DOES IT MAKE SENSE TO TRY TO PREDICT THE EURO'S MOVEMENTS?

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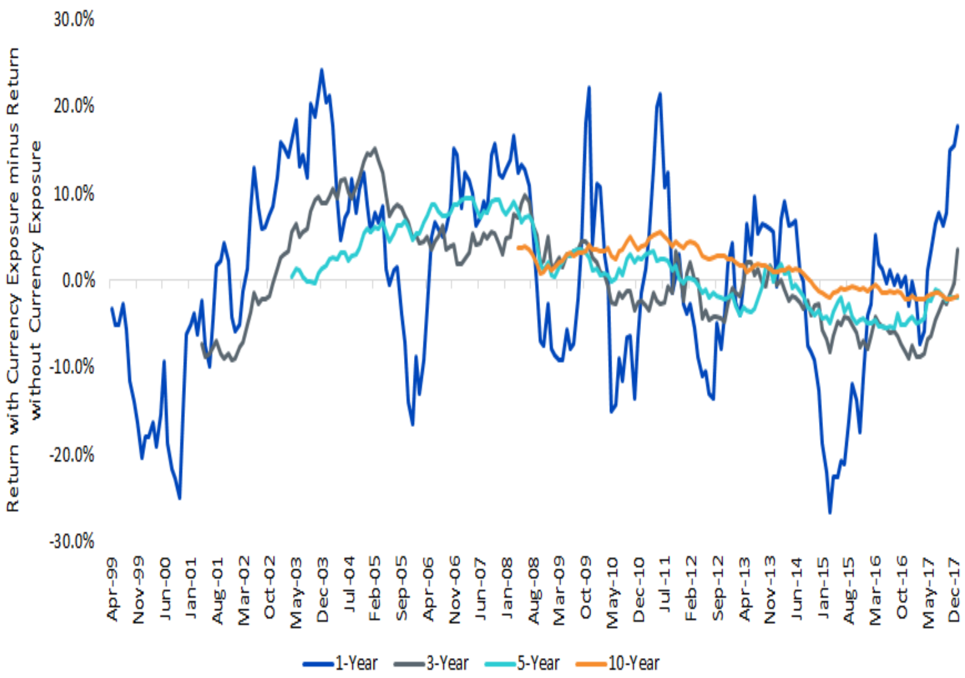
After the global financial crisis of 2008–2009, all investors started paying close attention to central bank activity. Then the U.S. Federal Reserve's (Fed) chairman, Ben Bernanke, provided innovative solutions that contributed to pulling the U.S. economic system back from the brink of collapse, and since then, many other global central banks have borrowed from and even expanded upon that initial playbook.

The result: We are all paying a lot more attention to how the U.S. dollar is moving against other global currencies.

The Euro Appreciated More Than 14% in 2017

The strength and intensity of this move caught us (and many others) by surprise in 2017, as the European Central Bank (ECB) was continuing both its negative policy rate and quantitative easing programs in earnest. One of the biggest effects of this move was that we saw many U.S. investors in exchange-traded funds (ETFs) shifting from hedged to unhedg ed European equity exposures. We found this interesting, in that many investors tell us that they find it difficult to time currency movements. However, we have to figure that a double-digit move can tilt the seesaw so that the "fear of missing out" on any further currency appreciation trumps remembering how tricky currency forecasting can be.

How Different Have Local and U.S. Dollar Returns Been? The MSCI EMU Index Example



Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index. Data is for the full period of live calculation of the MSCI EMU Index (with and without currency exposure), 4/30/1998–1/31/2018.

- **One-Year Rolling Differences:** Clearly, these differences are noticeable and they tend to influence investor behavior. At the beginning of 2017, for example, this difference was basically flat, but at present, it is approaching 20% (in favor of having currency exposure), and we all know where the flows have been heading. On average, the difference between having and not having exposure to the euro's moves against the U.S. dollar has been less than 1% on a rolling one-year basis, but the standard deviation of this difference is 11%, telling us that—while it has averaged out over time—at any given time the chance of seeing a value near 1% has been relatively low. It's also clear that since the beginning of the European Monetary Union in the late 1990s, the high end of the range for the outperformance of having currency exposure has been around 20%. In the past, mean reversion has had a powerful gravitational pull—we didn't see this outperformance gap get to 30% on a rolling one-year basis, meaning that having no currency exposure has tended to quickly come back into favor.
- **10-Year Rolling Differences:** Many people believe that the difference between having and not having currency exposure "comes out in the wash" over longer periods. The data supports this, in that the average difference is quite small on a rolling 10-year basis, and the standard deviation of this difference is around 2%.

Building a Strategic Allocation to European Equities

Still, we recognize that many investors may not have the fortitude to stay the course on their portfolio allocations for 10-year periods, so it makes sense to focus on ways to make things more easily stomached on a year-by-year basis. The critical message: minimize the risk of "regret." Regret comes when a choice is made and then the opposite is paraded out day after day, clearly having been "better."

