WHAT ADDITIONAL ROLE CAN THE U.S. DOLLAR PLAY IN INVESTOR PORTFOLIOS?

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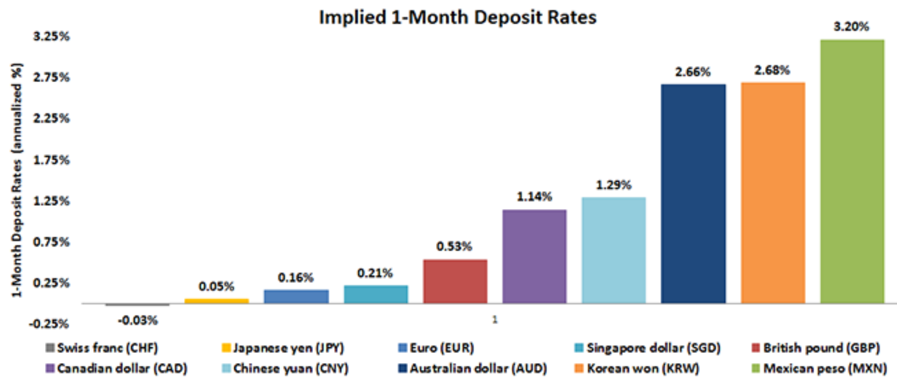
When thinking about the role the U.S. dollar plays in an investor's portfolio, an important distinction must be made: total returns and increases in future foreign purchasing power are not the same thing. U.S.-based investors' awareness and consideration of the U.S. dollar's impact on their portfolio usually occurs when they assess the merits of an unhedged international equity or a fixed income position. To offer investors a differentiated approach, WisdomTree has emerged as an industry leader in the currency-hedged equity exchange-traded fund (ETF) space. However, from the perspective of many U.S.-based investors, if they are buying U.S. dollar-denominated assets, they are implicitly long the dollar. In our opinion, this interpretation is only partially correct. It is true that the total returns of their investment are not impacted by changes in foreign exchange rates, but if the U.S. dollar appreciates against a foreign currency such as the euro, the investor is no better off with respect to total returns; his future purchasing power in euros has simply increased. In global markets, currencies are traded in pairs. When investors enter into a long position in a currency, they must sell another currency short to initiate their position. To potentially benefit from this move, if the investor was long the U.S. dollar against a short position in the euro as mentioned above, he would have generated total returns in addition to his increases in purchasing power. Keeping this important distinction in mind, in what scenarios should investors consider investing in the dollar against a basket of international currencies? **Currency as an Asset Class** At WisdomTree, we have long advocated that investors should consider allocations to foreign currencies, particularly in emerging markets (EM), as a complement to their traditional equity and fixed income portfolios. Higher EM interest rates, combined with greater long-term productivity rates, remain the key reasons why investors should consider diversifying their currency exposure through strategic long-term allocations to EM currencies. However, as we will detail below, there are also several instances where investors should consider a short position in foreign currencies against the U.S. dollar as part of a tactical asset allocation approach. **Low Opportunity Cost** With interest rate targets in most developed countries near zero, opportunity costs in many of these markets are negligible. Due to the arbitrage mechanism in many forward currency markets, investors with a short exposure to a foreign currency have a short position in foreign interest rates as well. Therefore, a long position in the U.S. dollar against a short position in a foreign currency results in a negative drag on performance if the foreign country's interest rates are higher than the United States'. With talk of tapering in the United States weighing on investors' minds ever since Fed Chairman Bernanke's speech in May 2013, traders started buying U.S. dollars and selling foreign currencies in advance of a potential rise in interest rates. However, in Europe, the European Central Bank (ECB) recently lowered interest rates by 0.25% in order to help stimulate the eurozone's economy. Mark Carney, the current Governor of the Bank of England, has pledged to maintain low policy rates until unemployment drops below 7%. And after years of slow growth, the Bank of Japan is continuing to signal its increasing commitment to Shinzo Abe's reflation agenda. As a result of these policies, the U.S. dollar may not only appreciate, but also diminish the costs associated with a short position in foreign currencies.



Source: Bloomberg, as of October 31, 2013. Past performance is not indicative of future results. Deposit rates are historical and do not reflect the returns of any WisdomTree currency fund.

The implied 1-Month deposit rate represents the annualized interest rate embedded in forward currency contracts. For definitions of indexes in the chart, please visit our Glossary.

A Hedge against Market Uncertainty As we have seen recently, foreign currency risk is undesirable in certain market environments. During periods of economic stress, investors flock toward stable, liquid assets when attempting to reduce their exposure to the markets. Given the U.S. dollar's current role as the world's reserve currency, it tends to appreciate during periods of increasing global uncertainty. When an investor buys a currency such as the dollar, he is implicitly selling short a foreign currency to gain this exposure. Given the simple laws of supply and demand, this trade has the effect of driving up the price of the dollar against the foreign currency that was sold.

Portfolio Diversification through Negative Correlation Historically, currency returns generally have a positive correlation with local asset prices. When U.S. investors buy foreign assets such as stocks and bonds, they must convert their dollars to the local currency and purchase locally denominated assets. This causes an increase in demand for the local currency as well as a rise in asset prices. The dollar, by comparison, is seen as a "safe haven" currency in the current market environment. Therefore, as risky assets decline in value, the value of the dollar may tend to increase. This perhaps overlooked current market dynamic has the impact of creating a negative correlation for most foreign currency positions against the S&P 500.

Weekly Correlations, October 31, 2008 – October 31, 2013

Currency	S&P 500 Index	Barclays U.S. Aggregate Bond Index
Euro (EUR)	-0.366	-0.055
Japanese yen (JPY)	0.193	-0.513
Canadian dollar (CAD)	-0.689	0.139
British pound (GBP)	-0.31	-0.025
Mexican peso (MXN)	-0.613	0.043
Australian dollar (AUD)	-0.677	0.068
Swiss franc (CHF)	-0.176	-0.198
Korean won (KRW)	-0.568	-0.028
Chinese yuan (CNY)	-0.108	-0.039
Singapore dollar (SGD)	-0.533	-0.049

Source: Bloomberg
Note: Correlations calculated above are based on appreciation of the U.S. dollar against a foreign currency.

Conclusion Investments in the U.S. dollar against foreign currencies can be used in a variety of ways in an investor's portfolio. Given the low opportunity costs associated with long positions in the U.S. dollar against many developed market currencies, the current role the U.S. dollar plays in the global financial system and the potential for diversification from a negatively correlated asset to traditional asset classes, we believe that certain market environments may create opportunities to benefit from a strengthening U.S. dollar.

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DEFINITIONS

Purchasing power parity : 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.

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

Dollar-denominated assets : Assets such as stocks and bonds that are priced in U.S. dollars.

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).

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).

Arbitrage Mechanism : The ability to compare the price of an ETF and its underlying basket and exchange one for the other utilizing the creation and redemption process.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Forward currency contracts : A forward contract in the forex market that locks in the price at which an entity can buy or sell a currency on a future date.