

How to Position Your International Portfolio

Published December 3, 2014

Jeremy Schwartz, CFA

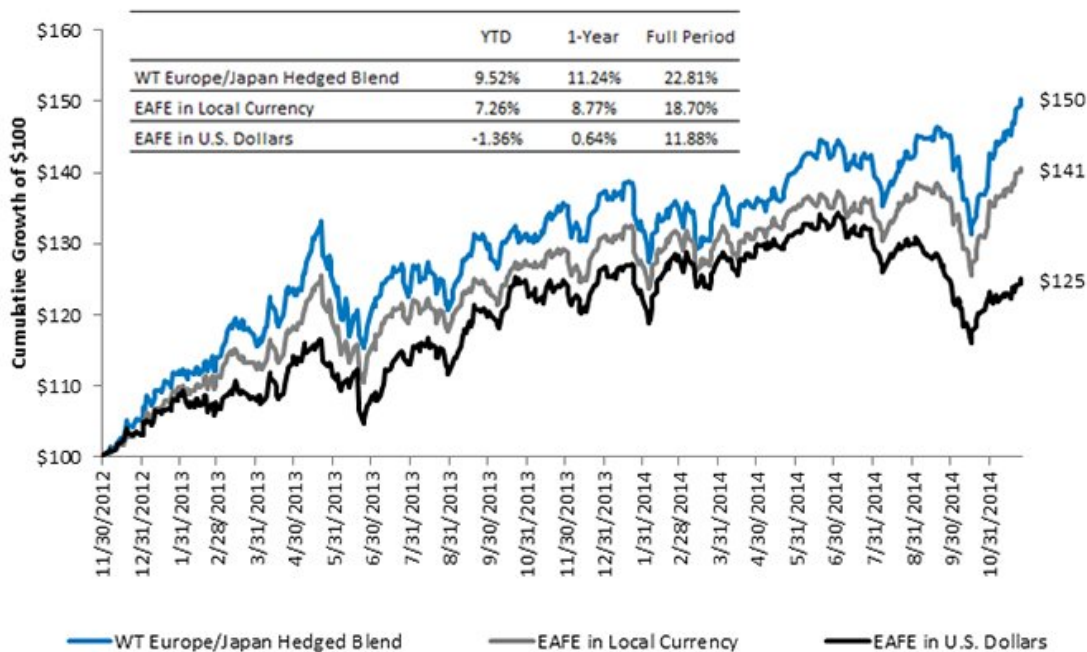
Global Chief Investment Officer

One of the most important trends in the markets in 2014 has been the rise of the U.S. dollar and the collapse of the euro and the yen. We've [written a lot](#) about utilizing hedged equity strategies to isolate international equity markets without adding the layer of euro and yen exchange rate risk. We believe the exchange rate risk to be a critical factor influencing returns and think investors should concentrate on the local equity opportunities in these regions without the currency volatility. The euro and the yen are the two currencies at the focal point for international investors given central bank trends, but below we show how a combination of these two markets tracks to a few broad international benchmarks.¹

Divergent Monetary Policies in Europe and Japan = Potential for Currency Weakness In looking at the central bank policy landscape today, the big story tilting away from the side of aggressive easing is the United States Federal Reserve (Fed), which ended its program of bond purchases during 2014. On the opposite end of the spectrum, the most aggressive "monetary easer" is the Bank of Japan (BOJ), with the European Central Bank (ECB) exploring further easing options. A greater degree of monetary easing could lead to a greater degree of currency weakness for the euro and the yen compared to the U.S. dollar.

Taking Action in Developed International Markets The euro and the yen are also the two biggest currency exposures in most traditional benchmarks targeting developed international stocks. For instance, within the MSCI EAFE Index, Europe—specifically the markets utilizing the euro currency—(approximately 31%) and Japan (approximately 21%) comprise just over 50% of the total Index and exist in approximate 60%/40% proportion to each other.² Given that Japan's and Europe's respective policy landscapes are bringing them into focus, we show how a 60% Europe/40% Japan hedged equity blend³ compares to the MSCI EAFE Index both in local currency and U.S. dollars.

