

Is Dynamic FX Hedging the Future of International Equity Investing?

Published July 21, 2016

Jeremy Schwartz, CFA

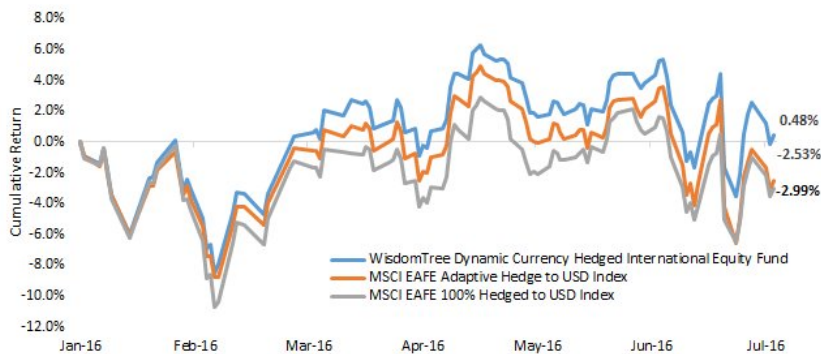
Global Chief Investment Officer

In early January 2016, WisdomTree launched a set of Funds that we consider to be the future of international equity portfolio management: a family of exchange-traded Funds (ETFs) that incorporate a dynamic element to the management of currency risk. For as far back as we can remember, investors in the U.S. have primarily defaulted to accepting currency risk when investing abroad—but that default assumption has changed over the last five years, since the concept of currency-hedged ETFs, a field in which WisdomTree has been a key player, entered the U.S. market in 2009. The volatility we've seen in currency markets this year re-emphasizes why currency hedging is of *strategic* importance to portfolios, in our view. In a period of two weeks, the British pound (GBP) dropped from a value of GBP1.50 to the dollar to below GBP1.301 to the dollar because of political uncertainty following the Brexit decision. What happened to UK stocks? They outperformed European markets on the idea that a weaker currency would support their multinational companies. If U.S. investors are diversifying away from U.S. stocks to buy inexpensive stocks around the world, why have they been betting on the pound? There is no logical reason why betting on the pound *always and forever* would add value to your portfolio as a U.S. investor. For the last seven to eight years, and this year in particular, the pound has been a major drag on investors' international results. The only case, in my opinion, to take on developed world currency risk is if you have a particular viewpoint on those currencies appreciating more tactically. It would be easy to look backward and say you should not have taken on this British pound risk. But how can you proactively determine whether you want that currency risk looking *forward*? WisdomTree developed a family of strategies that look at the most important factors and determinants of exchange rate movements. Those three factors are interest rate differentials, momentum and value. You may have heard the phrase "value and momentum everywhere." In our view, those two factors have worked in currency risk management. Our Index process, developed in conjunction with Record Currency Management, added interest rate differentials (or carry) to value and momentum, as interest rates are also known to influence currency moves. At the very least, by not hedging currencies that are expensive to hedge due to a high carry cost (as is now the case in Australia), you can turn the cost of hedging more into your favor by hedging only when you are paid to do so (as you are today in the euro, yen and Swiss franc). **How'd You Do in Real Time? The Results Are Encouraging** Now that we have six months of real-time results for this international family of dynamically hedged ETFs, we can evaluate how they've done during a period of perplexing currency moves and volatility. Last year was a very strong dollar period in which currency hedging strategies took in meaningful assets and hedging added value. In the first half of 2016, the yen has been surprisingly strong and the euro was also up prior to the Brexit vote. Below we show the results for the [WisdomTree Dynamic Currency Hedged International Equity Fund \(DDWM\)](#)

compared to a fully hedged and adaptively hedged index from MSCI since the inception of DDWM. The real-time results show a good start for the WisdomTree approach.

[For standardized performance of DDWM, visit the Fund page.](#)

International Equity Cumulative Return (1/7/16-7/7/16)



Sources: WisdomTree, Bloomberg. You cannot invest directly in an index.

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.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

For definitions of indexes in the chart, visit our [glossary](#).

[Learn more about our dynamic currency-hedging approach here.](#)

One of the key value-added features has been the hedge ratio on the British pound: our hedge ratio has been 83.3% since 12/28/15. The value signal has a half-hedge on it, but the momentum and interest rate differential signals we used have suggested to hedge the pound since the U.S. hiked rates and U.S. investors were being paid a marginal amount to hedge the pound. One of the reasons dynamic hedging is currently outperforming fully hedged strategies is that the yen has appreciated this year and dynamic hedging with WisdomTree had incorporated a 50% hedge ratio on the yen since late 2015, when the momentum signal rolled over. While interest rates are a slow-moving signal (i. e., when do you think the Bank of Japan will have a higher interest rate than the U.S.?), momentum is a faster-moving signal, and that hedge ratio can be raised if there is a catalyst that sparks another round of yen weakness. Investors may keep wondering: Is it too late to switch to a currency-hedged approach? Our short answer: Currency hedging for broad international mandates hasn't even meaningfully started. It is not too late. Adopting a dynamic hedging approach with WisdomTree's rules-based process moves you from

subjectively determining a hedge ratio and second-guessing yourself and toward a disciplined approach to currency risk management. The signals currently suggest being roughly half-hedged for the total FX exposure in a broad international strategy, with the highest hedge ratio actually being the British pound at 83% and the euro and yen each at 50%. We believe these are a good guide and also suggest (based on assets under management levels of unhedged funds) that investors may be taking on too much currency risk when they invest abroad.

¹Source: Bloomberg, period from 12/16/15 to 7/7/16.

Important Risks Related to this Article

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.

No WisdomTree Fund is sponsored, endorsed, sold or promoted by Record Currency Management ("Record"). Record has licensed certain rights to WisdomTree Investments, Inc., as the index provider to the applicable WisdomTree Funds, and Record is providing no investment advice to any WisdomTree Fund or its advisors. Record makes no representation or warranty, expressed or implied, to the owners of any WisdomTree Fund regarding any associated risks or the advisability of investing in any WisdomTree Fund.