

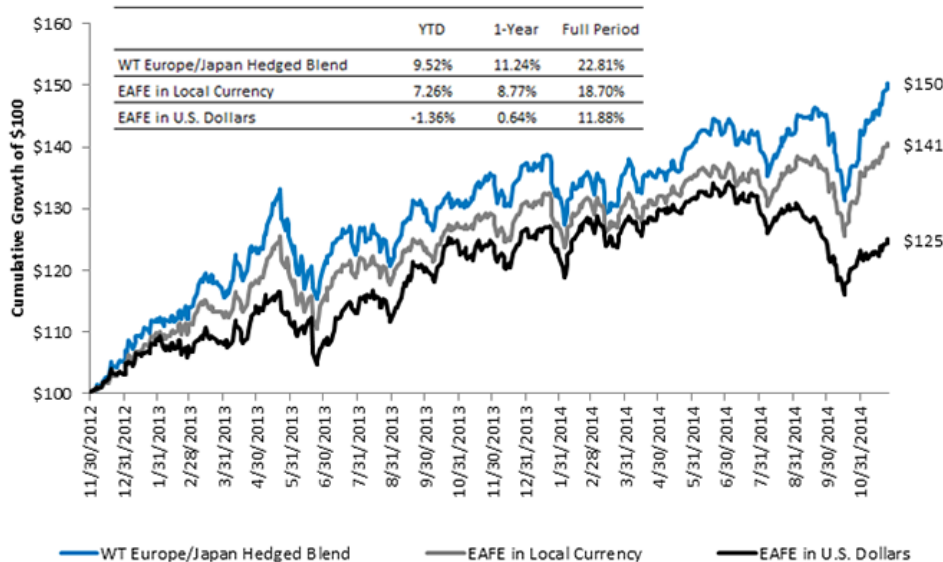
HOW TO POSITION YOUR INTERNATIONAL PORTFOLIO

Jeremy Schwartz — Global Head of Research
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One of the most important trends in the markets in 2014 has been the rise of the U.S. dollar and the collapse of the euro and the yen. We've [written a lot](#) about utilizing [hedged equity strategies](#) to isolate international equity markets without adding the layer of euro and yen exchange rate [risk](#). We believe the exchange rate risk to be a critical factor influencing returns and think investors should concentrate on the local equity opportunities in these regions without the currency [volatility](#). The euro and the yen are the two currencies at the focal point for international investors given central bank trends, but below we show how a combination of these two markets tracks to a few broad international benchmarks.¹

Divergent Monetary Policies in Europe and Japan = Potential for Currency Weakness In looking at the central bank policy landscape today, the big story tilting away from the side of aggressive [easing](#) is the United States Federal Reserve (Fed), which ended its program of bond purchases during 2014. On the opposite end of the spectrum, the most aggressive "monetary easer" is the Bank of Japan (BOJ), with the European Central Bank (ECB) exploring further easing options. A greater degree of monetary easing could lead to a greater degree of currency weakness for the euro and the yen compared to the U.S. dollar. **Taking Action in Developed International Markets** The euro and the yen are also the two biggest currency exposures in most traditional benchmarks targeting developed international stocks. For instance, within the [MSCI EAFE Index](#), Europe—specifically the markets utilizing the euro currency—(approximately 31%) and Japan (approximately 21%) comprise just over 50% of the total Index and exist in approximate 60%/40% proportion to each other.² Given that Japan's and Europe's respective policy landscapes are bringing them into focus, we show how a 60% Europe/40% Japan hedged equity blend³ compares to the MSCI EAFE Index both in local currency and U.S. dollars.

The WisdomTree Hedged Equity Blend: Close Tracking to MSCI EAFE Equities (as of 11/25/2014)



Source: WisdomTree, Bloomberg. Data starts from 11/30/12 due to methodology change to the WisdomTree Japan Hedged Equity Index applied as of that date to focus on Japan's exporters. EAFE in local currency refers to the MSCI EAFE Local Currency Index, which is not exposed to fluctuating exchange rates. EAFE in U.S. dollars refers to the MSCI EAFE Index and is exposed to changes in currency exchange rates relative to the U.S. dollar. Past performance is not indicative of future results. You cannot invest directly in an index.

