

The Right Time for Dynamic FX Hedging

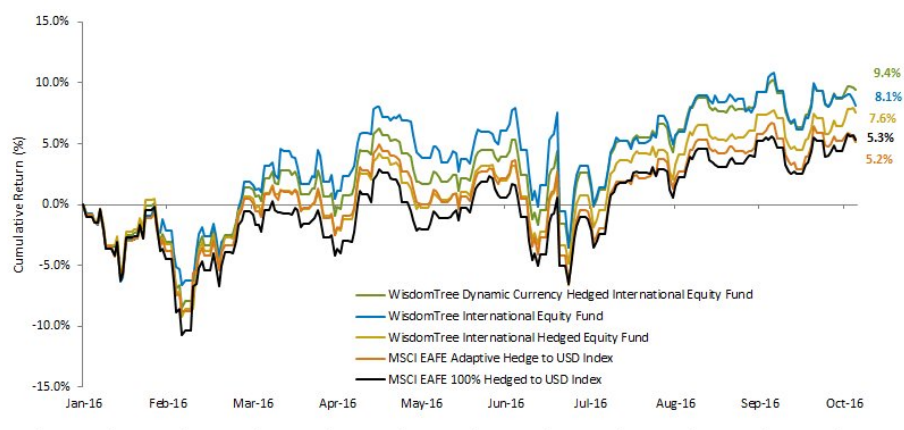
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In early January 2016, WisdomTree launched a set of Funds that we consider to be the future of international equity portfolio management: a family of exchange-traded Funds (ETFs) that incorporate a dynamic element to the management of currency risk. For as far back as we can remember, investors in the U.S. have primarily defaulted to accepting currency risk when investing in *equities* abroad. For developed world fixed income, sure, the volatility is so large that many, if not most, default to hedge. But interestingly, in equities, which often have higher volatility, investors have tolerated the higher risk that comes along with unhedged currency exposure. 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 months, 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 UK's Brexit decision. What happened to UK stocks? They outperformed European markets substantially on the premise that a weaker currency would support their company profits.² Having UK stock market exposure—to diversify risk of U.S. equities being an expensive equity market—was quite valuable thus far this year. Having GBP risk, not so valuable. But over the long run, there is no logical reason to bet the GBP will always and forever be appreciating versus the U.S. dollar, or that it should always add value to U.S. investors (as assumed in unhedged UK strategies). The only real case, in my opinion, to add developed world currency risk is if you have a viewpoint on those currencies appreciating more tactically. It is easy to look backward and say one should not have taken on this British pound risk this year. **Looking Forward: A Factor Approach to Dynamically Adjust Hedges** But how can you proactively determine whether you want that currency risk looking *forward*? WisdomTree developed a family of dynamic strategies that incorporates 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 help explain currency moves. 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 drive currency gains. 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 potentially turn the cost of hedging from paying carry and into your favor by hedging only when you are paid, through positive interest rate differentials, to do so (as you are today in the euro, yen and Swiss franc). **How'd Dynamic Hedging Do in Real Time? The Results Are Encouraging** Now that we have nine 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-hedged strategies took in meaningful assets and foreign exchange (FX) hedging added significant value. In the first half of 2016, the yen and euro were surprisingly strong, so unhedged strategies saw a tailwind that led to outperformance compared to hedged strategies. But 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, along with fully hedged and unhedged versions of the same WisdomTree strategy. The real-time results show an impressive start for the WisdomTree dynamic FX approach. **International Equity Cumulative Return (1/7/16–10/7/16)**



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.

Click each ticker for standardized performance: [DDWM](#), [HDWM](#), [DWM](#). For definitions of indexes in the chart visit our [glossary](#). **Where Dynamic Hedging Added Value** In a year when being unhedged has often outperformed hedged strategies, the broad dynamic hedged strategy from WisdomTree, which has consistently averaged over a 50% hedge ratio in aggregate positioning throughout 2016, has outperformed the unhedged strategies through October 7th. How can this be? It's because of a process that hedged the right currencies more and had lower hedge ratios on currencies that appreciated. A key attribution point comes with the British pound (GBP) and yen. **Hedged GBP:** Our hedge ratio on GBP has been 83.3% since December 28, 2015, and this helped protect returns following the GBP collapse post-Brexit. Why did the dynamic process have an 83.3% hedge for GBP heading into Brexit? The momentum and interest rate signals have both suggested to hedge the GBP since the U.S. hiked rates in December and U.S. investors were being paid a marginal amount to hedge the GBP, while the value signal has suggested a half-hedge. The GBP's fall in 2016 was one of its larger falls in history, and it is important to see that our hedging process was able to blunt its decline quite effectively—the exact goal of a dynamic hedging strategy. **Gains in Currencies Such as the Yen:** While passive currency-hedged strategies would have been better served by being 100% hedged on the GBP instead of 83.3% as done in the dynamic model, dynamic

hedging outperformed these hedged strategies in 2016, in large part because the yen has appreciated this year and dynamic hedging incorporated a 50% hedge ratio on the yen since late 2015, when the yen's momentum rolled over. **Trend toward FX Hedging Equities Still in Early Innings** In WisdomTree's view, developed world currencies offer higher expected risk levels with no expected return enhancement. Why should you desire these higher risk levels, unless you are good at timing when you want currency risk to be unhedged? Adopting a dynamic approach with WisdomTree moves you away from subjective calls and into a disciplined, "smart-beta" and factor approach to currency risk management. We believe our factors (carry, value and momentum) have potential to outperform both hedged and unhedged strategies over time by rotating currency hedges with their cycles. So far in 2016, the signals are showing promising added value in a year of large currency moves. Note that our signals currently suggest being roughly half-hedged for the total FX exposure in a broad international strategy. We believe this is a great current guide and also suggest (based on assets under management levels of unhedged international funds) that investors take on too much unnecessary risk when they invest abroad.

{{unknown}}1Source: Bloomberg, from 12/16/15 to 7/7/16. 2Refers to the MSCI United Kingdom Index relative to the MSCI EMU Index and MSCI Europe Index, from 12/16/15to7/7/16.

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