

THE SIMPLE BELIEF BEHIND SYSTEMATIC CURRENCY HEDGING

Jeremy Schwartz — Global Head of Research
06/17/2019

Many investors don't know what to make of currency fluctuations and whether they should take on [currency risk](#) or [hedge](#) it.

To help with this decision, WisdomTree launched a suite of dynamic currency hedged international equity funds in early 2016, led by our broadest international Fund, the [WisdomTree Dynamic Currency Hedged International Equity Fund \(DDWM\)](#).

DDWM has performed well since it launched, ranking in the 11th percentile of its Morningstar peer group since its inception and in the top 3% over the last three years.¹

The [small-cap](#) version, the [WisdomTree Dynamic Currency Hedged International SmallCap Equity Fund \(DDL\)](#), has performed similarly well, ranking in the 15th percentile of its peers since inception and in the 12th percentile over the last three years.²

These performance numbers are better than their [unhedged](#) WisdomTree counterparts that have more assets and longer histories, as the unhedged strategies were part of our original family that came to market in 2006.

Fund/Index	Fund Information			Average Annual Total Returns as of 3/31/19									
	Ticker	Exp. Ratio	Inception Date	NAV Returns (%)					Market Price Returns (%)				
				1-Year	3-Year	5-Year	10-Year	Common Period	1-Year	3-Year	5-Year	10-Year	Common Period
WisdomTree Dynamic Currency Hedged International Equity Fund	DDWM	0.35%	1/7/2016	1.26%	8.97%	N/A	N/A	9.05%	0.43%	8.76%	N/A	N/A	9.12%
MSCI EAFE Local Currency Index				3.01%	8.53%	5.98%	9.75%	7.45%	3.01%	8.53%	5.98%	9.75%	7.45%
MSCI EAFE Index				-3.55%	7.27%	2.33%	8.96%	7.59%	-3.55%	7.27%	2.33%	8.96%	7.59%
WisdomTree Dynamic Currency Hedged International SmallCap Equity Fund	DDL	0.43%	1/7/2016	-5.61%	8.23%	N/A	N/A	9.03%	-6.10%	8.47%	N/A	N/A	9.50%
MSCI EAFE Small Cap Local Currency Index				-3.13%	8.57%	8.01%	13.56%	8.05%	-3.13%	8.57%	8.01%	13.56%	8.05%
MSCI EAFE Small Cap Index				-9.12%	7.50%	4.47%	12.76%	8.37%	-9.12%	7.50%	4.47%	12.76%	8.37%

Sources: WisdomTree, FactSet, 1/7/16–3/31/19. Past performance is not indicative of future returns. 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. ET 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.

Our View on Currency Hedging Hasn't Changed

WisdomTree has long believed that some investors, by taking uncompensated currency bets, may take on too much risk when they invest internationally.

If you were to start with a blank sheet of paper that said:

Strategy 1: Exposure to A

Strategy 2: Exposure to A + B

With A being equal to the local equity market returns, and B, the currency return (e.g., of the euro), it should be clear that unhedged international equity strategies have exposures to two bets (A+B), and that fully hedged strategies focus on exposure to A only by hedging the traditional long bias currency exposure of unhedged strategies.

Today many investors still think of currency hedging as an exotic call and default to betting on the dollar going down forever (in other words, investors in European unhedged equities have an explicit call the euro is going to rise forever).

Of course, most investors don't actually believe the euro will perpetually rise—they just believe currencies will “wash out in the long run.”

I recently sat down with the CEO of Record Currency Management, James Wood Collins, to discuss how investors around the world look at these directional currency bets. We discussed factors that can take an uninformed directional bet on the dollar going down forever and transform it into a systematic overlay strategy that hedges currencies based on common factors that are rewarded over time.

One of the more interesting elements of the discussion focused on [interest rate carry](#) and some unique factors today.

Carry represents how much one is paid to hedge currencies. Right now, with the current [interest rate differentials](#) around the world, one can earn almost 3% a year hedging the euro and 2.5% a year hedging the yen.

These interest rates are being collected in the [forward contracts](#) that hedge currencies global fixed income mandates that hedging currencies have similar (if not higher) yields to [U.S. treasuries](#) even though Japanese government bonds have negative yields on them nominally.

James discussed some of the unique funding elements in the supply and demand of hedging instruments that can add even more [premium](#) to forward rates than normal.

Investors often say currency hedging can be expensive and use it as a reason not to hedge. I view unhedged strategies missing a 3% euro carry pickup as expensive, and at a structural disadvantage, unless investors have a view the euro is going to rally and make up this carry loss. This is also true for broad international baskets where the average carry pickup is currently well over 2%.

This was a great discussion and we encourage you to listen to the full conversation for more information on systematic hedging strategies.

Unless otherwise stated, data source is Bloomberg, as of June 10, 2019.

¹The percentile rank is the funds' total-return percentile rank compared to all funds within the same Morningstar category and is subject to change each month. 270 investments included in peer group for U.S. fund, foreign large value, for since inception performance, 2/1/16–3/31/19. 275 investments included in peer group for U.S. fund, foreign large value, for trailing three-years' performance, 4/1/16–3/31/19.

²The percentile rank is the funds' total-return percentile rank compared to all funds within the same Morningstar category and is subject to change each month. 49 investments included in peer group for U.S. fund, foreign small/mid value, for since inception performance, 2/1/16–3/31/19. 49 investments included in peer group for U.S. fund, foreign small/mid value, for trailing three-years' performance, 4/1/16–3/31/19.

Important Risks Related to this Article

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. The Funds invest 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 Funds may not perform as intended. Funds that have 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 Indexes underlying the Funds is heavily dependent on quantitative models and data from one or more third parties, and the Indexes may not perform as intended. The Funds invest in the securities included in, or representative of, their Indexes regardless of their investment merit, and the Funds do not attempt to outperform their Indexes or take defensive positions in declining markets. Please read each Funds' prospectus for specific details regarding the Funds' risk profiles.

No WisdomTree ETF is sponsored, endorsed, sold or promoted by Record, and Record makes no representation or warranty, expressed or implied, to the owners of these Funds regarding any associated risks or the advisability of investing in the Funds. Record provides certain research and information to WisdomTree and has licensed certain rights to WisdomTree, but Record is providing no investment advice to any WisdomTree ETF.

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 risk : the risk that an investment will decline in value due to a change in foreign exchange rates.

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.

Small caps : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

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.

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

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

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

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Premium : When the price of an ETF is higher than its NAV.