

# HOW TO BE A CONTRARIAN WHILE MANAGING CURRENCY RISK

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What has been one of the most important drivers of the negative total return within emerging market (EM) investment strategies in 2015? The answer: currency. For the first three quarters of 2015, emerging market currencies have depreciated compared to the U.S. dollar—some much more significantly than others. At the worst end of the spectrum, the Brazilian real lost approximately one-third of its value measured against the U.S. dollar, and on the other end of the spectrum, the Chinese yuan—a currency often remarked upon for the lack of a market-determined exchange rate—even lost a few percentage points of its value against the dollar.<sup>1</sup> **Why Not Currency Hedge?** The answer is simple: Because it's expensive. The cost to hedge emerging market currencies is quite high because these economies have much higher short-term interest rates than the U.S., with the Federal Funds Rate still targeting a range of 0% to 0.25%.<sup>2</sup> Taking the Brazil example: Using one-month forward contracts to initiate a hedge of the Brazilian real versus the U.S. dollar, there is a 13% difference in short-term interest rates between Brazil and the United States, and that is the cost to hedge the real versus the U.S. dollar.<sup>3</sup> **Being Contrarian while Managing the Currency Risk: Emerging Market Corporate Bonds Issued in U.S. Dollars** One of the notable contrarian investments today would be emerging markets, as performance has been challenged. But there is good news: Not all EM investments have as much currency risk. While the emerging market sovereign bond market is moving more and more toward debt issued in local currency, thereby better matching government revenues with government liabilities, the large majority of emerging market corporates issue debt denominated in U.S. dollars. This means that an investor can gain exposure to emerging market corporate credit without needing to have exposure to the performance of emerging market currencies against the U.S. dollar. Note, unlike many of the sovereign countries that issue their debt in U.S. dollars and earn revenue solely in their local currencies—leading to a different and often hidden currency risk due to the debt being owed to lenders in U.S. dollars—many emerging market corporations, especially commodity-centric ones, also earn their revenue in U.S. dollars. These emerging market corporations therefore have a better asset and liability matching than the countries issuing debt in U.S. dollars. WisdomTree has partnered with Western Asset Management Company in just such a strategy—the WisdomTree Emerging Markets Corporate Bond Fund (EMCB)—since March 2012. Given that currency has been a major headwind in emerging markets during the first three quarters of 2015, we show how EMCB performed compared to other emerging market assets, knowing that it avoided the currency impact. We also looked at the third quarter of 2015 performance, as this quarter was marked by significant volatility.

**Average Annual Returns as of September 30, 2015**

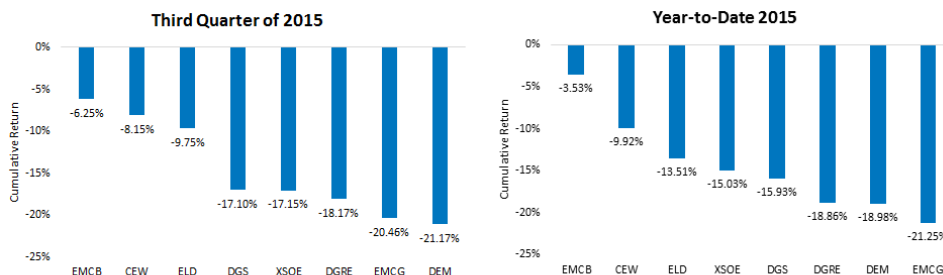
Average Annual Returns as of 9/30/2015		Fund Information		Total Return (NAV)					Market Price				
Fund	Ticker	Expense Ratio	Inception Date	YTD	1-Year	3-Year	5-Year	Since Fund Inception	YTD	1-Year	3-Year	5-Year	Since Fund Inception
WisdomTree Emerging Markets Local Debt Fund	ELD	0.55%	8/9/2010	-13.51%	-18.32%	-8.85%	-3.86%	-2.92%	-13.27%	-18.29%	-8.95%	-3.99%	-3.09%
WisdomTree Emerging Currency Strategy Fund	CEW	0.55%	5/6/2009	-9.92%	-14.86%	-6.91%	-4.33%	-1.19%	-10.05%	-14.98%	-6.94%	-4.39%	-1.38%
WisdomTree Emerging Markets Corporate Bond Fund	EMCB	0.60%	3/8/2012	-3.53%	-7.30%	-0.45%	N/A	1.62%	-3.95%	-8.30%	-0.83%	N/A	1.38%
WisdomTree Emerging Markets High Dividend Fund	DEM	0.63%	7/13/2007	-18.98%	-27.06%	-10.89%	-5.68%	-0.87%	-17.62%	-26.47%	-10.76%	-5.77%	-1.18%
WisdomTree Emerging Markets SmallCap Dividend Fund	DGS	0.63%	10/30/2007	-15.93%	-20.80%	-5.22%	-3.38%	-1.16%	-15.26%	-20.43%	-5.17%	-3.55%	-1.17%
WisdomTree Emerging Markets Quality Dividend Growth Fund	DGRE	0.63%	8/1/2013	-18.86%	-22.56%	N/A	N/A	-9.54%	-18.27%	-22.26%	N/A	N/A	-9.95%
WisdomTree Emerging Markets Consumer Growth Fund	EMCG	0.63%	9/27/2013	-21.25%	-21.20%	N/A	N/A	-9.92%	-20.76%	-20.97%	N/A	N/A	-10.06%
WisdomTree Emerging Markets ex-State-Owned Enterprises Fund	XSOE	0.58%	12/10/2014	-15.03%	N/A	N/A	N/A	-15.58%	-15.17%	N/A	N/A	N/A	-15.13%