• In 2014, the year-to-date

differential from the WisdomTree Europe/Japan (60/40) blend over MSCI EAFE in U.S. dollars was more than 10 percentage points. This shows just how important currency was as a driver of international returns in 2014. • **The WT Hedged Blend Performs Well Compared to EAFE in Local Currency:** Over this period, we can see clearly that the blend outpaced the EAFE in local currency. The [correlation](#) between the two was actually 0.95—a very high number—showing how closely tied these two markets are to the overall international benchmarks. • **Japan Drives the Relative Gains:** Over the past two years, Japan has been a robust generator of strong equity market returns—returns that if [unhedged](#) would be significantly cut by the depreciation of the yen. As we have written [here](#), we remain optimistic on prospects for Japan from a standpoint of [valuation](#) as well as increased flows from the Bank of Japan, the Japanese pension funds and other institutional investors. • **Why Europe/Japan May Be Opportunely Focused Blend:** Since the [WisdomTree Europe Hedged Equity Index](#) focuses solely on equity markets that use the euro currency, the United Kingdom (approximately 21% of MSCI EAFE) and Switzerland (approximately 9% of MSCI EAFE)⁴ are missed. The only other market with a greater than 5% weight in the MSCI EAFE that is missed is Australia (approximately 8% of MSCI EAFE). We'd note that the case for central bank policy divergence is the most clear with Europe and Japan—the United Kingdom is actually close to hiking rates alongside the U.S. Federal Reserve, and the cost to hedge Australia currency exposure is higher due to the country's higher [short-term interest rates](#). Investors may therefore think this blended combination of currency hedging Europe and Japan is where to focus the currency hedge part of international benchmarks. • **Currency Hedging Becoming a More Important Consideration:** The difference between EAFE in local currency and EAFE in U.S. dollars has been widening, starting from July 2014 when the yen (-12.86%), the euro (-6.84%) and the pound (-6.98%) depreciated against the U.S. dollar, with specific levels of depreciation noted in parentheses⁵. The [one-month interest rate differentials](#) between the Euro and the Yen contribute to making the current cost to hedge these currencies inexpensive. Given the uncertain nature of exchange rates, we believe at least blending in partial currency hedges makes sense for international investors, and the 60/40 Europe/Japan blend discussed in this piece is where we'd begin the focus.

¹Broad international benchmarks: Refers to the MSCI EAFE Index and the [MSCI EAFE Local Currency Index](#), as measures of the performance of developed international equities with and without the risk of fluctuating currencies against the U.S. dollar. ²Source: Bloomberg for data on exposures within the MSCI EAFE Index as of 11/25/14. Subject to change. ³60% Europe/40% Japan hedged equity blend: Refers to a 60% weight to the [WisdomTree Europe Hedged Equity Index](#) and a 40% weight to the [WisdomTree Japan Hedged Equity Index](#), rebalanced annually. ⁴Source: Bloomberg for data on exposures within the MSCI EAFE Index as of 11/25/14. Subject to change. ⁵Source: Bloomberg, with depreciation versus U.S. dollar measured from 7/31/14–11/25/14.

Important Risks Related to this Article

Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

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

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

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

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

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

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.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

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.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Short-term rates : the rate of interest on a debt instrument maturing in two years or less.

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

MSCI EAFE Local Currency Index : A market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan, with performance measured in local currency term.

WisdomTree Europe Hedged Equity Index : Index designed to provide exposure to European equities while at the same time neutralizing exposure to fluctuations between the Euro and the U.S. dollar. Constituents are European dividend-paying firms with a least 50% of their revenues from outside of Europe. Weighting is by cash dividends paid.

WisdomTree Japan Hedged Equity Index : Index designed to provide exposure to Japanese equity markets while at the same time neutralizing exposure to fluctuations of the Japanese yen movements against the U.S. dollar. Constituents are dividend-paying companies incorporated in Japan that derive less than 80% of their revenue from sources in Japan. Weighting is by cash dividends paid.