DYNAMIC CURRENCY HEDGING APPROACH GAINING TRACTION

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To hedge or not to hedge currency ("FX") exposure is no longer the question I ask investors; the question has shifted to *how* they should be FX hedging. WisdomTree launched a family of dynamic FX-hedged strategies this year, and the WisdomTree Dynamic Currency Hedged International Equity Fund (DDWM), a broad-based international dividend-weighted strategy, stands at $235 million in assets under management today.[1] Our expectation is that this dynamic hedged approach could solve key investor challenges and is poised to gain a bigger market share in international equity portfolios. **Revisiting the Case for Hedging** The long-term data clearly shows that currency exposure has increased the volatility of broad-based international equity portfolios over long periods, and it does so without adding to *expected* or forward-looking returns. Currency exposure may have added to backward-looking returns over some periods, but that does not mean foreign currencies will rise going forward. That is one reason WisdomTree believes currency exposure offers uncompensated risk in the long term. In our view, strategic hedging all the time is the most natural way to lower long-run volatility of international equity portfolios and neither benefit from currency exposure when foreign currencies are rising compared to the U.S. dollar nor suffer from currency exposure when foreign currencies are falling. But a new way to hedge currency exposure looks to add to expected returns of international equities by taking the hedges off when it appears less attractive and more costly to hedge foreign currency risk. WisdomTree, as the Index provider, collaborated with Record Currency Management to provide currency signals for the suite of four developed world Indexes that hedge currency risk dynamically, based on a three-factor, smart beta-like model for currency risk management. Those three factors are interest rate differentials, value and momentum, and the Indexes created covered developed world large and small caps, as well as Europe- and Japan-specific exposures. **Value Added of Dynamic Hedging** Our research leads us to believe that dynamic currency hedging can add anywhere from 100 basis points (bps) to 150 bps over fully hedged, half-hedged or unhedged strategies over long cycles. This is the expected return enhancement that could potentially be achieved through dynamically adjusting our FX hedge ratios. On the volatility-reduction side, static—in our view, passive—hedging is likely to receive the biggest volatility reduction compared to unhedged broad-based international strategies and can be 200–250 basis points per year over longer periods. But we believe dynamic FX hedging can capture more than three-quarters of the volatility reduction achieved by fully hedged FX.[2] This risk/return enhancement—for those who believe our factors will persist in driving currency movements over time—becomes an attractive value-added feature to international portfolios. **Exchange-Traded Funds (ETFs) Bring Transparent, Systematic Approach to Currency Risk Management** In the more than six years I have been discussing currency-hedged strategies with investors, the two most common objections to adopting a new currency-hedged mandate have been these: 1) "I leave it to my foreign equity managers to decide whether to hedge or not." 2) "I do not know how to time these FX hedges. I am likely to switch to your currency-hedged strategies at the exact wrong time." On the first question, I often point out that foreign equity teams may claim they do not hedge currency exposure because they are stock experts and not currency experts. They just default to the status quo and leave currency risk unhedged because that is how they are benchmarked. As a side note, this benchmarking question is an interesting one, as there are four versions of the MSCI EAFE Index (unhedged, fully hedged, local currency and now adaptive hedged). The choice of benchmarks dictates the status quo decision there, and the focus on equity risk to me appears to be more natural from a hedged standpoint rather than layering currencies on top. I believe that as investors look at their international equity fund returns over the recent three to five years, they will see that the active teams rarely hedge currency risk or rarely do so effectively. On the second question about timing FX hedges, there is a concern that many have already missed this latest U.S. dollar rally, and it is too late to switch to a hedged approach (although the pop higher in the euro and yen this year arguably mitigates that concern). From the perspective of the systematic, dynamic model the Indexes use, it currently suggests being 50% hedged on the euro, 50% hedged on the yen and 52.5% on broad international strategies for the Index tracked by a strategy such as DDWM. My sense is that investors still take on too much currency risk when they invest overseas. For those who do not want to make the timing decision themselves, there are now four WisdomTree ETFs that will help dynamically adjust currency-hedge ratios based on a data-driven, transparent process. One of these ETFs, DDWM, is a leading asset gatherer in dynamic FX-hedged investing, and we expect this approach to continue gaining acceptance, especially compared to unhedged strategies, over time. https://www.youtube.com/watch?v=r_ZlJTFQEvA&index=1&list=PLgiZliZDppqi3j0i3Jeg1HIHmFITb0Z26 [1]As of 5/5/16. [2]Sources: WisdomTree, Record Management, as of 3/31/16.

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DEFINITIONS

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.

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

Dividend weighted : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

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.

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

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

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

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Basis point : 1/100th of 1 percent.

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.

Adaptive Hedge : Using a rules-based strategy to hedge systematically.