HOW MUCH SHOULD YOU HEDGE CURRENCIES TODAY?

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Currency-hedged exchange-traded funds (ETFs) have been THE story in ETFs over the last three years as one of the leading categories for ETF flows. This has caused some critics to say the movement into currency-hedged ETFs is overdone. First and foremost, we think this assessment underestimates the investment thesis for strategic currency-hedged allocations. More on that below. Second, even based purely on flows, these would-be contrarians are missing the bigger picture. The flows toward currency-hedged ETFs have occurred in two of the smaller pieces of the asset allocation pie—Europe and Japan. When we look at Morningstar categorization for non-U.S. equities, Europe had approximately $88 billion in assets under management (AUM) as of November 2015, Japan had approximately $48 billion of AUM and the foreign large-cap category was approximately $1.3 trillion.[1] While we think Europe and Japan can become bigger categories over time as investors view them more favorably, broad international allocations are more common. In the dedicated European and Japanese category of investments, the adoption of currency hedging has been staggering. Currency-hedged ETFs, which were nonexistent six years ago, now represent as much as one-third of total European-focused AUM in the U.S. and 40% of total Japanese AUM—when including both mutual funds and ETFs.[2] Yet in the broad international category, the trend toward hedging, in our view, hasn't even started, with only 2% to 3% of the total $1.3 trillion in the category being strategically hedged. WisdomTree believes currency offers uncompensated risk and that most of the $1.3 trillion in assets is taking on more risk than necessary to deliver the returns of international equities. **Myths about Hedging** Many active managers propagate a generalization and myth that it is expensive to hedge currencies. We see interest rate differentials as the most important cost to hedge. For certain markets, such as Brazil, it could be expensive to hedge because short-term interest rates in Brazil are approximately 14%[3], and this creates a high hurdle for how much currency has to decline to break even from the hedge. **Being Paid More to Hedge** But in general, over the last 30 years, an investor was paid on average about 40 basis points (bps) per year to hedge developed world currency exposures[4]. In Japan over the last 30 years, an investor was paid on average almost 2.5% per year to hedge currency exposures simply from the interest rate differentials in the forward contracts.[5] With the U.S. Federal Reserve now raising its Federal Funds Rate and other central banks continuing to pursue stimulative policy, an investor is now being paid more to hedge foreign currencies in the short run, making hedging even more attractive from an interest rate perspective in 2016 and 2017 than it was in 2015, 2014 or 2013, when currency hedging first took off. This is a reason hedging is becoming *more attractive*. **Is It Too Late to Hedge the Euro and Yen?** We argue that currency hedging should serve as the baseline and that investors should add currency risk whenever they view it as less attractive to hedge (or more desirable to have the currency exposure). Investors can switch from hedged to unhedged exposures or blend such strategies together—but now there is a new solution through our dynamically hedged family. This index family solves the challenge of trying to time when currency hedging should be in place. WisdomTree Investments partnered with Record Currency Management to build an index family that incorporates Record's hedging signals into a dynamically hedged index.[6] Record has been evaluating currency risk and return trade-offs for more than 30 years, and research showed the most important hedging signals for developed world currencies are threefold: • **The Interest Rate:** If the implied interest rate in the United States is higher than that in the targeted currency, it is more attractive to hedge. This signal helps manage the cost to hedge when it is more expensive to do so (like in Australia today). • **Momentum:** Simply put, a downward trend in the targeted currency would signal to put on the hedge, whereas an upward or appreciating trend would signal to take it off. • **Value:** When the targeted currency is overvalued compared to "fair value," as determined by purchasing power parity (PPP), it is attractive to hedge, and when deeply undervalued, it is less attractive to hedge. Importantly, this is a long-run signal, and a wide band is used in applying this signal. **Monitoring the Hedge Ratios by Currency & by Signal**

Currency	Overlay Ratio Value Overlay Ratio	Momentum Overlay Ratio	Interest Rates Overlay Ratio	Signal Overlay Hedge Ratio
Australian Dollar	16.67%	33.33%	0.00%	50.00%
Swiss Franc	33.33%	33.33%	33.33%	100.00%
Danish Krone	16.67%	33.33%	33.33%	83.33%
Euro	16.67%	33.33%	33.33%	83.33%
British Pound	16.67%	33.33%	33.33%	83.33%
Japanese Yen	16.67%	0.00%	33.33%	50.00%
Norwegian Krone	16.67%	33.33%	0.00%	50.00%
New Zealand Dollar	16.67%	33.33%	0.00%	50.00%
Swedish Krona	16.67%	33.33%	33.33%	83.33%
WisdomTree Dynamic Currency Hedged International Equity Index*	16.73%	25.69%	27.32%	71.05%
WisdomTree Dynamic Currency Hedged International SmallCap Equity Index*	15.73%	21.83%	24.40%	64.57%

Source: WisdomTree, Record Currency Management, with data as of 12/29/15. You cannot invest directly in an index. *Reflects weighted average hedge ratio of currencies in the applicable index; each currency in the index will have the respective hedge ratio shown.

For definitions of terms in the chart, visit our glossary. The currency-hedge signals are determined on an individual currency basis, but in aggregate, for the developed world currency exposures in the WisdomTree Dynamic Currency Hedged International Equity Index the models suggest hedging 71.05%, and for the WisdomTree Dynamic Currency Hedged International SmallCap Equity Index they suggest hedging 64.57%. These models are by nature dynamic, and when it is more/less favorable to hedge, some of these hedge ratios will come up/down. While many investors think they missed the opportunity to switch to currency-hedged strategies, we reiterate that we believe the most important drivers of long-term currency movements suggest hedging a majority of your currency exposures today.

[1]Source: Morningstar Direct. Europe refers to the universe of U.S.- listed mutual funds and ETFs within the Europe Stock peer group. Japan refers to the universe of U.S.- listed mutual funds and ETFs within the Japan Stock peer group. Broad international refers to the universe of U.S.- listed mutual funds and ETFs within the Foreign Large Value, Foreign Large Blend and Foreign Large Growth peer groups. Data is as of 11/30/2015. [2]Source: Morningstar Direct. Same universes and as of date as the prior footnote.[3]Source: Bloomberg, with data as of 12/31/15. [4]Developed world currency exposures refer to those defined by the MSCI EAFE Index universe from 12/31/1988 to 9/30/2015. [5]Source for paragraph: Record Currency Management, with data from 12/31/1988 to 9/30/2015.[6]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.

Important Risks Related to this Article

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.

Investments focused in Japan or Europe increase the impact of events and developments associated with the regions, which can adversely affect performance.

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DEFINITIONS

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

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.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

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

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 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.

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.

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.

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

Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.