WHY WE JUST RAISED OUR EURO FX HEDGE RATIO DYNAMICALLY

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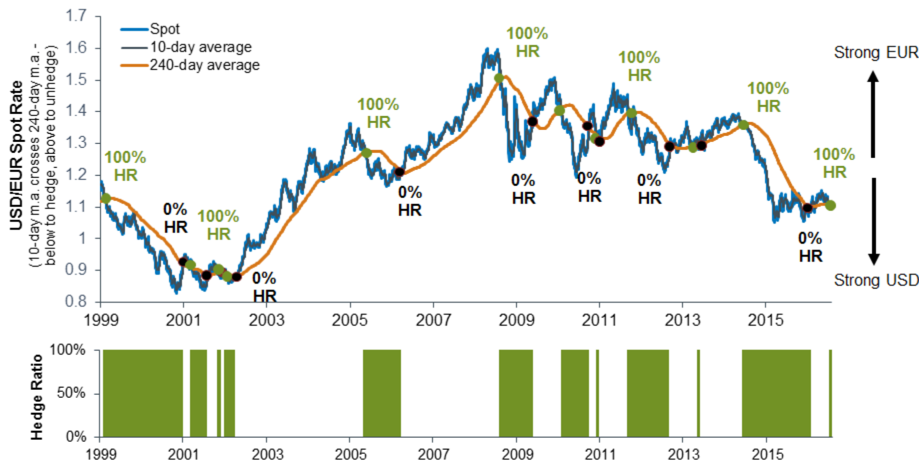
Many investors deride the trend toward currency hedging in international equities as a passing fad. Strong inflows over recent years—particularly in 2015 for European-focused funds—followed by significant outflow pressure in the first half of 2016 fuel those views. WisdomTree has maintained for seven years that most U.S. investors are unnecessarily taking on too much risk strategically when they invest internationally. Why such conviction? **Compensated vs. Uncompensated Risk: Stocks vs. Foreign Exchange (FX)** We believe investors should take risks that are *compensated*. There is a reason, in our view, to own equities over the long run. As Wharton professor Jeremy Siegel suggested in his best-selling book *Stocks for the Long Run*, investors must assume risk to earn the equity premium or risk premium that stocks tend to earn over "risk-free" assets. *Bullish the euro for the long run*? What is the case for the euro to appreciate against the dollar for the long run? I don't know, and, frankly, most investors don't either. Unless one has an outright bullish view on the euro, I often suggest that investors should hedge the euro strategically, for the long-run volatility reduction benefits and to not bet on the euro always and forever appreciating, as unhedged funds are banking on. Further, there is currently no real cost to hedging the euro. Investors are being paid meaningful interest rate differentials now that the European Central Bank (ECB) has cut interest rates to -40 basis points (bps) and the U.S. Federal Reserve (Fed) has a positive interest rate of close to 40 bps. This carry that investors earn for hedging the euro is added return from hedging—and a return that unhedged ETFs are missing— if the euro has no spot move. And the carry is likely to increase over the coming years, in our view. **Is the Timing Right to Switch?** Investors might understand that currency hedging for the euro could reduce volatility substantially. The volatility in the euro has been consistently 10% per year—why would one want to have that risk? But many fear they will get the timing wrong to switch to the euro-hedged option, even if hedging might be better for strategic allocations. To help investors make the tactical timing decision, WisdomTree developed an Index family that incorporates a systematic, dynamic hedge ratio that adjusts the currency hedges based on factors we see as increasing the probability of putting on profitable hedges and avoiding unprofitable hedges. Our broad dynamic hedged international strategy has seen early traction both from the performance basis and from the investor interest perspective. **The Model Output in July 2016 Says: Timing Is Right to Increase Hedges on the Euro** Our dynamic hedging model incorporates three signals: momentum factor, interest rate differentials and value. For the last five months, our hedge ratio for the euro stood at 50%. We arrived at this 50% hedge ratio in the following way. Our hedge ratio has three components, each of which contributes one-third to the total hedge ratio: • We're 33% hedged on the interest rate signal. As discussed earlier, there is a positive interest rate differential between the euro and the U.S. dollar. As such, our interest rate hedging signal has indicated to be hedged in order to allow investors to capitalize on this benefit. • Our value signal remained at half, accounting for 16.66% of the current hedge ratio. The hedge ratio goes to zero only when a currency is more than 20% undervalued versus its purchasing power parity, and while the euro may look inexpensive, it is not 20% inexpensive until it crosses below €1.04 to the U.S. dollar. • Momentum on the euro did not indicate to be hedged for the last five months, so the hedge ratio here was zero. As of July's month-end, the momentum crossed down and our hedge ratio came back on while the other two signals were unchanged. With the momentum model switching, our dynamic model increased our total hedge ratio from 50% to 83.3%. Tactically, this suggests the timing could be right for investors to reconsider switching European unhedged options toward a hedged approach. Below is a history illustrating when the momentum rule would have suggested hedging the euro since the euro was introduced. While momentum is the fastest moving of the signals—when do you anticipate the ECB will have a higher short-term interest rate than the Fed?—momentum signals or hedge ratio changes would have occurred 21 times since 2000, or just 1.3 times per year. However, these adjustments added meaningfully to the return. **U.S. Dollar/Euro Spot**



Source: WisdomTree, Record Currency Management, Thomson Reuters as of 7/27/16. Past performance is not indicative of future results.
HR = Hedge ratio.

Rate

The Added Value of Dynamic Signals Our research, conducted in conjunction with Record Currency Management, has shown that this dynamic model could add value compared to both hedged and unhedged approaches over the long run. We expect that the dynamic hedging model could add anywhere between 100 to 200 bps per year compared to unhedged or fully hedged options for the euro. The two strongest factors in our research were interest rates and momentum. These both now suggest that one should be hedged on the euro and that the hedge ratio just increased as of our latest signal for July's month-end. Just as smart beta and factor models are designed to add excess returns to the equity process, our dynamic hedging model is designed to increase returns by adding hedges when they are expected to be more profitable. **How to Incorporate Dynamic Hedging in Portfolios** The early investors' interest in dynamic hedging has come in our broad-based international strategy, the WisdomTree Dynamic Currency Hedged International Equity Fund (DDWM). We have argued this is the future of international equity investing, because investors often want to let their portfolio managers make the hedge/no-hedge decision. While it might be easier for investors to form a view on a single currency like the euro, we also see a case for having the dynamic euro-hedged strategy. The WisdomTree Dynamic Currency Hedged Europe Equity Fund (DDEZ) can help investors implement a dynamic hedge ratio for the euro area equity markets.

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

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

Equity premium : the excess return that investors may receive over the risk free rate as compensation for taking on the relatively higher risk associated with equit.

Risk premium : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

Bullish : a position that benefits when asset prices rise.

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.

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

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

Basis point : 1/100th of 1 percent.

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

Spot currency : The foreign exchange rate of a currency available for immediate delivery.

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

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.

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.

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.

Short-term rates : the rate of interest on a debt instrument maturing in two years or less.

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

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