

How to Build a Strong Dollar Emerging Markets Equity Index

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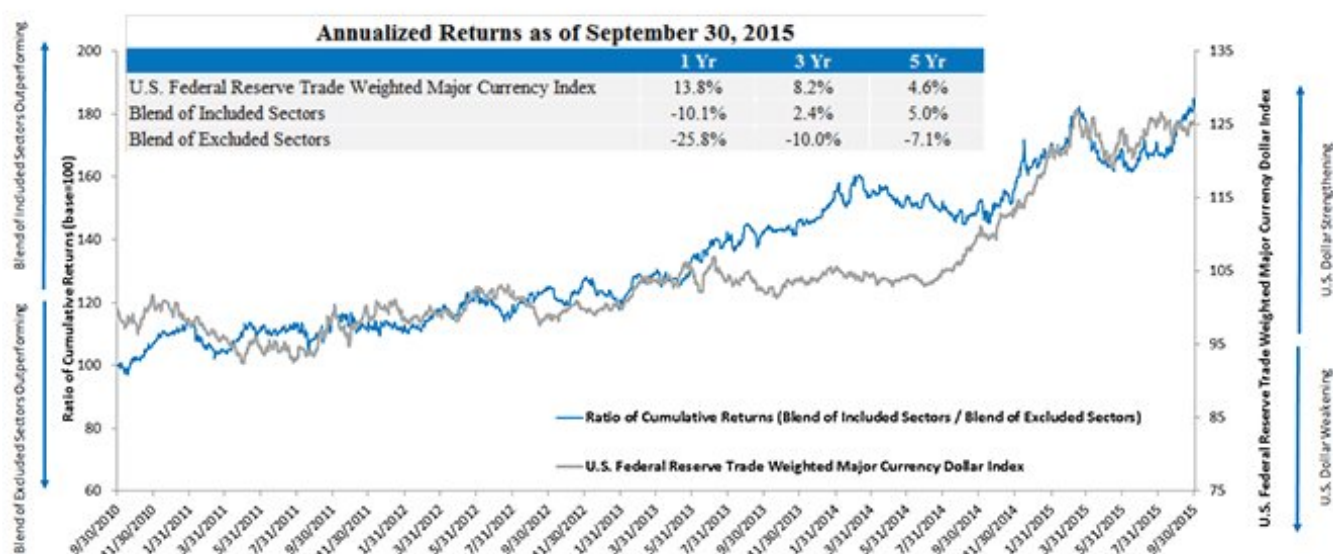
At WisdomTree, we have written extensively regarding how the movement of currencies can have the potential to impact equity investments. Within emerging markets, the approach of currency hedging, which has become quite popular within developed markets, is currently expensive.¹ That's why we created a new approach, the [WisdomTree Strong Dollar Emerging Markets Equity Index](#), which seeks to [mitigate the potentially adverse impact of a strengthening U.S. dollar against emerging market currencies](#). **Does a Stronger U.S. Dollar Impact All Emerging Market Equities Equally?** Our answer is no—a strengthening U.S. dollar (and weakening emerging market currencies) does not create an equivalently negative impact across all emerging market stocks. Some important considerations could include:

- **Geographic Revenue Distribution:** Companies that derive more of their revenues from the United States actually see their goods and services become less expensive to U.S. consumers as the dollar strengthens.
- **Commodity Sensitivity:** Since many commodities are priced in USD, a strengthening U.S. dollar is usually accompanied by declining commodity prices. Certain emerging market companies are commodity sellers, thereby having the potential to see revenues increase as commodity prices rise. Of course, others are commodity buyers, so they have the potential to see their costs decrease as commodity prices fall.
- **Debt Levels:** For the most part, emerging market corporate debt issuance is in U.S. dollars. If the dollar is strengthening compared to a company's home currency, and the majority of that company's revenues are in that home currency, a scenario in which it is tougher for that company to continue to pay for its debt obligations can develop. These represent just some of the considerations to think about when looking at how companies within emerging markets may respond to a stronger U.S. dollar.