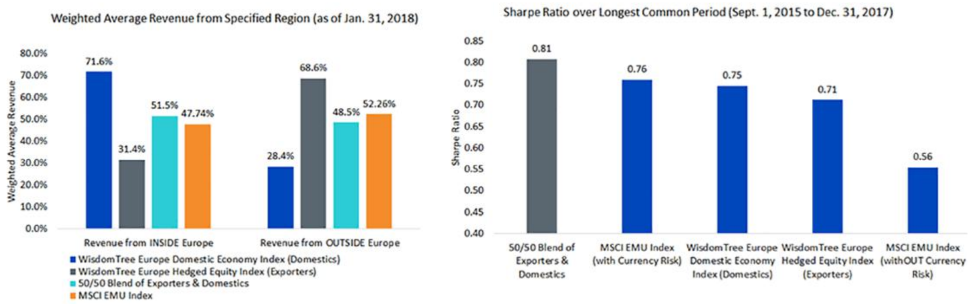
50/50 Blend with a Foundation in both Currency Exposure and Fundamental Drivers

WisdomTree has such a broad suite of European-focused equity strategies that we believe investors may not even realize the flexibility with which they might more finely tailor their European exposure. Examples include the following:

- **WisdomTree Europe Hedged Equity Index:** On the plus side, this strategy requires all constituents to generate more than 50% of their revenues from outside of Europe. One theme that is being discussed at present: synchronized global growth. These are global firms that happen to have their headquarters in Europe. Currency exposure between the euro and the U.S. dollar is also neutralized, so on the minus side, the returns of this strategy have not benefited at all from the appreciating euro that we've seen more recently.

- **WisdomTree Europe Domestic Economy Index:** From a revenue perspective, this is the opposite in that each constituent must derive more than 50% of revenue from inside Europe. On the currency side, it also has exposure to movements of the euro versus the U.S. dollar, and it therefore has benefited from the euro appreciation of late.

Diversification of Geographic Revenue and Currency Exposure



Index/Blend	1-Year Cumulative Return	Sept. 1, 2015 to Dec. 31, 2017 Avg. Ann. Return	Full Period Avg. Ann. Risk	Full Period Sharpe Ratio
50/50 Blend of Exporters & Domestics	**24.1%**	**11.8%**	**14.0%**	**0.81**
MSCI EMU Index (with Currency Risk)	28.1%	11.0%	14.0%	0.76
WisdomTree Europe Domestic Economy Index (Domestics)	34.8%	12.5%	16.3%	0.75
WisdomTree Europe Hedged Equity Index (Exporters)	14.0%	10.7%	14.5%	0.71
MSCI EMU Index (withOUT Currency Risk)	12.6%	7.8%	13.4%	0.56

Sources: WisdomTree, Bloomberg, Zephyr StyleADVISOR. Past performance is not indicative of future results. You cannot invest directly in an index. The period 9/1/15–12/31/17 corresponds to the start date of live calculation for the WisdomTree Europe Domestic Economy Index. MSCI EMU Index (with Currency Risk) is the MSCI EMU Index. The MSCI EMU Index (without currency risk) is the MSCI EMU Local Currency Index.

		Average Annual Total Returns				
Index	WisdomTree Index Inception Date	1 year	3 years	5 years	10 years	Since WisdomTree Index Inception
WisdomTree Europe Hedged Equity Index	**7/2/2012**	**14.0%**	**10.0%**	**11.7%**	**N/A**	**14.0%**
WisdomTree Europe Domestic Economy Index	**9/1/2015**	**34.8%**	**N/A**	**N/A**	**N/A**	**12.6%**
MSCI EMU Index		28.1%	8.6%	8.6%	-0.1%	N/A
MSCI EMU Local Currency Index		12.6%	8.9%	10.7%	1.9%	N/A

Source: WisdomTree, as of 12/31/2017. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the chart, please visit our glossary.

- It's notable that the 50/50 blend of exporters and domestics for European equities arrived very closely at a 50/50 geographic revenue split between inside and outside of Europe. We already know that the currency exposure is split 50/50 due to one index being hedged and the other having the full exposure to the euro's movements.

- Additionally, over the period of live history, we wanted to see if the Sharpe ratio exhibited any advantage to this blend. Typically, hedging the euro versus the U.S. dollar tends to lower overall volatility. However, when the euro appreciates, hedged approaches miss this boost to returns. Of the different strategies we show, the 50/50 blend of exporters and domestics had, in aggregate, the strongest Sharpe ratio, indicating that the risk/return trade-off was actually better for the blend than for either exporters or domestics alone. This initial track record plus the diversification of revenue exposure and the 50/50 starting point to minimize regret of taking the "wrong" approach to currency exposure all make this blend very interesting, in our view.
- We can also see the difference between the one-year cumulative returns versus even the full period returns, as the full story of outperforming/underperforming on the one-year basis was based on the "currency versus no currency" exposure decision. As periods lengthen—and one even sees the start of this impact from September 1, 2015, to December 31, 2017—this gap would be expected to narrow and the risk reduction from hedging at least a portion of an exposure would become more interesting.

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Investments focused in Europe increase the impact of events and developments associated with the region, which can adversely affect performance.

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You cannot invest directly in an index.

DEFINITIONS

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

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

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.

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.

European Monetary Union : 18 countries in Europe that use the Euro currenc.

Mean reversion : The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.