Three Options Illustrating Smart Hedging Potential

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Jeremy Schwartz, CFA
Global Chief Investment Officer

Wesley Gray, the Alpha Architect, joined me recently in co-hosting a podcast with the Wharton School's Nikolai Roussanov, one of world's top academics on the topic of currencies.

Roussanov's academic work has focused on the carry trade—a currency factor he sees as explanatory in major currency group movements. The carry trade represents the tendency for higher interest rate currencies to outperform lower interest rate currencies, on average, over time.

Roussanov and I debated the strategic rationale for currency hedging broadly. WisdomTree has been a rather passionate advocate for the view that investors tend to take on unnecessary risk when they invest abroad—one need not utilize double-decker strategies that package currency returns on top of equities. More simply, investors can buy single-decker strategies that have an expressed goal of delivering returns of equity markets only, mitigating risks from a secondary and distracting bet on currencies.

Roussanov says currencies like the yen can offer diversification. I think the yen is an outlier when it comes to its strong negative correlations to equities. But when I pressed Roussanov if he believed investors should "always be betting long on the euro always going up" as required by unhedged double-decker strategies, he said that investors should not be doing that either. So what's an investor to do?

Roussanov is a fan of "smart hedging" strategies that time foreign exchange (FX) hedges based on factors that historically have been rewarded and studied in the academic literature.

FX Factors to Adjust Hedge Ratios

What are currency factors? Academics like Roussanov have focused on interest rate differentials—the carry factor. But there is also work on a value factor within FX and price momentum.

WisdomTree created smart hedging indexes that combine these three currency factors into a dynamic hedging family that raises and lowers hedge ratios once per month on these three currency factors. Value and carry are two relatively slow-moving signals and normally will not change that frequently.

As an illustration, the carry factor as WisdomTree applies it is modeled based on interest rate differentials between the European Central Bank and the U.S. Federal Reserve (Fed). This carry factor has U.S. investors earning an approximately 1.6%1 carry from hedging the euro and suggests that investors stay hedged as far as I can see. To wit: when do you think the ECB will have a higher policy rate than the Fed?

Value also is a slow-moving signal. Momentum can move around more quickly because it is based on price changes, but even with this faster factor, our signals, on average, may involve only one to two hedging switches per currency a year due to the trending nature of currencies.

WisdomTree now has five different indexes that apply this dynamic, smart hedging process. I am going to review how the three broad international indexes have been performing below. Before I do that, however, I have a question.

Where Are the Skeptics on Unhedged Flows?

We've seen investors flock to unhedged strategies in 2017 as the dollar has weakened—in terms of exchange-traded fund (ETF) flows in 2017, this has been the largest category of all ETF flows through early August.2 An interesting comment on this sentiment: when currency-hedged strategies were in vogue in 2013 through 2015, many naysayers critiqued the flows to hedged strategies from the contrarian perspective that money was chasing performance. Where are these people on unhedged strategies today?

I'd argue that is happening today, with unhedged strategies receiving the lion's share of all inflows—chasing dollar weakness but with no strong rationale for why that dollar weakness may persist, especially over the longer run.

A self-reflection test for readers: how many of you know with certainty the odds of the euro being higher than 1.20 a year from now, or three years from now, are greater than 50-50? If you do not hold this high-conviction view, why are you taking a double-decker strategy that layers in this euro bet?

Most people will never believe they have this crystal ball, which is why WisdomTree comes back to removing the currency bet—and thinking about achieving just equity risk for a broad developed-world index like the MSCI EAFE Index.3

But for those who think currency can offer diversification or returns at times, there are now multiple ways of packaging a dynamic currency factor on top of different subsets of the international equity market. This smart hedging combined with smart beta at the core for equities creates a really powerful combination, in our view.

Consider the three ETFs below, all of which have added meaningful value over a broad currency-hedged international index.

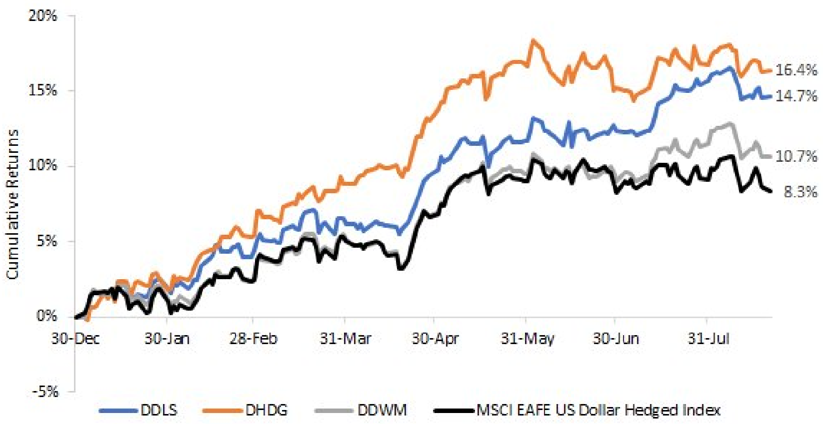
These three WisdomTree ETFs offer unique equity exposures with this smart hedging overlay.

1)The WisdomTree Dynamic Currency Hedged International Equity Fund (DDWM): Broad-based international equities with high correlation to the MSCI EAFE Index with the smart hedging program.

2)The WisdomTree Dynamic Currency Hedged International SmallCap Equity Fund (DDLS): International small caps with a value tilt with the smart hedging program.

3)The WisdomTree Dynamic Currency Hedged International Quality Dividend Growth Fund (DHDG): International quality factor with the smart hedging program. These stocks have much higher returns on capital than broad market indexes by screening for factors of return on equity, return on assets, and earnings growth expectations.

YTD Cumulative Returns (12/30/16–8/21/17)



Sources: WisdomTree, Bloomberg, as of 8/21/17. You cannot invest directly in an index. 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.

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.

Click here for DDLS, DHDG and DDWM standardized performances.

To reiterate: WisdomTree believes these three ETFs represent the future of international investing and apply a systematic process to adding value both from a risk and a return perspective. If you do not have a model for forecasting currency returns into the future, we'd suggest you question why you think it is smart to always be long the euro as in unhedged strategies—and either adopt a strategic currency-hedged position to mitigate that risk or try to find a model that you think can help time hedges more systematically.

1Source: FactSet, 6/30/17.

2Sources: WisdomTree, Bloomberg.
3Applying to emerging markets is a different story, as that comes back to the carry factor of Roussanov's work that emerging markets have a high interest rate differential and thus a high cost to hedge that negates the reduction in volatility that comes with it.

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 Funds invest 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 Funds may not perform as intended. Funds 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 Funds are heavily dependent on quantitative models and data from one or more third parties, and the Index may not perform as intended. The Funds invest in the securities included in, or representative of, its Index regardless of their investment merit, and the Funds do not attempt to outperform its Index or take defensive positions in declining markets.

Dividends are not guaranteed and a company currently paying dividends may cease paying dividends at any time. Please read the Funds' prospectuses for specific details regarding the Funds' risk profiles.

Diversification does not eliminate the risk of experiencing investment losses.