

IS THE DOLLAR THE MOST IMPORTANT FACTOR FOR INTERNATIONAL INVESTING?

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01/11/2017

One of the most discussed topics in 2016 was the “[smart beta](#)” conversation. Many investors are evaluating whether and how to integrate factors that have been associated with driving stock returns—value, size, momentum and quality—into their overall allocations, and which exchange-traded funds (ETFs) best help them to do so. Over the past 10 years, WisdomTree has been leading this conversation with our family of [dividend-weighted](#) and earnings-weighted ETFs.

2016 also reminded us that the U.S. dollar is often an important “factor” when investing outside the United States. Consider the [MSCI ACWI ex-U.S. Index](#), which measures the returns of developed world and emerging markets stocks outside the U.S. In 2016, the MSCI ACWI ex-U.S. Index underperformed the [S&P 500 Index](#) for the fourth year in a row and for the fifth time in the last six years. The chart below plots the ratio of total returns (in white) generated by the MSCI ACWI ex-U.S. Index to those of the S&P 500 Index, going back to 2000. Note how that ratio rose from 2002 through early 2008 to more than 1.6, during a period when the U.S. dollar declined by about 25% against a basket of foreign currencies (in orange).¹ Once that process reversed itself and the dollar began to appreciate again, beginning in the summer of 2011, the ratio of the MSCI ACWI ex-U.S. Index relative to the S&P 500 declined precipitously. Over that period, the dollar appreciated 28%, or roughly 4.7% per year. Many of the gains generated by foreign equity markets over those last five and a half years were washed away by losses posted by foreign currencies. In a low-yielding, low-return world, losing 4.5% per year due to foreign currency movements is not a formula for success.

Total Returns of MSCI ACWI ex-U.S. Index Relative to S&P 500 Index (12/31/99–12/31/16)



Source: Bloomberg, as of 12/31/16. Past performance is not indicative of future results. You cannot invest directly in an index.

Once an investor realizes that success in overseas investing is typically shaped by

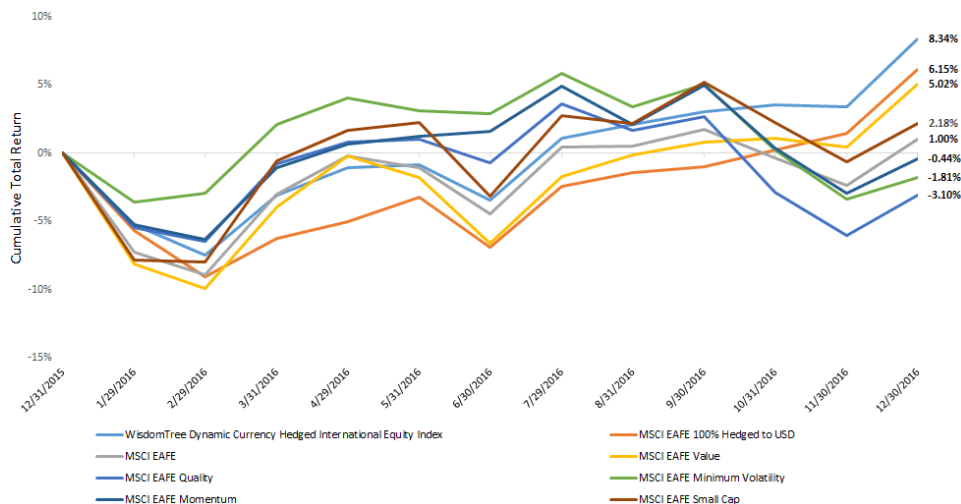
multi-year moves in the dollar, the question then becomes this: what is the best way to capitalize on this phenomenon while managing the risk that comes from foreign currency exposure? WisdomTree believes the answer is to [dynamically hedge](#) exposure to foreign currencies. Or stated another way, seek to capture the lion's share of the foreign currency move when it helps you, and seek to avoid foreign currency exposure when it hurts you.