Zeroing In on Strong Dollar Emerging Market Constituents The WisdomTree Strong Dollar Emerging Markets Equity Index steers around companies that may be the most at risk to respond negatively to a strengthening U.S. dollar by virtue of its annual screening process:

- **Sectors Excluded at the Annual Screening²:** Energy, Financials, Materials, Telecommunication Services and Utilities. We believe that the companies within these sectors, in aggregate, could be at greater risk of responding negatively to a strengthening U.S. dollar.
- **Sectors Included at the Annual Screening:** Consumer Discretionary, Consumer Staples, Health Care, Industrials and Information Technology. We believe that companies within these sectors—given that they also must derive a minimum of 15% of their revenue from the United States—could be at a lower risk to respond negatively to a strengthening U.S. dollar. In the chart below, we look to explore these premises, utilizing blends of MSCI Indexes to represent included sectors³ and excluded sectors⁴. Within this chart, the U.S. dollar is measured by the U.S. Federal Reserve Trade-weighted Major Currency Index . **Last Five**

Years: As U.S. Dollar Strengthened, Blend of Included Sectors Outperformed Blend of Excluded Sectors



Source: Bloomberg, with data for five years ending 9/30/15. Past performance is not indicative of future results. You cannot invest directly in an index.

• **Overall Upward Trend of the U.S. Dollar:** Over the five years ended September 30, 2015, the U.S. dollar strengthened 4.6% per year, creating a potential headwind for any unhedged exposure to emerging market equities. But we see that the ratio of the performance of the blend of the included sectors compared to the performance of the blend of the excluded sectors tended to increase. That means that the blend of included sectors outperformed that of the excluded sectors—showcasing our initial point that emerging market equities do not all respond equally to a stronger U.S. dollar.

• **Positive Returns Even While Not Hedging:** What we also find interesting is that over the three-year and five-year periods, the blend of included sectors exhibited positive returns. This occurred as the dollar was getting strong, AND it is important to note that this blend is NOT currency-hedged. The performance of the underlying equities was enough to more than offset the currency headwind during these periods. While there is no way to know if this performance will continue, if an investor believes that the U.S. dollar has the potential to continue to strengthen and that U.S. short-term interest rates will remain lower than the short-term interest rates seen within many emerging markets for a considerable time, WisdomTree's Strong Dollar Emerging Markets Equity Index could be interesting to consider.

1Source: Bloomberg, as of 9/30/15. 2Subsequent to Index screening it is possible that a current constituent may spin off a subsidiary company that may be classified as a Consumer Staples, Health Care, Telecommunication Services or Utilities sector firm. Spin off firms that remain within the Index do not get removed between Index rebalances due to their sector classification. 3Blend of included sectors: Represents the eligible sectors of the WisdomTree Strong Dollar Emerging Markets Equity Index, while maintaining sensitivity to the country exposures of this Index as of 9/30/15. Includes the MSCI Taiwan Information Technology Index, 24.7%; MSCI Taiwan Consumer Discretionary Index, 12.0%; MSCI Taiwan Industrials Index, 9.5%; MSCI South Korea Information Technology Index,

15.2%; MSCI South Korea Consumer Discretionary Index, 13.9%; MSCI South Korea Industrials Index, 7.6%, MSCI South Korea Health Care Index, 6.3%; MSCI India Information Technology Index, 5.7%; and MSCI India Health Care Index, 5.1%. 4Blend of excluded sectors: Represents an equally weighted blend of the sectors excluded from eligibility for the WisdomTree Strong Dollar Emerging Markets Equity Index and includes the MSCI Emerging Markets Energy Index, the MSCI Emerging Markets Materials Index, the MSCI Emerging Markets Financials Index, the MSCI Telecommunications Services Index and the MSCI Emerging Markets Utilities Index.

Important Risks Related to this Article

Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments.