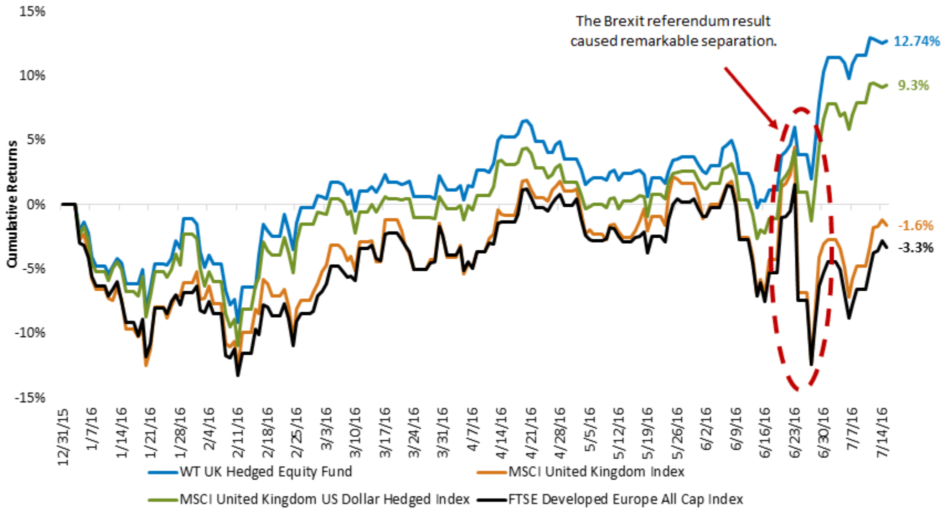
WHY IS THIS UK STRATEGY SIGNIFICANTLY OUTPERFORMING EUROPEAN MARKETS?

Jeremy Schwartz — Global Chief Investment Officer
07/29/2016

The Brexit vote occurred last month, creating uncertainty about the United Kingdom's role and future in the European economy, yet the WisdomTree United Kingdom Hedged Equity Fund (DXPS) has been up 12.74% year-to-date (YTD) as of July 15, 2016, while a broader index of European stocks—the FTSE Developed Europe All Cap Index—is down 3.3% YTD in 2016.[1] What is happening here? For starters, DXPS employs a currency hedge—and thus has not been affected by the sharp falloff in the value of the British pound following the Brexit vote. Traditional exposures to European stocks typically include two components of returns: the foreign stock prices and the foreign currency moves against the U.S. dollar. Broad European strategies[2], which have as much as 30% exposure to the British pound, saw as much as a negative 12.8%[3] impact on these stocks in the two weeks following Brexit. But there is something more than just the currency hedge in the works. The United Kingdom is home to many global companies that generate their revenues outside the UK. With a fall in the British pound, these companies are becoming more competitive in the global markets and their stock prices have been rising. Further, WisdomTree has an exporter orientation and screen in its WisdomTree United Kingdom Hedged Equity Index, which DXPS seeks to track before fees. The screen is designed to exclude stocks that derive more than 80% of their revenue from within the United Kingdom as of the annual rebalance. Comparing DXPS to the MSCI United Kingdom US Dollar Hedged Index (which also mitigates the risk of a depreciating pound by hedging), one can see there has been more than a 3 percentage point outperformance for DXPS year-to-date, as of July 15, 2016. Factoring in the British pound depreciation against the U.S. dollar, the MSCI United Kingdom Index, in U.S. dollar terms, was down 1.6% over this same YTD period. Another way to illustrate the outperformance of UK exporters: Germany's DAX is down 6.3% YTD as of July 15 priced in euros, while, to reiterate, DXPS is up 12.74%. Click here for standardized



Sources: WisdomTree, Bloomberg, with data shown for the period from 12/31/15 to 7/15/16. 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.

performance of DXPS.

What Are the Lessons? Currency-hedged exchange-traded funds (ETFs) have gained market share as a way to allocate to international stocks, largely on specific views for certain markets and currencies such as European markets and the euro and Japanese markets and the yen. The moves in the British pound this year are another illustration of how currency hedges can be valuable additions to international allocations. Where does the British pound go from here? No one knows for sure, and that is largely why we believe currency hedging has strategic value. Unless you take the view that the British pound is now inexpensive and bound to appreciate, we believe that currency hedging adds to the risk profile of UK stocks without adding to the expected return profile. We have been emphasizing that currency can offer uncompensated risk—and that there is no model to say that the British pound will always go up in value—so why always bet on that occurring unless you have a strong conviction that the British pound is going to increase against other currencies? There may be some value players, contrarians who react to sharp falls as an opportunity. I am sympathetic to thinking the market often overreacts, and perhaps the large drop in the pound is an example of such an opportunity. But it is equally possible we have not seen the full fallout of divergent trends in monetary policies, where it seems the U.S. Federal Reserve is on a path to normalizing (on some delayed timeline), while all eyes are on the next August meeting for the Bank of England to potentially expand monetary stimulus. **There Is More Than One Way to Incorporate Currency Hedges into Portfolios** The one long-term international investment strategy I would not advocate: being fully unhedged all the time, unless you believe these foreign currencies are structurally appreciating (i.e., the dollar is in long-term decline). There may be some investors who believe that. But most of those voting to remain unhedged think currency nets out and it effectively doesn't matter. We argue that the last four to five years show that currency can be quite significant and no one can tell you exactly where we are in that cycle today. I believe investors should either adopt a passive hedging program to help reduce the volatility of international stocks or adopt a dynamic hedging program that looks at multiple factors such as interest rate differentials, value and momentum of currencies to help determine how much currency exposure should be hedged. For what it's worth, this dynamic model of the WisdomTree Dynamic Currency Hedged International Equity Index suggests being 83% hedged on the British pound as of our latest signal, measured at the end of June 2016. Learn more about the benefits of a dynamically hedged approach. [1]Sources: WisdomTree, Bloomberg, with data from 12/31/15 to 7/15/16. [2]Refers to the FTSE Developed Europe All Cap Index. [3]Source: Bloomberg, with data from 6/23/16 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. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. The Fund focuses its investments in the United Kingdom, thereby increasing the impact of events and developments in the United Kingdom that can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile, and 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. 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)

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

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

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

MSCI United Kingdom US Dollar Hedged Index : represents a close estimation of the performance that can be achieved by hedging the currency exposures of its parent index, the MSCI United Kingdom Index, to the USD, the "home" currency for the hedged index.

MSCI United Kingdom Index : A market capitalization-weighted index designed to measure the performance of the United Kingdom equity market.

DAX Index : A stock index that represents 30 of the largest and most liquid German companies that trade on the Frankfurt Exchange. The prices used to calculate the DAX Index come through Xetra, an electronic trading system. A free-float methodology is used to calculate the index weightings along with a measure of average trading volume.

Contrarian : Practice of seeing what the majority of market participants are focused on and attempting to look in the complete opposite direction.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

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.

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

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.

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.

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.

FTSE Developed Europe All Cap Index : a market- capitalization index representing the performance of companies in developed European markets, including UK.