WisdomTree created an Index that makes this decision for you, at the end of each month, based on how foreign currencies are behaving relative to the U.S. dollar. The [WisdomTree Dynamic Currency Hedged International Equity Index](#) incorporates three signals—momentum, [interest rate](#) differentials and relative value based on [purchasing power parity \(PPP\)](#)—to determine how much foreign currency exposure to assume. It began 2017 with roughly 70% of foreign currencies hedged.

The chart below illustrates how well the wisdomTree Index did relative to the unhedged [MSCI EAFE Index](#) and to a 100% currency-hedged version of the MSCI EAFE.

The wisdomTree Index returned 8.3% in 2016, outperforming the MSCI EAFE Index by more than 7 percentage points and beating the 100% hedged version of the MSCI EAFE by 219 [basis points \(bps\)](#). As the chart and table below show, the impact these depreciating foreign currencies had on MSCI EAFE's returns for U.S.-based investors—515 bps—had a bigger impact on returns in 2016 than did tilting toward MSCI EAFE Value, MSCI EAFE Quality, MSCI EAFE Minimal Volatility or even MSCI EAFE Small Cap.

2016 Cumulative Total Return



Index	Average Annual Total Returns as of 12/31/2016		
	1 Year	3 Year	Since WT Index Inception
WT Dynamic Currency Hedged Int'l Equity Index	8.34%	N/A	4.91%
MSCI EAFE 100% Hedged to USD	6.15%	5.61%	3.93%
MSCI EAFE	1.00%	-1.60%	-1.64%
MSCI EAFE Value	5.02%	-2.14%	0.38%
MSCI EAFE Quality	-3.10%	-1.13%	-4.50%
MSCI EAFE Min Vol	-1.81%	3.51%	-1.92%
MSCI EAFE Momentum	-0.44%	-0.47%	-0.69%
MSCI EAFE Small Cap	2.18%	2.10%	2.52%

Source: Bloomberg, MSCI, as of 12/31/16. The WisdomTree Dynamic Currency Hedged International Equity Index launched on 11/2/15. Past performance is not indicative of future results. You cannot invest directly in an index.

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](#).

Although returns over many decades are not expected to be impacted by currency exposure in the developed world, in any given year, foreign currency exposure can impact returns as much or more than any of the so-called smart beta factors. This was true in 2016, and it has been true over the past three years. The strength of the U.S. dollar has had a greater impact on international equity returns than any of the commonly used smart beta factors, if MSCI EAFE is your proxy.

Most international equity managers measure themselves against the unhedged MSCI EAFE Index. And with last year's paltry 1% return, many, like their benchmark, have generated negative returns over the past few years, disappointing U.S. investors. Much of the disappointment stems from international equity managers—and unhedged index funds—not having a viable strategy to manage foreign currency risk.

Conclusion

2017 could well be another year in which the U.S. dollar appreciates in value against other developed world currencies. That could once again pose a challenge for investors who own funds that buy stocks outside the United States. For investors looking to outsource the decision regarding when to hedge foreign currency exposure, WisdomTree has a one-stop solution. Launched in January 2016, the [WisdomTree Dynamic Currency Hedged International Equity Fund \(DDWM\)](#) provides broad exposure to the developed world equity markets while dynamically mitigating the impact of foreign currency exposure, using a rule-based algorithm that resets at the end of each month. Learn more about the [WisdomTree Dynamic Currency Hedged International Equity Fund \(DDWM\)](#).

¹U.S. dollar uses the [Real Trade Weighted U.S. Dollar Index](#) from the St. Louis Fed.

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DEFINITIONS

Smart Beta: A term for rules-based investment strategies that don't use conventional market-cap weightings.

Dividend weighted: Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

MSCI ACWI ex-U.S. Index: A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets excluding companies based in the United States.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

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.

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

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.

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.

Basis point: 1/100th of 1 percent.

Real Trade Weighted U.S. Dollar Index: A weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners.