks.

Buffett implemented a currency hedge by issuing yen-denominated bonds maturing between 2023 and 2060. If the yen depreciates, his debt levels go down, offsetting any losses that come from being long the yen with his stock purchases. Consequently, Berkshire has "only minor exposure to yen/dollar movements."[1]

Buffett often has access to preferred deals and opportunities that the common investor does not. But investors of all stripes have access to these same currency-hedging concepts by using currency-hedged ETFs.

WisdomTree pioneered these ETFs more than a decade ago.

The spike in popularity in 2014 and 2015 on central bank policies perhaps gave a misguided impression that currency-hedged strategies were supposed to be "tactical trading" vehicles, reliant on a view of the dollar's direction.

But that's not the intention of hedging currency bets.

Buffett is not a tactical investor making a bet the yen is going to depreciate. Rather, he is a stock investor who identified a good investment opportunity and wants to lower the risk his thesis goes astray with an unintentional currency bet on the yen.

Whether for broad international strategies or for specific regions like Japan and Europe, WisdomTree believes investors should consider investing internationally in a lower-risk fashion by removing unintentional currency calls through hedging instruments.

For those interested in WisdomTree's offering of currency-hedged solutions, we believe the WisdomTree International Hedged Quality Dividend Growth Fund (IHDG) can help meet these objectives.

[1]Source: https://www.berkshirehathaway.com/news/aug3020.pdf

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. To the extent the Fund invests a significant portion of its assets in the securities of companies of a single country or region, it is likely to be impacted by the events or conditions affecting that country or region. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. 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 effect 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. 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. 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.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.

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, Kara Marciscano, 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.

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

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.

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

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Currency bet : an investment made in a currency in order to profit from a rise or fall in the valu.