ONE WAY TO MANAGE RISK INTERNATIONALLY: HEDGE EURO RISK

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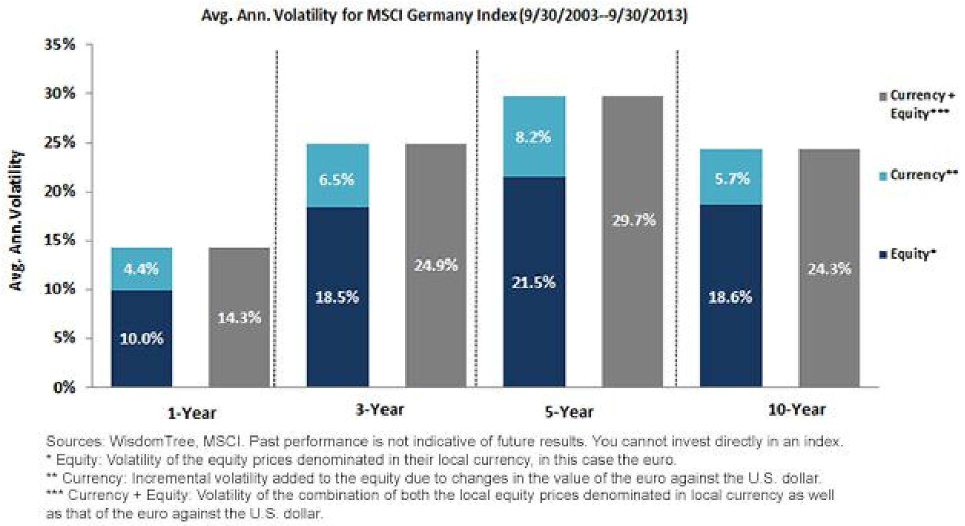
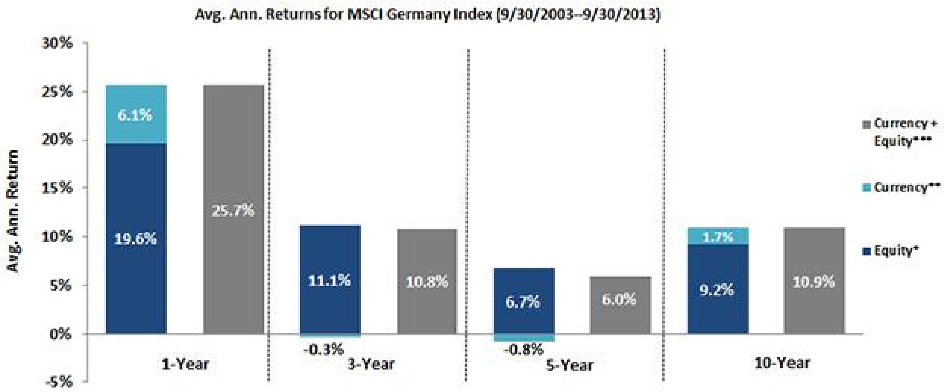
Germany has been a key driver of European growth and has proven to be a resilient force throughout the crisis. With (i) the eurozone exiting recession in the second quarter of this year, and (ii) developed market growth now charting an upward trajectory, Germany's export channel looks well positioned. In a previous blog post on the declining correlation between German equities and its currency, the euro, we made the case for investors seeking exposure to Germany to hedge out the currency exposure. Furthermore, even in the absence of a strong negative correlation, we note below how hedging out currency exposure can lead to lower volatility in an investor's total returns profile, as it has historically. **Hedging Out the Euro Can Reduce Overall Volatility** When an unhedged investment is made in foreign securities, the investor is not only taking on the equity exposure but also the currency risk. This can potentially increase the overall volatility of the investment. Over the past 10 years, the difference in volatility has been considerable. Consider how much additional risk has come from the euro currency itself over recent years based on the volatility of the MSCI Germany Index[1]: + 4.4% over 1 year + 6.5% per year over 3 years + 8.2% per year over 5 years + 5.7% per year over 10 years These statistics show that over one-quarter of the volatility of German equities for U.S. investors would have come from the euro itself. Is that extra risk compensated with expectations of higher returns for the euro going forward?



Despite adding significantly to the volatility picture, historically, the euro's returns have hardly compensated the investor for the additional volatility. The euro returned[2]: + 6.1% over 1 year - 0.3% per year over 3 years - 0.8% per year over 5 years + 1.7% per year over 10 years The decline in return over the five years more than wiped out any equity gains over that period.



Sources: WisdomTree, MSCI. Past performance is not indicative of future results. You cannot invest directly in an index.
* Equity: Returns of the equity prices denominated in their local currency, in this case the euro.
** Currency: Incremental returns added to the equity due to changes in the value of the euro against the U.S. dollar.
*** Currency + Equity: Returns of the combination of both the local equity prices denominated in local currency as well as those of the euro against the U.S. dollar.

We make the case for hedging out euro exposure in order to potentially reduce overall volatility and mitigate the risk of hurting the overall return profile through potentially adverse currency movements. **Conclusion** While we made the case here with respect to Germany, we also could broaden the argument with respect to the Eurozone at large. WisdomTree believes there is an increased need to consider hedging currency risks when it comes to international investing. WisdomTree has thus created a series of hedged equity Indexes that include one for the broader European markets as well as for some of the largest countries in Europe, such as Germany and the United Kingdom. [1]Sources: WisdomTree, MSCI. [2]Sources: WisdomTree, MSCI, Bloomberg.

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DEFINITIONS

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

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.

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.

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

MSCI Germany Index : Index weighted by float-adjusted market capitalization designed to measure the performance of the German equity market.