ADDING RISK IN A ZERO-SUM GAME: A BAD IDEA

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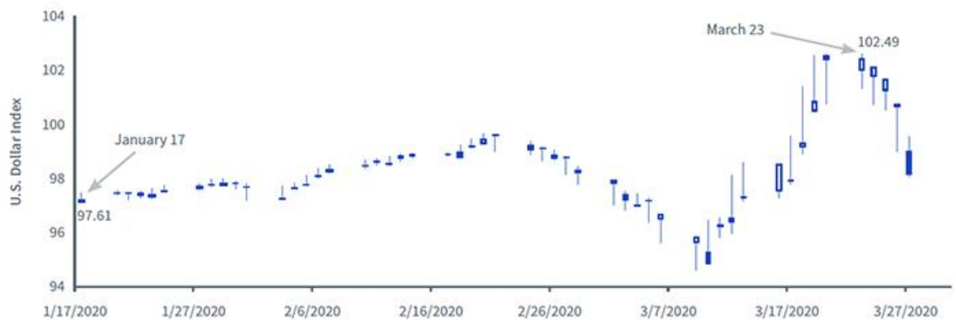
Many investors do not hedge currency in their foreign equity mandates. Their main rationales include a desire to conform to the status quo, a discomfort with hedging or belief in currencies' diversifying effect.

Investors should think twice if they are strongly embracing any of those three approaches.

Let's start with foreign exchange "diversification" during the COVID-19 crash, when the dollar surged during March 2020's fear (figure 1). It's like the old joke about "de-worsification"—owning foreign currencies backfired during that episode.

Figure 1: U.S. Dollar Index during COVID-19 Panic



Source: Thomson Reuters Refinitiv, 1/17/20–3/30/20. You cannot invest directly in an index.

That action explains how hedged-currency equity mandates tended to have more muted downside than the MSCI EAFE Index (MXEA), which rode the currencies as they oscillated. The WisdomTree International Hedged Quality Dividend Growth Fund (IHDG) provides an example (figure 2).

Figure 2: COVID-19 Crash Performance from MSCI EAFE's 1/17/20 Peak to Mid-Year 2020

Source: WisdomTree Digital Portfolio Developer, 1/17/20–6/30/20. You cannot invest directly in an index. **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.** 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. 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.

Standardized performance for IHDG is available here.

During the COVID-19 crash, it was simple:

Crisis "On" = Stocks ↓ USD ↑

Crisis "Off" = Stocks ↑ USD ↓

Challenging Preconceived Notions

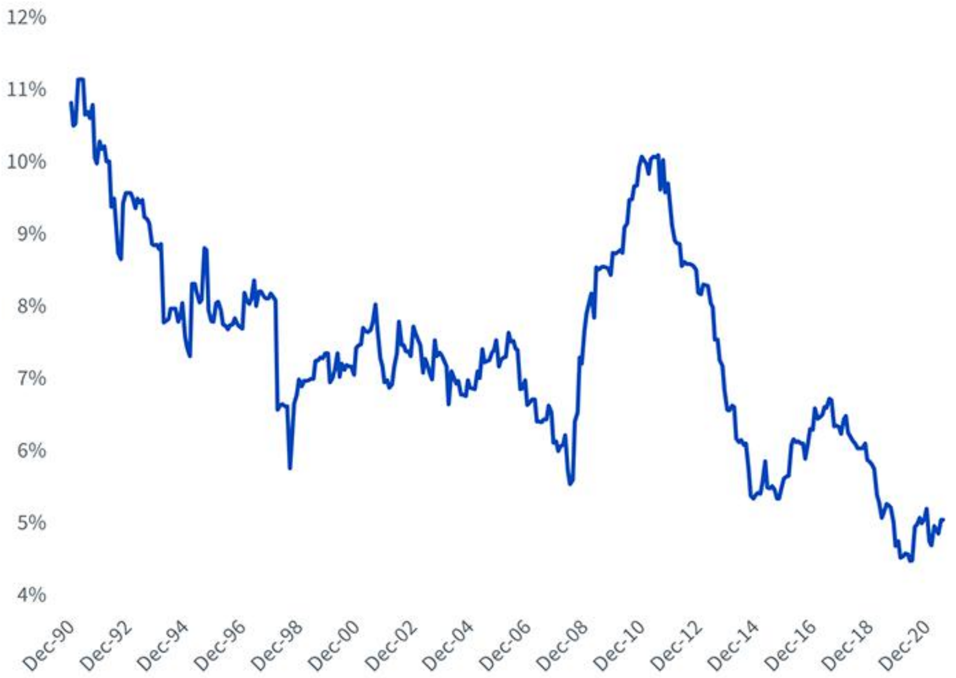
There are three common theories:

1. Having foreign currency exposure helps mitigate portfolio risk
2. Hedging currency is expensive, regardless of reality
3. The U.S. dollar (USD) will weaken

The first theory we disagree with, the second is wrong and the third is a weak argument unless the investor is table-bangingly bearish USD.

