

Does Currency Hedging Have a Branding Problem?

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One topic I often find myself exploring with investment professionals is the role of currency risk in international portfolios. I believe the industry has a branding problem with currency-hedged strategies; this is a legacy issue that may never be fixed for the industry, so education is critically important. The branding issue goes to the heart of what should be the default choice for international investments, in our view.

Let's say we erase all legacy biases, start with a clean slate and face the following choice:

Investment A: International Stocks

Investment B: International Stocks plus Currency

If fund choices were branded International Stocks plus Currency and others more simply International Stocks, I think the vast majority of investors would choose International Stocks only.

The branding problem for currency hedging is the default labeling and branding makes it seem like the active decision to do something more exotic and complicated is the International Stocks plus Currency Hedge choice.

The reality is that unhedged international strategies carry a second layer of risk and exposure, not the hedged strategies. The currency-hedged strategies have the goal of getting you the stock returns in their local markets.

So why do people continue to buy international stocks plus currencies, especially if many have no conviction on the direction of currency moves?

I believe part is just status quo bias. For as long as people have invested internationally, the most common investment option was this default to be unhedged (stocks plus currencies). Now, over the last three to five years, currency hedging has made dramatic investment gains compared to being unhedged because the dollar has moved significantly.

This leads many value-oriented investors—who tend to be the ones going overseas today for their valuation opportunities—to argue that perhaps now is exactly the time not to be hedged and to take on currency exposure. This line of thinking says the dollar should head back down from here. Maybe. But also maybe not.

No one knows for sure which direction the dollar is going to go—and I would argue that taking these bets on currencies is not something one is paid to do via any natural currency risk premium akin to the equity risk premium. That is why I suggest the default should be to be currency neutral to lower overall volatility (i.e., hedged with no ability to benefit from currency appreciation but also no headwinds from currency depreciation).

And this “hedged” or currency-neutral default should be the norm, in my view, unless one has the more tactical view that the dollar is going to fall. If you have this specific tactical view, you absolutely should express that view. Do you?

How to Form a More Tactical View

The argument to be bearish on the dollar and bullish on the euro or pound is just a reflection that people feel the dollar has moved a lot already. And yes, of course, it has moved a lot.

But when I look at what factors drive currencies over time, the academic research settles on three factors that tend to be most influential in driving the direction of currencies: value, momentum and interest rate differentials.

WisdomTree created a family of Indexes that is dynamic in how hedged or exposed to currencies the Indexes are based on these long-term currency factors.

Tug of War between Value and Interest Rates

Today the currency “value factor” and “interest rate factor” are tugging the U.S. dollar in opposite directions.

In recent weeks, we had the U.S. Federal Reserve (Fed) continue its interest rate policy normalization cycle. Our research on dynamic currency signals, done in collaboration with Record Currency Management, showed that using short-term interest rate differentials has been a very meaningful signal of when you want to hedge currencies.

When there is a “cost to hedge” developed world currencies—and today that exists only for Australia and New Zealand—you’d rather be unhedged. When you are paid interest rate differentials to hedge—as you are today for currencies such as the euro, yen and pound—you ought to be hedged, in our view.

Rising Rate Differentials Suggests Being Hedged

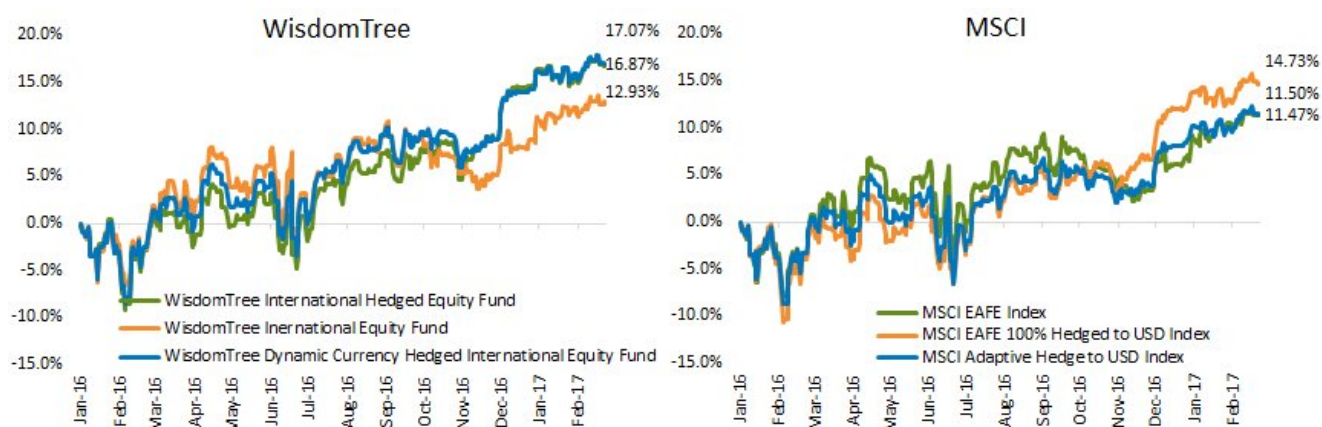
The amount you could be paid to hedge just widened with the Fed hike, suggesting a stronger signal to stay hedged, or at least lengthening how long the signal will suggest being hedged. I could see this interest rate factor signal suggesting to be hedged versus the euro for the next five years or more. As an example of how rate differences can be persistent, the interest rate factor suggested staying hedged on the yen for the last 24-plus years. Japan has been lower for longer.

The value factor would say the U.S. dollar looks expensive and investors should be less hedged as a result. The issue with timing from the value signal is that it is not meant to be a *short-term* timing signal. Over time, of course, valuations matter. Our currency hedge ratio for the euro, on the value signal, did come

down recently. Our dynamic hedging approach today suggests being only two-thirds hedged for the euro (based on momentum indicators still pointing to euro weakness and interest rate differentials being paid to hedge). Momentum will be the final arbiter of whether the interest rate differential or value side wins out. Any political uncertainty and risk should be captured by the momentum signal.

On balance, for a broad international equity strategy like the [WisdomTree Dynamic Currency Hedged International Equity Fund \(DDWM\)](#) the overall hedge ratio is approximately two-thirds hedged today. This would suggest, on balance, the environment still favors a stronger dollar. If the environment changes, this dynamic family will lower the hedge ratio, thereby increasing currency exposure.

In the short 14.5-month track record of this dynamic offering, we have seen the dynamic hedged Fund, DDWM, outperform both of WisdomTree's fully hedged and unhedged strategies, the [WisdomTree International Hedged Equity Fund \(HDWM\)](#) and the [WisdomTree International Equity Fund \(DWM\)](#), during a time when hedging paid off meaningfully. This has been a strong real-time result, especially compared to the MSCI EAFE Adaptive Hedge to USD Index, which actually lagged both the MSCI EAFE Index (which is unhedged) and the MSCI EAFE 100% Hedged to USD Index (hedged) by even more.



Sources: WisdomTree, FactSet, for the period 1/7/16 (DDWM inception date) through 2/28/17. You can not invest directly in an index. Past performance is not indicative of future results.

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 at www.wisdomtree.com.

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. EST 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.

Where Are Today's Opportunities?

Many look at international equities as presenting attractive valuations compared to U.S. counterparts. When going overseas, our research suggests currency can be by far one of the most important factors driving returns, more so [than other smart beta equity factors](#). We believe this dynamic hedged approach can play an important, core, long-run holding in portfolios. Instead of having to rotate subjectively when it makes sense to add in currency risk to being neutral on currencies, this systematic, disciplined strategy will determine when it is best to have currency exposure. We believe this is the future of international investing.

Important Risks Related to this Article

Double-digit returns were achieved primarily during favorable market conditions. Investors should not expect that such favorable returns can be consistently achieved. A fund's performance, especially for very short time periods, should not be the sole factor in making your investment decision.

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 Fund invests 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 Fund 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 Index underlying the Fund is heavily dependent on quantitative models and data from one or more third parties, and the Index may not perform as intended. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit, and the Fund does not attempt to outperform its Index or take defensive positions in declining markets. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.