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CUTTING VOLATILITY IN FOREIGN STOCKS
While Remaining 100% Invested: Hedge The Currency.

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If an asset class shoots up, then crashes down, all to end up right where it started, why own it?

Why take on volatility, only to find yourself back at Square One?

The U.S. dollar index does a lot of going up, a lot of going down, a lot of moving around with nothing to show for it. It's right back where it was in 1973. Unchanged. It's also sitting at the same level as in 1974. And 1978. And 1980, 1981, 1987, 1988, 1989, 1990, 1991, 1992, 1993, 1994, 1997, 1998, 2003, 2005, 2015, 2016, 2017, 2018 and 2020.

In other words, you own euros, you own yen, whatever it is, and some years you make money, some years you lose money. But it has wash out over the long run.

Why then do so many investors own developed economy stocks with full exposure to the vagaries of forex? Unless an investor has a strong opinion on the currency, that seems like a bad idea.

Figure 1: U.S. Dollar Index

Source: Thomson Reuters Eikon, 12/31/1971 – 9/7/2021. Past performance is not indicative of future results. You cannot invest directly in an index.

IT'S WHY WE HEDGE

After looking at hundreds of asset allocations across this industry over the years, we have seen many investors own foreign stocks with no hedge. They have plenty of rationales, but the main ones are a desire to go along with the status quo, a discomfort with hedging or belief in currencies' diversifying effect.

We strongly feel the status quo argument –that maintaining currency exposure because it is the common thing to do – is hardly a satisfactory explanation for following that path.

As for hedging being complex, we believe that simply is not true. ETFs can make this easy to execute in one package.

Finally, assertions that foreign currencies like the euro or the yen offer diversification benefits to US consumers who have liabilities in U.S. dollars are spotty at best.

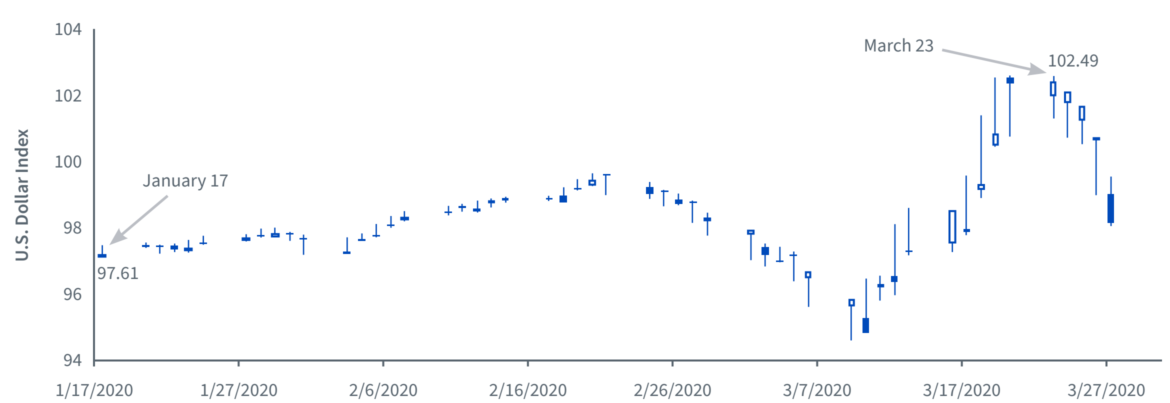
Think about what transpired in the 2020 Covid-19 crash. Those who hedged forex exposure to USD were fortunate to see less volatility, plus a mitigation of losses.

Consider what happened with British equities, which are the second-largest country exposure in the MSCI EAFE index of non-U.S. developed market stocks. Like most everything else, U.K. stocks fell out of bed amid 2020's lockdowns. To add insult to injury, so did sterling, and hard. GBP entered 2020 at $1.32, cratering to $1.15 by mid-March of that year. Those 17 cents of currency translation loss were given up at exactly the time that equity investors could least withstand extra pain.