Source: WisdomTree.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at [www.wisdomtree.com](http://www.wisdomtree.com).

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

over Year-to-Date & the Third Quarter of EMCB Outperformers of 2015



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

#### • EMCB as Least Negative:

While neutralizing the currency headwind to returns did improve the picture, it was still not quite enough for a positive return. However, this shows just how important it is to think carefully about different emerging market options. We think that pairing an investment vehicle like EMCB with other emerging market investments that may have currency exposure could offer an interesting strategy.

• **CEW Provides a Diversified Metric for Emerging Market Currency Performance:** CEW represents a basket of 15 emerging market currencies, all rebalanced back to an equally weighted 6.67% each quarter. Its performance, at least in part, provides an interesting window into how emerging market currencies, broadly, are faring against the U.S. dollar. The one caveat to this is that, as of September 30, 2015, [embedded income yield](#) of these positions was in the neighborhood of 5.5%, and this would provide a cushion to any decline in the spot prices of the represented currencies against the U.S. dollar. (See current standardized yield information for CEW). [XSOE](#), [DGS](#), [DGRE](#), [DEM](#) and [EMCG](#)—exchange-traded funds designed to track the performance of equity indexes<sup>4</sup>—do not have exposure to this cushion. It's also worth noting that it is precisely this cushion that makes hedging these currencies with forward contracts more expensive.

**Implementing an Emerging Market Strategy in the Fourth Quarter of 2015** While we believe that emerging market asset classes may be getting to a point where the negative performance and present [valuations](#) may appropriately reflect the inherent risks, it still does not make allocating there easy—especially with things like the U.S. [Federal Reserve](#) interest rate decision, China's economic growth picture and a commodity price recovery all being open questions. Investors often use bonds in the U.S. to mitigate the volatility of equities. This strategy could work very well for those who want to increase their exposure to the emerging market asset class. <sup>1</sup>Source: Bloomberg, for period 12/31/14–9/30/15. <sup>2</sup>Source: Bloomberg, as of 9/30/15.

<sup>3</sup>Source: Bloomberg, as of 9/30/15. <sup>4</sup>Specifically, XSOE tracks the [WisdomTree Emerging Markets ex-State-Owned Enterprises Index](#); DGS tracks the [WisdomTree Emerging Markets SmallCap Dividend Index](#); DGRE tracks the [WisdomTree Emerging Markets Quality Dividend Growth Index](#); DEM tracks the [WisdomTree Emerging Markets High Dividend Index](#); and EMCG tracks the [WisdomTree Emerging Markets Consumer Growth Index](#).

#### Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing on a single sector, region and/or smaller companies generally experience greater price volatility. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. 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. Certain Funds may invest in the securities included in, or representative of, their Indexes, regardless of their investment merit, and those Funds do not attempt to outperform their Indexes or take defensive positions in declining markets.

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Investments in commodities may be affected by overall market movements, changes in interest rates and other factors such as weather, disease, embargoes and international economic and political developments. Hedging can help returns

when a foreign currency depreciates against the U.S. dollar, but can hurt when the foreign currency appreciates against the U.S. dollar.

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

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You cannot invest directly in an index.

## DEFINITIONS

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

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

**Federal Funds Rate** : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

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

**Contrarian** : Practice of seeing what the majority of market participants are focused on and attempting to look in the complete opposite direction.

**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.

**Corporate Bonds** : a debt security issued by a corporation.

**Sovereign** : A national government.

**Government Revenues** : refers to the money received by a government from sources such as taxes, government owned corporations or central banks.

**Government Liabilities** : refers to government debt obligations.

**Corporate Credit** : compensation associated with the risk of lending to a corporation.

**Volatility** : A measure of the dispersion of actual returns around a particular average level.&nbsp;nbsp;.

**Embedded Income Yield** : Represents the annualized rate of return generated by a fund’s investments in both fixed income securities and derivatives exclusive of interest rate changes and movement in foreign exchange spot rates. The calculation is intended to capture the Fund’s potential to earn income return over the following year given current holdings and market conditions. The embedded income yield will differ from the portfolio’s yield to maturity, due to the incorporation of derivatives in the embedded income yield. Embedded income yield and portfolio yield to maturity may differ from a Funds actual distribution and SEC yield and do not reflect Fund expenses.

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