Before we get into it, look at figure 3 to fully appreciate this market's sleepy persona—for now (figure 3).

Figure 3: 3-Year Currency Volatility, MSCI EAFE Countries



Source: Thomson Reuters Refinitiv, as of 7/31/21. You cannot invest directly in an index.

Addressing Theory #1: Is Having Foreign Currency Exposure Useful?

Since the MSCI EAFE Index launch in 1989, the cumulative annual gain from its component currencies has been just 0.1%. But that stability over 30+ years masks several bouts of intense action. MSCI EAFE component currencies witnessed annualized standard deviation of 7.5% in that time.

For what? For basically no reward. Sure, there were sometimes diversification benefits, but the 14.7% annualized standard deviation of stocks in their local markets ends up rising to 16.8% when tracked with currency layered on top (figure 4).

Figure 4: Currency Effect on MSCI EAFE Risk/Return

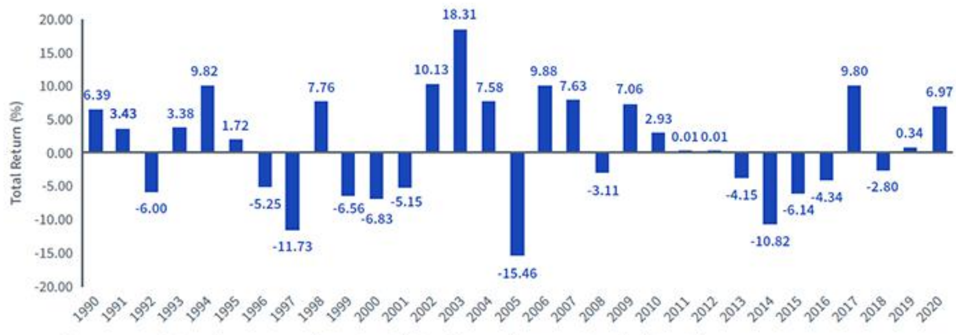
	Average Annual Returns			Average Volatility			
	MSCI EAFE (USD)	MSCI EAFE (Local)	MSCI EAFE FX	MSCI EAFE (USD)	MSCI EAFE (Local)	MSCI EAFE FX	S&P 500 (USD)
Includes FX Impact	Yes	No		Yes	No		
Since 1989	5.4%	5.3%	0.1%	16.8%	14.7%	7.5%	14.7%
Last 20-Years	6.4%	5.1%	1.2%	16.7%	14.3%	7.0%	14.9%
Last 10-years	6.6%	9.0%	-2.2%	15.0%	12.7%	5.9%	13.7%

Source: Thomson Reuters Refinitiv, as of 07/31/21. Past performance is not indicative of future results. You cannot invest directly in an index.

In the other "pain year"—2020—foreign currencies rallied 6.97%, but all of that came in the recovery months, not the panic period.

Looking at the rest of the time frames, the prospect of gains or losses in any given year is a coin toss. If foreign exchange is hedged, all the chart's bars collapse to zero. We think that means fewer sleepless nights.

Figure 5: MSCI EAFE Index Calendar Year Returns from Currency



Source: Thomson Reuters Refinitiv, as of 12/31/20. Past performance is not indicative of future results. You cannot invest directly in an index.

Addressing Theory #2: Hedging is Expensive

According to our Capital Markets team, bid/ask spread "slippage" from trade execution may cost investors in currency-hedged developed market equity funds just a basis point (bp) or two annually.

Also, currency hedging costs are directly tied to relative interest rates. Because so many other central banks pin overnight rates in negative territory while the federal funds rate is slightly above 0%, U.S. investors get paid to hedge.

Addressing Theory #3: Precipice of a Secular USD Bear Market

How about the investor that is steadfastly dollar bearish? Consider this: U.S. portfolios' heavy bias to domestic large caps may already reflect that view.

We estimate that U.S. multinationals earn nearly half their profits abroad. When the dollar rallies, earnings have historically taken a hit from the currency translation. When it weakens, earnings have risen.

That means hedging forex to dollars has often ended up giving much-needed help in investment returns during the tough times—when Wall Street is reporting disappointing financial results.

It's something to think about.

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You cannot invest directly in an index.

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.

U.S. Dollar Index (USDX) : A measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

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.

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.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

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

Standard deviation : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

Bid/Ask Spread : This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

Basis point : 1/100th of 1 percent.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

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