In future panics, which assets can we reasonably expect investors to sell in tough times? While our brains immediately think of unsavory candidates like subprime mortgages or junk-rated bonds, how about something as simple as the euro? Market crashes often witness euro selling and dollar buying.

We believe dollar-denominated assets were exactly the place to seek cover when Covid took over the public's psyche in early 2020. The U.S. dollar index spiked several percentage points in the weeks leading up to March 23, the day the S&P 500 reached its crash low (Figure 2). Currencies like the euro and the Australian dollar were discarded in the panic.

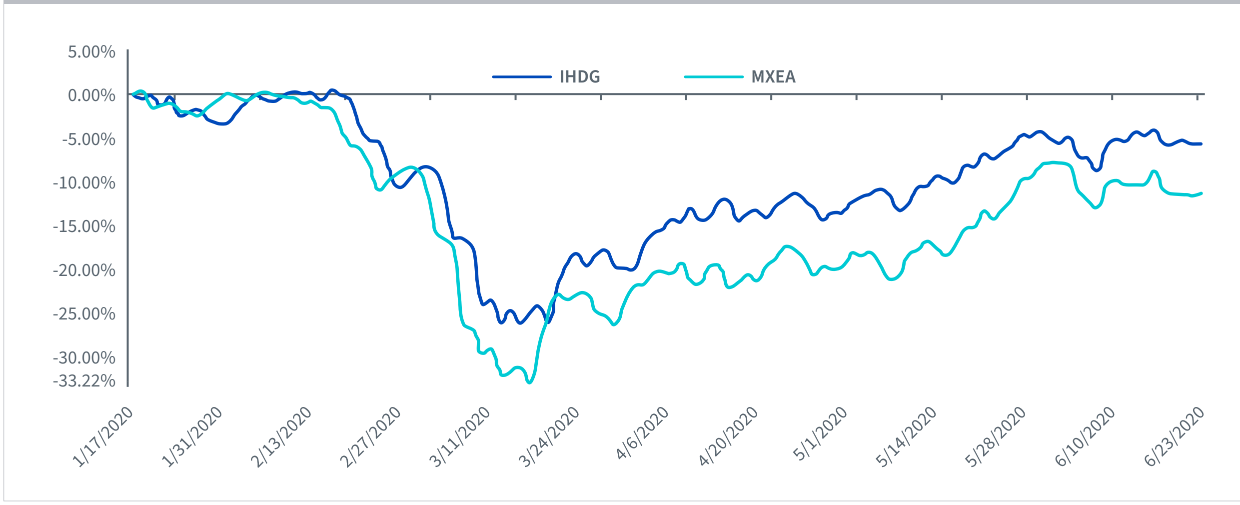
Figure 2: U.S. Dollar Index During Covid Panic



Source: Thomson Reuters Refinitiv, 1/17/2020 – 3/30/2020. Past performance is not indicative of future results. 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, which rode the currencies as they oscillated. IHDG, the WisdomTree International Hedged Quality Dividend Growth Index ETF, provides an example of having slowed down the rollercoaster (Figure 3).

Figure 3: Covid Crash Performance from MSCI EAFE's 1/17/2020 Peak to Mid-Year 2020



The Data is net of the fees for the fund. 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. Performance data for the most recent month-end is available above. You cannot Invest Directly in an Index. Short Term Performance may not be indicative of long-term results. For Standardized performance click here.

DURING THE COVID-19 CRASH, IT WAS A SIMPLE EQUATION:

Crisis "On" = Stocks ↓, USD ↑

Crisis "Off" = Stocks ↑, USD ↓

If the key to the long game is avoiding getting wiped out in panics, then the odds would seemingly favor hedging foreign currency exposure.

CHALLENGING PRECONCEIVED NOTIONS

There are three precepts that we come across:

1) A belief that, in most cases, having foreign currency exposure is helpful to portfolio risk
2) The notion that it is expensive to hedge currency risk, regardless of reality
3) A contention that the US dollar will weaken, owing to the trifecta of inflation, money supply expansion and government spending

The first precept we disagree with. We believe the second one is just wrong. And though we are sympathetic to the third one, it may not be enough of an argument to abstain from hedging forex in the absence of extremely strong conviction.

