

IS YOUR MUTUAL FUND MANAGER MANAGING CURRENCY RISK?

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In January, WisdomTree surveyed nearly 200 advisors to find out how many delegated the decision to [hedge](#) foreign currencies to an international fund manager. Nearly 7 in 10 replied that they did. Making decisions on when to take on currency exposure—or to mitigate its impact—is not easy. Thus, many financial advisors, investment firms and investment committees choose to outsource that decision to an [active manager](#). That raises two interesting questions: Have active managers been hedging foreign currencies? And if so, how have they done? The past five-year period is a useful window to examine these questions, because it coincides with one of the most visible U.S. dollar rallies of the past four decades. From early August of 2011 through January 22, 2016, the latest date with available data, the [U.S. trade-weighted dollar](#) has surged 40% on a cumulative basis against the currencies of America's major trading partners. As shown in the table below, surely if active managers had been managing the risk that depreciating foreign currencies pose to their clients' portfolios, we would have noticed it over this period. Managers who had mitigated currency risk would climb in the "league rankings" and would have matched or surpassed the returns generated by the [MSCI EAFE 100% Hedged to USD Index](#), which mitigates the impact of currency. Those that did not hedge currency, or hedged in an ineffective manner, would have had to exhibit extraordinary stock picking prowess to make up for the huge headwind created by being on the wrong side of the dollar's ascent over this period. Since June of 2014, the annualized difference between owning a basket of MSCI EAFE Index stocks hedged versus [unhedged](#) has amounted to nearly 11 percentage points per year. So how did the active mutual fund managers do? We ran screens to help answer that question. We identified all the international equity funds characterized by Morningstar as "[Foreign Large Value](#), [Foreign Large Blend](#) or [Foreign Large Growth](#)" and analyzed their returns over the trailing one-, three- and five-year periods to see how they performed against the MSCI EAFE 100% Hedged to USD Index.

| Morningstar Fund Category: US MF Foreign Large Blend, Growth & Value | | % of Peer Group Beaten as of 12/31/2015 | | | | |
|---|--|---|--------|--------|-----------------------|---------------------------------------|
| Index Name | | 1-Year | 3-Year | 5-Year | Since Fund Inception* | Since Fund Inception* Total Return |
| WisdomTree International Hedged Quality Dividend Growth Fund | | 100% | N/A | N/A | 100% | 6.90% |
| MSCI EAFE Index | | 51% | 70% | 68% | 45% | -5.85% |
| MSCI EAFE 100% Hedged to USD Index | | 95% | 100% | 98% | 99% | 4.86% |

| | | Average Annual Returns as of 12/31/2015 | | | | | | | | | | | |
|---|--------|---|---------------------|----------------------|--------|--------|--------|----------------------|------------------|--------|--------|--------|----------------------|
| Fund/Index Name | Ticker | Fund Information | | Total Return NAV (%) | | | | | Market Price (%) | | | | |
| | | Expense Ratio | Fund Inception Date | YTD | 1-Year | 3-Year | 5-Year | Since Fund Inception | YTD | 1-Year | 3-Year | 5-Year | Since Fund Inception |
| WisdomTree International Hedged Quality Dividend Growth Fund | IHDG | 0.58% | 5/7/2014 | 12.55% | 12.55% | N/A | N/A | 8.25% | 12.14% | 12.14% | N/A | N/A | 7.55% |
| WisdomTree International Hedged Quality Dividend Growth Index | | | | 13.15% | 13.15% | N/A | N/A | 8.92% | 13.15% | 13.15% | N/A | N/A | 8.92% |
| MSCI EAFE 100% Hedged to USD Index | | | | 5.02% | 5.02% | 12.02% | 7.74% | 6.53% | 5.02% | 5.02% | 12.02% | 7.74% | 6.53% |
| MSCI EAFE Index | | | | -0.81% | -0.81% | 5.01% | 3.60% | -4.63% | -0.81% | -0.81% | 5.01% | 3.60% | -4.63% |

Sources: Morningstar Direct, Bloomberg, WisdomTree, as of 1/15/2016.

*Since Fund Inception refers to the closest month-end date following intra-month inception date.

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.

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The MSCI EAFE 100%

Hedged to USD Index beat 95% of the active managers over the last year, 100% over the last three years, and 98% over the last five years. This tells us, indirectly, that the vast majority of active managers have not been managing the currency call. In fact, when we searched for the best-performing [open-end fund](#) over the last year, we found that it was a

WisdomTree exchange-traded Fund, the [International Hedged Quality Dividend Growth Fund \(IHDG\)](#), which actually beat the MSCI hedged benchmark, and more than 1,400 mutual funds in the process. So why didn't more active managers manage foreign currency risk more effectively over this period? We think some didn't because they don't believe, philosophically, that hedging currency adds value over time—even if there may be seven- or eight-year periods when currency moves can work for or against them. Some didn't because they believe there is a cost to hedging that works against them. Though this may be true in certain periods, today the cost of hedging in the developed world is virtually nil, and over the last 30 years, the differential in [interest rates](#) between the foreign currencies within [MSCI EAFE Index](#) and the U.S. dollar has actually favored U.S. investors. Some active managers may not hedge currencies because they are more comfortable making stock calls rather than currency calls. And many are benchmarked against unhedged indexes, and so, for them, hedging a currency is an active decision they may not wish to make. But in a world at risk for [deflation](#), making a permanent bet against the dollar—which is what 100% unhedged positions do—may not be in investors' best interest. Increasingly, advisors are making the decision for themselves. In just a few years, the percentage of the \$360 billion invested in developed world equity ETF assets that hedge out currency has increased from virtually 0% to roughly 17%. But with the vast majority of active international mutual funds (representing more than \$1 trillion in assets under management) still predominantly unhedged, the migration into 100% hedged or dynamically hedged strategies may still lie ahead. For those who delegate the decision to an active manager but are disappointed with their ability to do so effectively, WisdomTree has created a family of hedged currency Indexes and [dynamically hedged](#) currency Indexes that make the decision regarding when and how much to hedge for you. WisdomTree's underlying Index for IHDG mitigates the risk of currency exposure each month. Dynamically hedged indexes have the ability to [rebalance](#) the currency exposure each month based on three signals: [momentum](#), interest rate differentials and relative value between currencies, ranging from 0% hedged to 100% hedged based on [purchasing power parity](#). [Learn more about WisdomTree's approach to dynamic currency hedging in the developed world.](#) ***Unless otherwise notes, data source is Bloomberg, as of 1/31/2016.***

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Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.

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You cannot invest directly in an index.

DEFINITIONS

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Trade-weighted currency : multilateral exchange rate with the weight of each foreign country equal to its share in trade.

MSCI EAFE 100% Hedged to USD Index : Achieves an index return very similar to the MSCI EAFE Index but with the addition of hedging its currency exposure.

Foreign Large Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This is achieved while focusing on relatively larger companies abroad.

Foreign Large Blend : Characterized by exposure spanning across stocks exhibiting both value and growth attributes. This is achieved while focusing on relatively larger companies abroad.

Foreign Large Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals. This is achieved while focusing on relatively larger companies abroad.

Open-End Mutual Funds : Type of mutual fund that does not have restrictions on the amount of shares the fund will issue, so if demand is high enough the fund will continue to issue shares. These funds buy back shares when investors wish to sell.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Deflation : The opposite of inflation, characterized by falling price levels.

Dynamic Hedge : Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of time.

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.