DOLLAR SENSITIVITY: THE NEW STYLE AND SIZE DEBATE

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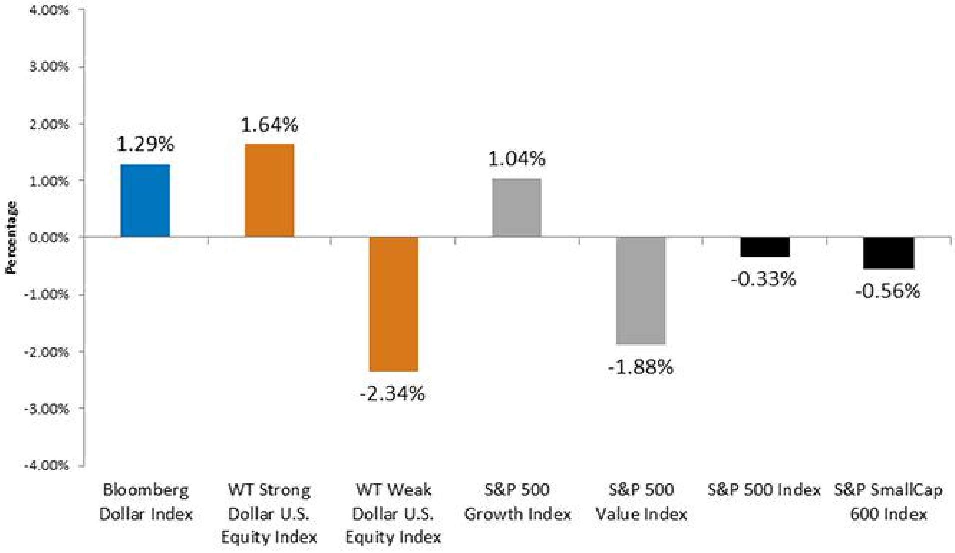
When making investment decisions, many are familiar with making allocation decisions between large and small caps or between growth and value stocks. These decisions to over- or under-weight different segments of the market are what drive relative returns, and depending on your allocation mix, the returns can be quite different. Recently, as a result of the divergence in central bank policies, investors have also had to take views on currency risk, with clear winners and losers. Increasingly, we have seen investors shift away from currency risk in the developed international markets—specifically Europe and Japan—and focus just on the equities through [currency-hedged](#) indexes. But what about the currency impact on domestic equities? **Currency Factor in U.S. Equities** Currency moves are not just important to foreign markets. In the U.S., we have also seen U.S. dollar strength impact stocks that are exposed to sales in foreign markets. It is widely known that a significant percentage of the revenues of U.S. companies in the [S&P 500 Index](#) comes from abroad. If the U.S. dollar continues to strengthen, this is likely to provide continued headwind for the companies with meaningful revenue from and business exposure in foreign markets. By contrast, if the U.S. dollar reverses, these firms should benefit. WisdomTree designed two new U.S. equity factor Indexes to help position investors according to their view of the U.S. dollar's direction. • **[WisdomTree Strong Dollar U.S. Equity Index (WTUSSD)](#)**– includes only firms that derive more than 80% of their revenues from the United States. These companies tend to be less impacted by a strong-dollar environment—they aren't focused on selling their goods and services abroad, and their import costs decrease with the dollar's rising [purchasing power](#). The Index also tilts weight more heavily toward stocks whose returns have a higher [correlation](#) to the returns of the U.S. dollar. • **[WisdomTree Weak Dollar U.S. Equity Index (WTUSWD)](#)**– includes only firms that derive at least 40% of their revenues from exports. These firms tend to be more impacted by a strong-dollar environment, as they are focused on selling their goods and services abroad. Similarly, during a weak-dollar period, we'd expect these firms to become more competitive in selling their goods abroad. The Index also tilts weight to stocks whose returns are more negatively correlated (or have a lower correlation) to the returns of the U.S. dollar. Below we compare the since-inception performance of the WisdomTree Dollar Indexes, as well as popular size and style indexes, to get a sense of divergence between factors. **Index**



Sources: WisdomTree, Bloomberg, 5/29/15–8/14/15. Past performance is not indicative of future results. You cannot invest directly in an index.

Performance *For definitions of indexes in the chart, visit our glossary.* • **Dollar Indexes Divergence:** we find the 3.98% divergence between WTUSSD and WTUSWD interesting, especially considering the short-term performance period. Despite that and the fact that analyzing just performance is not a robust statistical analysis, it seems there have been clear winners and losers, with WTUSSD coming out ahead. It is also interesting that the discrepancy is larger than the 2.92% difference between the S&P 500 Growth and S&P 500 Value, leading us to believe that the WisdomTree Dollar Indexes are offering differentiated exposures. • **Performance Differences between Size Indexes:** have been the smallest (at 0.23%) of the indexes shown above. The difference is interesting to us because we often hear that small caps should be impacted less by a strengthening dollar because their revenues are typically more domestically focused. We estimate the weighted average revenue from outside the U.S. at 19% and 38% for the S&P SmallCap 600 and the S&P 500 indexes, respectively. Again, the period is short and there could be other factors driving the returns, but it is something we will continue to monitor. **Can the Separation Continue?** One of the most important macroeconomic forces impacting the markets have been currency changes motivated by diverging monetary policies. If you believe the U.S. dollar will continue to strengthen over the coming years, as is WisdomTree's baseline view, this could provide the backdrop for continued divergence among U.S. equities. The degree or speed of the divergence is hard to predict, but we think it will be important to continue monitoring the performance differences for this new factor and look to provide commentary around any continued divergence.

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DEFINITIONS

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

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.

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.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

S&P 500 Growth Index : A market capitalization-weighted benchmark designed to measure the growth segment of the S&P 500 Index.

S&P 500 Value Index : A market capitalization-weighted benchmark designed to measure the value segment of the S&P 500 Index.

S&P SmallCap 600 Index : Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.