ATYPICALLY CALM

Start with the first precept, one that might be perpetuated by fading memories of the pain of the Lehman Brothers bankruptcy, the Covid crash and other former panics: the assertion that having developed market foreign currency exposure is helpful for risk management.

Currency markets have been relatively quiet since 2020, a situation that may be lulling some investors to sleep, causing them to forget acute risks that manifest at the worst possible time.

One measure of foreign currency volatility, the three-year annualized standard deviation, is at its lowest reading in 30 years (Figure 4). When no one is paying much attention to currency, perhaps that is exactly the time to sharpen a pencil.

Figure 4: 3-Year Currency Volatility, MSCI EAFE Countries

Source: Thomson Reuters Refinitiv, as of 7/31/2021.

ADDRESSING PRECEPT #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%. That makes complete sense if you consider that a zero-sum market like that of foreign currency should result in a rough wash between two parties over the course of long horizons.

But that stability in total price change over 30+ years masks several bouts of intense action. Despite essentially zero gains – or losses – the MSCI EAFE component currencies witnessed annualized standard deviation of 7.5% in that time.

For what? For basically no reward. Forex risk, borne for three decades, with nothing to show for it.

Sure, there are sometimes diversification benefits; you cannot just lop the entire 7.5% onto the equity risk number.

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-- and those two incremental points of volatility served only the purpose of creating headaches (Figure 5).

Figure 5: 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
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 9/30/2021. Past performance is not indicative of future results. You cannot invest directly in an index.

In the same table, focus now on the last 10 years. EAFE currencies declined 2.2% per year, which dragged down the return to unhedged international indexes. Then again, over 20 years it was flipped, with EAFE currencies rallying about 1.2% per year.

And some currencies do not have a reputation for declining in panics. To the contrary, both the Japanese yen and the Swiss franc have a knack for rallying in times of trouble. But those two are more of an exception than a rule – and they are far exceeded in portfolio weights by the collective weight of the other currencies.

Could it be that perhaps no one has a clue which currencies will "work" over the next 5, 10, 20 years? If that is the case, why guess if all that is received for the trouble is more volatility? Not only that, but if the Covid crash is any guide, much of that volatility hits in precisely those markets when you can least afford to bear it, in years like 2008, which saw the U.S. dollar run higher.

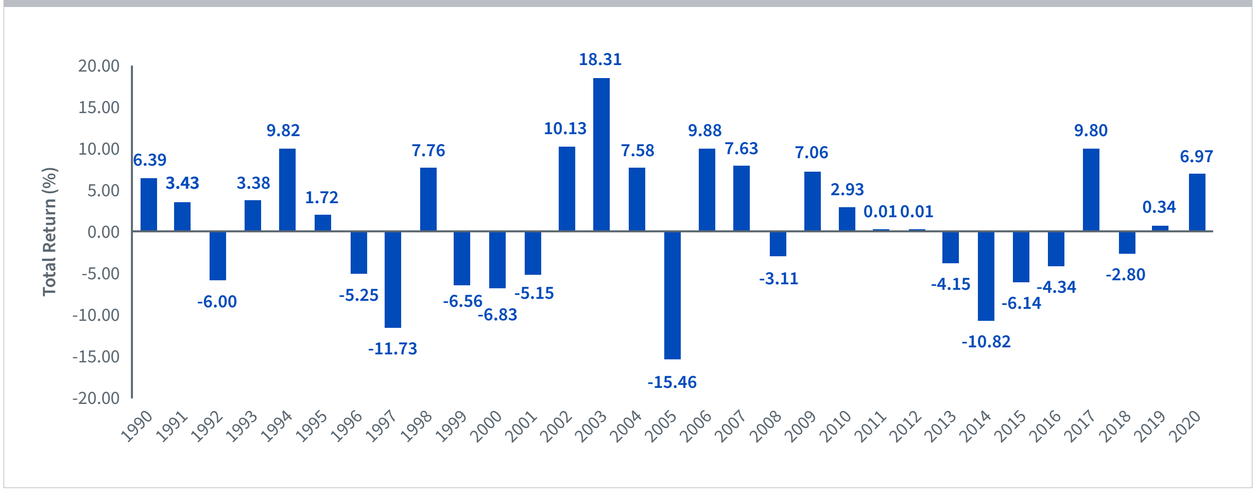
In the other "pain year" -- 2020 -- take note that foreign currencies rallied 6.97%, but all of that was in the latter three-quarters of the year – the recovery months.

