

# THE SIMPLE BELIEF BEHIND SYSTEMATIC CURRENCY HEDGING

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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.<sup>1</sup>

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.<sup>2</sup>

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									
				NAV Returns (%)					Market Price Returns (%)				
	Ticker	Exp. Ratio	Inception Date	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](http://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.*

<sup>1</sup>The 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.

<sup>2</sup>The 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.

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For more investing insights, check out our [Economic & Market Outlook](#)

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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.