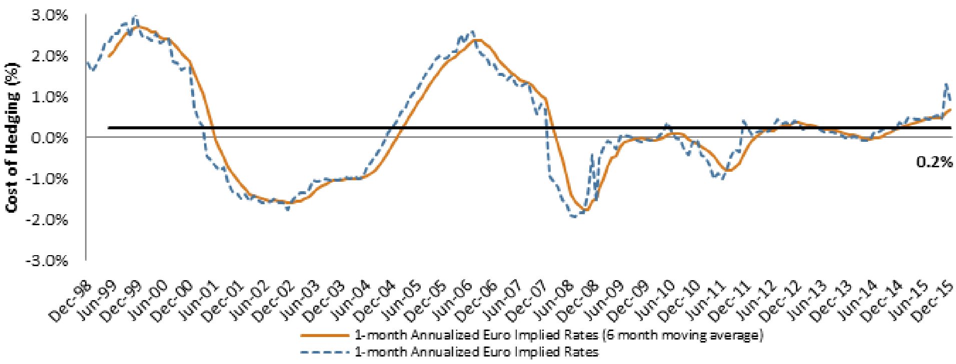
GETTING PAID TO HEDGE

Jeremy Schwartz — Global Chief Investment Officer
01/21/2016

Last year, one of the most important investment themes was currency hedging, particularly for euro-denominated stocks. Many investors believed the euro was going to weaken on the back of quantitative easing by the European Central Bank (ECB)—and that's exactly what happened. Versus the U.S. dollar, the euro started 2015 at 1.21 and closed the year at 1.09. With such a big move, many investors are wondering if they missed the boat. From our perspective, to the contrary. The case to hedge the euro has gotten stronger by one very important measure: how much you are now being paid to hedge. An important element of currency-hedged strategies involves the use of forward contracts to neutralize currency exposure. The pricing of these forward contracts is based on relative interest rate differentials. In some countries like Brazil, short-term interest rates are very high, so it can cost U.S. investors upward of 14% per year to hedge exposure to currencies like the Brazilian real. That creates an incredibly high hurdle for how much the currency has to decline before an investor breaks even on paying that hedge cost. But the actions the ECB took in December 2015 make hedging the euro different. The ECB took its deposit rate more negative—cutting rates to -30 basis points (bps). The U.S. Federal Reserve (Fed) hiked interest rates for the first time in nine years and now has a band on its short-term rate of 25–50 bps; the midpoint of the range would be 37.5 bps. This means currency hedging is not only inexpensive—investors are actually getting paid to hedge the euro. And if/when the Fed increases rates in 2016, that "payment" will increase further.

Historical Cost of Hedging the Euro (1-Month Currency Forward Implied Rates as of 12/31/15)



Source: Bloomberg. Past performance is not indicative of future results.

From a tactical perspective, when we look at what factors can help improve the returns from a purely passive hedging standpoint, interest rate differentials are the most powerful long-run signal. Given that an investor is starting to get paid more than 50 basis points a year from the differential in interest rates, this offers a boost to returns to hedged strategies over unhedged strategies, even if the euro does not move. Of course, if the euro appreciates, the hedged strategies will not participate in those gains, but they will be hedged against further losses in the euro if those were to occur. WisdomTree has three exchange-traded fund (ETF) options to target euro-area stocks with a currency hedge: 1) **WisdomTree Europe Hedged Equity ETF (HEDJ):** Provides access to the dividend-paying exporters of Europe, which can be positioned to benefit from a decline in the euro with their goods becoming more competitively priced in the global markets. We believe these companies have not fully benefited from the fall in the euro yet, as many of them also have large amounts of business coming from the emerging markets, which have also been weak in the last year. This is our flagship ETF for euro-area-hedging strategies. 2) **WisdomTree Europe Hedged SmallCap Equity ETF (EUSC):** Provides access to small-cap companies of the euro area and offers exposure to a more local side of European stocks. This fund can pair nicely with the large-cap multinationals to diversify size exposure and geographic revenue mixes of the companies. 3) **WisdomTree Dynamic Currency Hedged Europe Equity ETF (DDEZ):** Provides access to a broad cross-section of dividend payers from the euro area and implies a dynamic currency hedge. For investors who do not want to rotate between hedged and unhedged strategies, but want to have some currency exposure when the environment is supportive of it, this fund can adapt and provide that type of tactical hedging solution.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. These Funds focus their investments in Europe; the impact of events and developments associated with the region can adversely affect performance.

The securities of small-capitalization companies generally trade in lower volumes and are subject to greater and more unpredictable price changes than larger-capitalization stocks or the stock market as a whole. The Funds use various strategies to attempt to minimize the impact of changes in the value of the euro against the U.S. dollar, and these strategies may not be successful.

DDEZ invests 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. 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.

Due to the investment strategy of these Funds, they may make higher capital gain distributions than other ETFs. Please read each Fund's prospectus for specific details regarding each Fund's risk profile.

Diversification does not eliminate the risk of experiencing investment loss.

Dividends are not guaranteed, and a company's future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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

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.

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

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

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

Basis point : 1/100th of 1 percent.

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

1-Month Currency Forward : A binding one month contract in the foreign exchange market that locks in the exchange rate for the purchase or sale of a currency on the following one month.

Implied interest rate : The annualized interest rate implied by forward currency contracts relative to spot rates.

Dividend : A portion of corporate profits paid out to shareholders.

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.