RISK VS. RETURN IN INTERNATIONAL PORTFOLIOS

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After an unexpected move by the Swiss National Bank on January 15 to abandon its peg against the euro and the announcement of quantitative easing by the European Central Bank (ECB) on January 22, investors around the world have been forced to re-evaluate currency risk as part of their asset allocation decisions. For many U.S.-based investors, currency hedging continues to resonate as they seek out new opportunities in foreign markets. Over the past 10 years, foreign currencies declined modestly against the U.S. dollar.[1] However, as we have highlighted previously, our analysis shows that we may currently be in the middle stages of a secular appreciation in the U.S. dollar. As a result, investors should continue to consider hedging investments exposed to foreign currency risk. One way investors have historically managed volatility in their portfolios was through allocations to cash. By maintaining a portion of their portfolios in cash, investors would hypothetically be able to deploy capital when markets became undervalued. However, today's interest rates environment is much different than it once was. From 2004 through 2007, short-term interest rates averaged 3.46%.[2] Today, the U.S. 30-year bond only yields 2.40%.[3] With yields this low across the yield curve, U.S. cash positions can provide a significant drag on performance. Today, the argument for short-term fixed income is that it reduces exposure to risk assets, albeit with considerably less income potential than in the past. However, volatility across asset classes is trending higher. Due to such low opportunity costs from short-term fixed income, hedging foreign currency risk via a long-dollar strategy provides investors additional flexibility compared to simply allocating to cash. As illustrated in the chart below, investors were able to have a significant impact on portfolio volatility while still capturing a large percentage of returns from their equity positions. **Dialing Down Risk while Maintaining Returns Risk/Return Implications of Dollar Bull Strategies for International Equity Positions, 11/30/04- 11/30/14**

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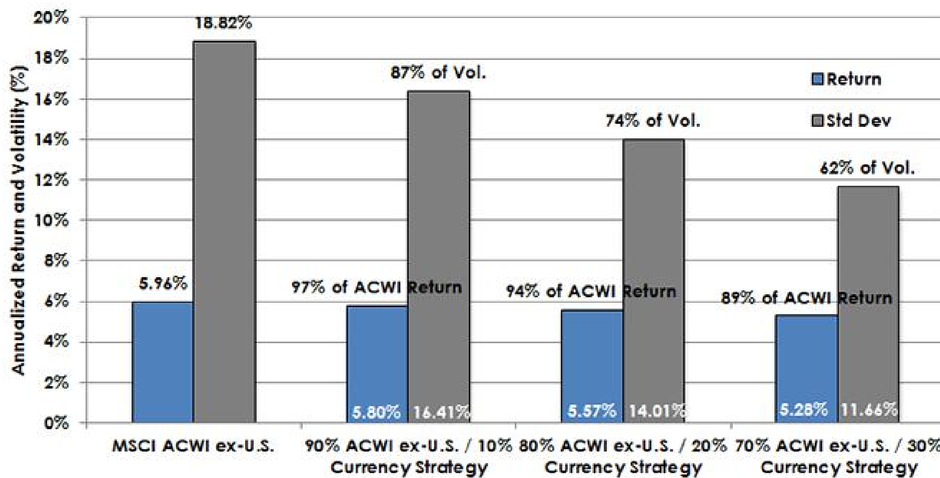

Sources: Bloomberg, WisdomTree, as of 11/30/14. Past performance is not indicative of future results. The hypothetical blends represent an isolated analysis for a specified period. You cannot invest directly in an index.

Interestingly, even though the volatility of the dollar bull strategy was significantly higher than cash over this period, it actually reduced overall portfolio risk to a greater degree due to its negative correlation (-0.71) with international equities.[4] In our view, the real value of bullish dollar strategies in the current market environment is for investors with long-term international holdings. Given that many of these legacy positions may have large unrealized capital gains, a bullish dollar currency strategy can help reduce volatility from currency markets while maintaining existing exposure. In our analysis over the last 10 years, investors would have been able to capture a large portion of the upside, while significantly reducing volatility. As illustrated in the chart above, a 20% allocation to a currency strategy would have been able to capture 94% of total returns while reducing volatility by 26%. In our view, a blended approach to managing currency risk can help investors navigate increasingly uncertain markets. With volatility of many asset classes rising, deploying currency hedging strategies may represent one way investors can enhance risk- adjusted returns.

[1]Source: Bloomberg, as of 11/30/14. [2]Refers to the three-month U.S. Treasury bill. Source: Bloomberg, 12/31/03–12/31/07. [3]Source: Bloomberg, as of 1/15/15. [4]Source: Bloomberg, as of 11/30/14.

Important Risks Related to this Article

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DEFINITIONS

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Currency risk : the risk that an investment will decline in value due to a change in foreign exchange rates.

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.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

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

Short-term rates : the rate of interest on a debt instrument maturing in two years or less.

U.S. 30-year bond : A debt obligation issued by the United States government that matures in 30 years.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Bullish : a position that benefits when asset prices rise.

Capital gains : Positive difference between the sale price of an asset and the original purchase price.

Risk-adjusted returns : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.