

# INTRODUCING DYNAMIC CURRENCY HEDGED EQUITIES

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Traditionally, venturing outside the United States has required two parts of an investment:

- The equities, frequently the primary interest
- The currencies, an additional layer that is typically not as essential to the investment thesis

WisdomTree believes there is a strong case to be made that [currency-hedged](#) solutions provide a more attractive strategic and baseline exposure for long-run portfolios. However, many investors are reluctant to switch to a fully hedged strategy for fear of getting the timing wrong and missing a period when currency exposure contributes to returns—even if using a fully hedged approach could result in lower [volatility](#) over the long run. And some investors also have concerns about their ability to decide when to rotate between hedged and unhedged strategies and so have either left that decision to their [active managers](#) or have defaulted to their status quo and retained currency exposure.

**Dynamic Hedging as Long-Run Core Allocation** WisdomTree created a solution to serve as a core, long-run international equity allocation that embeds a [dynamic currency-hedging](#) program that solves the challenge of trying to time the currency hedge. This dynamic hedging solution will combine WisdomTree equity strategies—some of which have nine years of real-time performance results—with a dynamic hedging program that seeks to hedge currencies when the environment is judged to be most suitable.

**Record Currency Management—An Experienced Partner** WisdomTree partnered with Record Currency Management (“Record”) to use its currency research and currency signals in order to dynamically hedge currency exposures within international equity indexes. We believe this represents an important evolution in currency-hedged strategies. As of September 30, 2015, Record managed \$53.3 billion in client currency exposures.<sup>1</sup> It 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.<sup>2</sup>

**The Three Signals That Best Capture Currency Trends** The 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. The three signals used:

- **The Momentum Signal:** 33.3% of the total [hedge ratio](#) is determined by relative price [momentum](#) of the foreign currency with reference to two [moving average](#) signals on the historically observed [spot rates](#) over 10 and 240 business-day periods. Simply put, a downward trend in the currency would signal to put on the hedge, whereas an upward or appreciating trend would signal to take it off.
- **The Interest Rate (Frequently Referred to as Carry):** 33.3% of the total hedge ratio is determined by measuring the difference in interest rates, as implied in one-month [foreign exchange \(FX\) forwards](#), between each currency and the U.S. dollar. If the [implied interest rate](#) in the United States is higher than that in the targeted currency, a further 33.33% hedge ratio is applied for this signal.
- **Value:** The final 33.3% of the total hedge ratio is determined by a value signal that references foreign currency spot exchange rates smoothed over 20 business days and a band of over-/undervaluation of 20% versus the latest [purchasing power parity \(PPP\)](#) as published by the [Organization for Economic Cooperation and Development \(OECD\)](#).<sup>3</sup> The signals are equally weighted at one-third each in terms of contribution to the overall index hedge ratio because it is very difficult to know which of the signals will have the greatest influence on a currency’s performance against the U.S. dollar from month to month.

**Analyzing the Historical Efficacy of the Signals across Developed International Currencies** To review how the dynamic hedge might have performed across international equities, we looked at a universe of developed market currency exposures and tested them to see just how much incremental value was added by 1) the application of the individual signals and 2) the application of the [Record Signal Overlay](#) over a period of nearly 30 years. Our baselines, compared to incremental value, are:

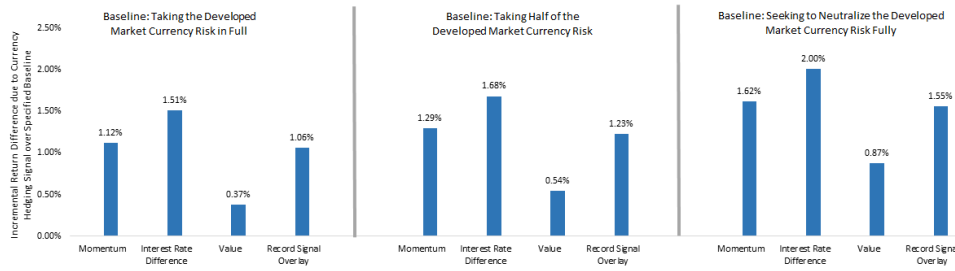
- A decision to take the full amount of currency [risk](#) (also known as an unhedged approach)
- A decision to hedge half of the currency risk (also known as a [50% hedged approach](#))
- A decision to neutralize all of the currency risk (also known as the [100% passively hedged approach](#) approach)

The results were quite interesting:

- **The Greatest Incremental Value Added:** The dynamic hedge added the greatest incremental value when compared to the 100% passively hedged exposure. This is because the dollar declined over this approximately 30-year period, so hedging passively was not helpful.
- **Incremental Value Added over Taking Currency Risk in Full:** The traditional thinking has stated that returns attributable to currency movements should basically “come out in the wash,” or in essence be flat. The dynamic hedge (Record Signal Overlay), however, was also able to

generate 1.06% per year in incremental added return when compared to the unhedged exposure over a period of nearly 30 years.

**Evaluating the Performance of the Signals Over Time** (MSCI EAFE Index currency exposures, 12/31/1988 to 9/30/2015)



Sources: WisdomTree, Record Currency Management.

WisdomTree has been a pioneer in three important categories of indexes and exchange-traded funds (ETFs): international equities, currency-hedged equities and global small-cap equities. *The [WisdomTree Dynamic Currency Hedged International Equity Fund \(DDWM\)](#) and the [WisdomTree Dynamic Currency Hedged International SmallCap Equity Fund \(DDL5\)](#) enable investors to access international equities with a dynamic currency hedge.* <sup>1</sup>Source: Record Currency Management, as of 9/30/15. <sup>2</sup>No WisdomTree Fund is sponsored, endorsed, sold or promoted by Record Currency Management. 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. <sup>3</sup>Refers to the most recently available statistical release.

**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 Funds invest 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 Funds 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. The composition of the respective Index underlying each Fund is heavily dependent on quantitative models and data from one or more third parties, and the Index may not perform as intended. 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. Please read each Fund’s prospectus for specific details regarding each Fund’s risk profile.

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

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

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

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

**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.

**Hedge Ratio** : The specified percentage of currency exposure being hedged, with 0% indicating that none of the currency exposure is being hedged and 100% indicating that all of the currency exposure is being hedged.

**Momentum Factor** : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

**Moving Average** : is a calculation to analyze data points by creating a series of averages of different subsets of the full data set.

**Spot price** : The current price at which a particular security can be bought or sold at a specified time and place.

**Carry** : The amount of return that accrues from investing in fixed income or currency forward contracts.

**Foreign Exchange (FOREX, FX)** : The exchange of one currency for another, or the conversion of one currency into another currency.

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

**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.

**Organization for Economic Cooperation and Development (OECD)** : the organization for economic co-operation and development aims to promote policies that will improve the economic and social well-being of people around the world.

**Record Signal Overlay** : The specific strategy of dynamic currency hedging that utilizes three signals, developed by WisdomTree and Record.

**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.

**50% Hedged Approach** : refers to a strategy that implements a static hedge ratio aiming to hedge half of the currency risk.

**100% Passively Hedged Approach** : Strategy designed to have the full currency exposure hedged, regardless of any changes in market conditions.

**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.