THREE APPROACHES TO INTERNATIONAL SMALL CAPS: A 10 YEAR RETROSPECTIVE

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Earlier this year, we celebrated the 10-year anniversary of the launch of the first small-cap international exchange-traded fund (ETF) in the United States, the WisdomTree International SmallCap Dividend ETF (DLS). We saw the value in small-cap investing and the diversification it can add to portfolios. We asked, if investors have benefited from small-cap investing in their allocations to the United States, and particularly small-cap investing with a value-based orientation like the one our dividend-weighted Indexes incorporate, why should they not have that same opportunity for international allocations? Our investors agreed. DLS resonated from its launch on day one, and it became our biggest ETF less than one year after its launch, based on its assets under management. DLS remains one of WisdomTree's largest ETFs, with more than $1 billion in assets 10 years later. **Questioning the Role of Currency Risk** A few years after we launched, around 2008, the U.S. dollar was in the midst of a seven- to eight-year decline, the euro was approaching $1.60 dollars per euro and foreign ETFs were being driven by these foreign currency gains. During that time, we questioned the strategic role of currency risk, the modus operandi of practically the entire U.S. investing population when they invest in foreign equities abroad. In fixed income, it is par for the course to assume an investor hedges currencies in developed world *fixed income*. Why would you take FX volatility that swamps fixed income asset-class volatility? But equities are more volatile, so investors tend to rationalize that they can withstand a few extra percentage points of annualized volatility because perhaps they believe currency can be a "diversifier." We challenged this assumption. Instead, we championed the view that developed world currencies offer "uncompensated risk"—or higher expected risk for zero gains in expected returns for U.S. investors. Sometimes currency helps; sometimes currency hurts. It may wash out in the end, but if it adds to your volatility profile, why should U.S. investors assume that currency risk? We started offering the first currency-hedged ETFs in late 2009 and have continued to expand, offering a focus on Europe, Japan and multiple currency baskets from the developed world, including spaces such as international small caps with DLS. **Same Strategy but Different Currency Hedges** Almost 10 years after the original international small-cap ETF, we launched two more firsts and follow-ups to DLS to mitigate currency risk in two separate ways. • In 2015, we were the first firm to apply a full currency hedge to international small-cap ETFs, with a passive currency-hedged version of DLS, the WisdomTree International Hedged SmallCap Dividend Fund (HDLS). This is a version of DLS that allows investors to focus on the stock market risk and diversification offered by international small-cap equities. Note that even some of the biggest critics of currency hedging have suggested hedging currency risk for companies that have more local revenue bases. The argument was that currency volatility is more impactful for companies with a local revenue base that do not see gains in revenue from a weaker currency. International small-cap companies tend to fit this more local revenue stream base very well. • In early January 2016, WisdomTree launched a set of Funds that incorporate a dynamic element to the management of currency risk. This dynamic version of DLS is the WisdomTree Dynamic Currency Hedged International SmallCap Equity Fund (DDLS). Status quo bias is hard to overcome, and investors have largely kept unhedged exposures—except in cases such as Europe and Japan where they have largely been expressing specific views on the euro and yen. But I encourage investors to rethink their framework and question why they want to bet "that" a broad basket of foreign currencies in unhedged strategies will *forever and always* appreciate against the U.S. dollar. **Looking Forward: A Factor Approach to Dynamically Adjust Hedges** It is clear that over last five years, hedging currency risk would have improved the returns of international equities. But how can investors proactively determine whether they want that currency risk looking forward? Our dynamic strategies incorporate the most important factors and determinants of exchange rate movements. Those three factors are interest rate differentials, momentum and value. You may have heard the phrase "value and momentum everywhere." In our view, those two factors help explain currency moves. Our Index process, developed in conjunction with Record Currency Management, added interest rate differentials (or carry) to value and momentum, as interest rates are also known to drive currency gains. At the very least, by not hedging currencies that can be expensive to hedge because of a high carry cost (as is now the case in Australia), you can potentially turn the cost of hedging from paying carry to your favor by hedging only when you are paid to do so (as you are today in the euro, yen and Swiss franc, through positive interest rate differentials). In a future blog post on this topic, I will review the performance of the fully hedged and dynamically hedged international small-cap ETFs. Read more on how dynamic hedging has been working in the large-cap part of the market. ***Unless otherwise noted, data source is Bloomberg.***

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DEFINITIONS

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Dividend weighted : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

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

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

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

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

Dynamic Hedge : Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of time.

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

Momentum Factor : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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