In other words, "upside capture" in unhedged mandates was fantastic in 2020 – but the price was paid in greater than 1-for-1 "downside capture" in a particularly miserable crash.

It was the opposite of diversification.

Looking at the rest of the years, the prospects of gains or losses in any given year is a coin toss. Sometimes, smiles abound, as in 2002-2004. Other times are ugly, as in 2013-2016. The average move is about 7% a year, one way or the other.

Figure 6: MSCI EAFE Index Calendar Year Returns form Currency



Source: Thomson Reuters Refinitiv, as of 7/31/2021. Past performance is not indicative of future results. You cannot invest directly in an index.

If forex is hedged, all the chart's bars collapse to zero. You do not make or lose any money from the forex. Own Roche or Unilever because you want to own Roche or Unilever, not because you want to guess heads or tails on whether a foreign currency is going to run to 10 cents, 15 cents, 20 cents, one way or the other.[1]

PRECEPT #2: "HEDGING IS EXPENSIVE."

If the currency in question is the Ukrainian hryvnia or even something less esoteric, like the Indian rupee, then yes, currency hedging is expensive.

But the mainstream pairs, like the dollar vs. euro and dollar vs. yen witness trillions of dollars change hands daily. 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 or two annually.

Also, currency hedging costs are directly tied to relative interest rates. Because the European Central Bank, the Bank of Japan, the Swiss National Bank and many others pin overnight rates in negative territory while the Fed funds rate is slightly above 0%, U.S. hedgers get paid when they hedge.

Hedging only becomes more expensive at the point when foreign rates exceed U.S. rates. We do not think such a situation in the cards anytime soon. But even if it does come to pass, there is a simple solution: stop doing it if it stops making sense.

[1] These are example companies that comprise 5.3% and 5.2% of IHDG, respectively, as of 9/21/2021.

PRECEPT #3: "PRECIPICE OF A SECULAR USD BEAR MARKET"

How about the investor that is steadfast in a dollar weakness forecast? Consider this: U.S. portfolios' heavy bias to domestic Large Caps may already reflect that view.

We estimate that U.S. multinationals have nearly half their profits earned abroad. When the dollar rallies, earnings take a hit from the currency translation. If it weakens, earnings rise.

That means hedging forex to dollars often ends up giving much-needed help in investment returns during the tough times -- when Wall Street is reporting disappointing financial results. On the other side, when the hedge is going against the investor, it detracts from performance during times of robust corporate earnings.

It's like when Keynesian economists encourage hiking taxes and cutting federal spending in boom times, while cutting taxes and increasing spending in recessions, in an effort to keep the economy in check. These are "automatic stabilizers," like unemployment benefits.

In our case, the currency hedge is an automatic stabilizer as well: investors have often found themselves losing money on the currency hedge in bull markets, while making money on it in bear markets.

CUTTING OUT DOUBLE-BARRELED RISK

For investors who have no strong opinion on foreign currency, we ask the question: by owning foreign stocks without the hedge, why does it make any sense to bet on the dollar declining forever if that is not your strongly held view?

Sure, investors that are dead set on dollar bearishness need to do what they want to do. But what about everyone else? If the next 32 years are anything like 1989-2021, then we believe the play may be to hedge – as a matter of course.

Important Information

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, please call 866.909.9473 or visit WisdomTree.com to view or download a prospectus. Investors should read the prospectus carefully before investing.

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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: A weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners. 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. Volatility (Standard Deviation): A measure of the dispersion of actual returns around a particular average level. Basis point: 1/100th of 1 percent.