The WisdomTree Hedged Equity Blend: Close Tracking to MSCI EAFE Equities (as of 11/25/2014)



Source: WisdomTree, Bloomberg. Data starts from 11/30/12 due to methodology change to the WisdomTree Japan Hedged Equity Index applied as of that date to focus on Japan's exporters. EAFE in local currency refers to the MSCI EAFE Local Currency Index, which is not exposed to fluctuating exchange rates. EAFE in U.S. dollars refers to the MSCI EAFE Index and is exposed to changes in currency exchange rates relative to the U.S. dollar. Past performance is not indicative of future results. You cannot invest directly in an index.

- In 2014, the year-to-date differential from the WisdomTree Europe/Japan (60/40) blend over MSCI EAFE in U.S. dollars was more than 10 percentage points. This shows just how important currency was as a driver of international returns in 2014.
- **The WT Hedged Blend Performs Well Compared to EAFE in Local Currency:** Over this period, we can see clearly that the blend outpaced the EAFE in local currency. The correlation between the two was actually 0.95—a very high number—showing how closely tied these two markets are to the overall international benchmarks.
- **Japan Drives the Relative Gains:** Over the past two years, Japan has been a robust generator of strong equity market returns—returns that if unhedged would be significantly cut by the depreciation of the yen. As we have written [here](#), we remain optimistic on prospects for Japan from a standpoint of valuation as well as increased flows from the Bank of Japan, the Japanese pension funds and other institutional investors.
- **Why Europe/Japan May Be Opportunely Focused Blend:** Since the [WisdomTree Europe Hedged Equity Index](#) focuses solely on equity markets that use the euro currency, the United Kingdom (approximately 21% of MSCI EAFE) and Switzerland (approximately 9% of MSCI EAFE)⁴ are missed. The only other market with a greater than 5% weight in the MSCI EAFE that is missed is Australia (approximately 8% of MSCI EAFE). We'd note that the case for central bank policy divergence is the most clear with Europe and Japan—the United Kingdom is actually close to hiking rates alongside the U.S. Federal Reserve, and the cost to hedge Australia currency exposure is higher due to the country's higher short-term interest rates. Investors may therefore think this blended combination of currency hedging Europe and Japan is where to focus the currency hedge part of international benchmarks.
- **Currency Hedging Becoming a More Important Consideration:** The difference between EAFE in local currency and EAFE in U.S. dollars has been widening, starting from July

2014 when the yen (-12.86%), the euro (-6.84%) and the pound (-6.98%) depreciated against the U.S. dollar, with specific levels of depreciation noted in parentheses⁵. The one-month interest rate differentials between the Euro and the Yen contribute to making the current cost to hedge these currencies inexpensive. Given the uncertain nature of exchange rates, we believe at least blending in partial currency hedges makes sense for international investors, and the 60/40 Europe/Japan blend discussed in this piece is where we'd begin the focus. ¹Broad international benchmarks: Refers to the MSCI EAFE Index and the MSCI EAFE Local Currency Index, as measures of the performance of developed international equities with and without the risk of fluctuating currencies against the U.S. dollar. ²Source: Bloomberg for data on exposures within the MSCI EAFE Index as of 11/25/14. Subject to change. ³60% Europe/40% Japan hedged equity blend: Refers to a 60% weight to the WisdomTree Europe Hedged Equity Index and a 40% weight to the WisdomTree Japan Hedged Equity Index, rebalanced annually. ⁴Source: Bloomberg for data on exposures within the MSCI EAFE Index as of 11/25/14. Subject to change. ⁵Source: Bloomberg, with depreciation versus U.S. dollar measured from 7/31/14–11/25/14.

Important Risks Related to this Article

Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.