

# THE LATEST DYNAMIC FX HEDGED ETF: AN INTERNATIONAL QUALITY STRATEGY

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11/03/2016

Among the investment factors gaining traction in recent years has been the [quality](#) factor. We often refer to our quality Indexes as an implementation of a Warren Buffett-lite and -like screening process. A passage in Buffett's latest annual letter reveals how he thinks about attractive investment options. A key feature of companies that make good acquisition candidates for Berkshire Hathaway are "businesses earning good [return on equity \(ROE\)](#) while employing little or no debt."

WisdomTree offers a series of U.S., international and emerging market Indexes—our [Quality Dividend Growth family](#)—that employ this "Buffett factor" of return on equity and [return on assets \(ROA\)](#) as a driving force for stock selection. The reason we included ROA in powering stock selection is that it penalizes the use of debt ([leverage](#)) in delivering ROE; therefore, the resulting list of companies that qualify for our Indexes also tend to employ little debt.

While Buffett will always be a master stock picker, he also has advocated [index investing](#) for both his legacy asset base and as a generally sound philosophy for individual investors.

## Time to Look Abroad?

After a decade of U.S. equity market outperformance, [it may be time for the developed world to outperform](#) over the next decade. Once an investor decides to allocate more weight to international stocks, there are a number of important follow-up questions on implementation: Should one invest by region? Tilt weight to various size segments? Take foreign currency [risk](#)?

## Emphasizing Quality Leads to Unique Exposures

We believe the emphasis on quality measures is a critical distinguishing factor for the [WisdomTree International Quality Dividend Growth Index](#) that enables us to identify and avoid companies that are using excessive leverage to achieve their return on equity. This results in having an under-weight to Financials. Conversely, Consumer Staples and Consumer Discretionary receive greater over-weights, as they typically have higher return-on-equity and return-on-assets metrics.

## Dealing with Uncompensated Currency Risk

Since 2009, WisdomTree has focused on a critical topic related to developed international equities: the uncompensated risk of currency. Over long periods, foreign currencies have moved in broad, sweeping trends compared to the U.S. dollar—sometimes adding to and other times detracting from [unhedged](#) international equity returns.

The typical experience has been one of increased risk with only a small chance of incrementally enhancing returns.

WisdomTree launched the full currency-hedged version of its international quality strategy first in an exchange-traded fund (ETF) format in 2014.

This ETF, the [WisdomTree International Hedged Quality Dividend Growth Fund \(IHDG\)](#), now has a 2.5-year track record. Since its inception, it has beaten 97% of its international peers. Click here for standardized performance of [IHDG](#).

Fund/Index	Morningstar Category	Percent of Peers Beaten as of 9/30/2016		
		1-Year	2-Year	Since Fund Inception (5/7/14)
WisdomTree International Hedged Quality Dividend Growth Fund	Foreign Large Growth	62%	97%	97%
Number of Peers		368	352	352

Sources: WisdomTree, Morningstar, as of 9/30/16. Past performance is not indicative of future results.

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**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.

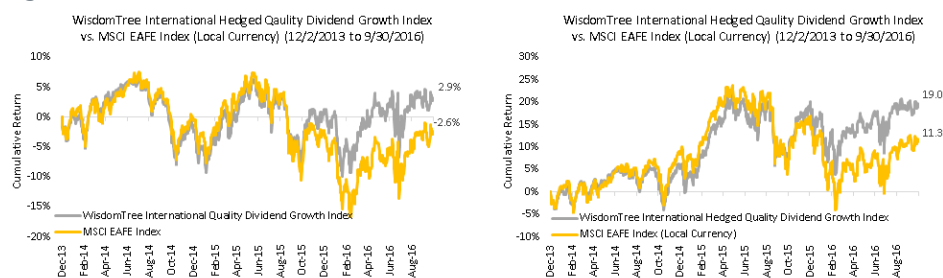
## Value Added from Quality Approach

Part of the value add of this Fund was driven by the stock selection, and part of it was driven by the [currency hedge](#), which the vast majority of international mutual funds still do not incorporate systematically.

Pushing the innovation envelope further, WisdomTree now has an unhedged option and a fully hedged option, in addition to its latest launch of the [WisdomTree Dynamic Currency Hedged International Quality Dividend Growth Fund \(DHDG\)](#), which incorporates a [dynamic currency-hedged](#) approach on top of the equity exposure. We'll get into the motivations for the dynamic hedge below, but first a breakdown of equity performance unhedged and fully hedged.

Figure 2 indicates the cumulative performance for those unhedged and fully hedged Indexes.

**Figure 2: What Has the Performance Picture Shown?**



Sources: WisdomTree, Bloomberg, with data as of 9/30/16 from respective Index inception dates, in both cases, 12/2/13. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. Past performance is not indicative of future results.

For definitions of indexes in the chart, visit our [glossary](#).

## Why Dynamic Hedge?

While we can advocate strongly that passive hedging can help reduce volatility of a broad international equity strategy, a number of investors worry about lagging the older, unhedged funds when currencies such as the euro are appreciating in value. So one question we sought to answer is this: Could we lower [hedge ratio](#) and take on currency exposure when it is more attractive to do so?

WisdomTree partnered with Record Currency Management Ltd. (Record) to use its currency research and currency signals in order to dynamically hedge currency exposures. Record has been in the business of managing currency-hedging strategies and overlays since 1983, and throughout this period of more than 30 years, it has focused solely on the risk/reward trade-offs in the currency markets.

A first step to developing a currency model is to carefully specify the signals that will be used. Adjustments to WisdomTree's currency hedge and how much to hedge are the result of a rules-based, well-researched and codified process developed in conjunction with Record.

At the October hedge [rebalance](#), the WisdomTree Dynamic Currency Hedged International Quality Dividend Growth

Index had an approximate hedge ratio for the combined currency exposures of more than 70%. Some of the individual hedge ratios are the euro (83.3%), the British pound (83.3%) and the yen (50%). More information on [how these signals are determined can be found here](#).

WisdomTree now has five ETFs that incorporate this dynamic hedging process, and as discussed here, dynamic hedging has added value over both traditional unhedged and fully hedged strategies in the live start in 2016.

WisdomTree anticipates that a growing number of investors will determine that they are taking too much unnecessary currency risk in their unhedged international equity strategies and increasingly will begin to adopt either full static hedged or dynamically hedged strategies.

#### 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. The Fund 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. Derivatives used by the Fund may not perform as intended. A Fund that has exposure to one or more sectors may be more vulnerable to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed and a company currently paying dividends may cease paying dividends at any time. The composition of the Index underlying the Fund is heavily dependent on quantitative models and data from one or more third parties, and the Index may not perform as intended. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit, and the Fund does not attempt to outperform its Index or take defensive positions in declining markets. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

No WisdomTree Fund is sponsored, endorsed, sold or promoted by Record Currency Management ("Record"). Record has licensed certain rights to WisdomTree Investments, Inc., as the index provider to the applicable WisdomTree Funds, and Record is providing no investment advice to any WisdomTree Fund or its advisors. Record makes no representation or warranty, expressed or implied, to the owners of any WisdomTree Fund regarding any associated risks or the advisability of investing in any WisdomTree Fund.

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

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.

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You cannot invest directly in an index.

## DEFINITIONS

**Quality** : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

**Return on Equity (ROE)** : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

**Return on assets (ROA)** : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

**Leverage** : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

**Passive** : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

**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.

**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.

**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.

**Dynamic Hedge Ratio** : refers to the percent of currency risk that a strategy is seeking to mitigate at a particular point in time.

**Rebalance** : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.