RETHINK YOUR INTERNATIONAL ALLOCATIONS

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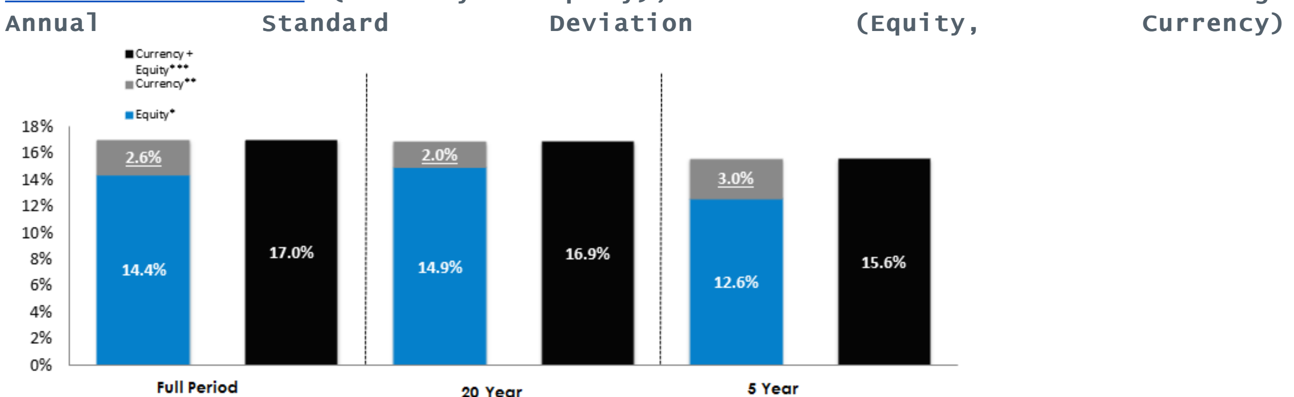
The latest weakness in the U.S. dollar has a number of investors re-examining the case for currency hedging their foreign equity portfolios. Many unhedged investors express thoughts like these: "See, there is a benefit to adding currency risk in my portfolio" and "This currency risk is all going to wash out in the long run, so why should I bother hedging, especially since I am likely to get the timing wrong to switch to a currency-hedged strategy?" The important philosophical portfolio question investors must determine is this: Is there really a long-run benefit to portfolios from betting that currencies such as the euro, yen and pound will always appreciate in value versus the U.S. dollar? The phrase "betting on currencies" is important to re-emphasize. There is no model that says the euro, yen and pound will *always and forever* appreciate in value versus the U.S. dollar. These currency exposures in unhedged strategies are thus *always* implementing a tactical bullish call on the euro, yen and pound versus the U.S. dollar. In 2016 and the last 12 months, the euro and yen have appreciated from their lows. My question to unhedged investors is this: Why is your call for the euro and yen to continue appreciating from here? If you cannot make a strong case to be bullish the euro or the yen, you should re-examine why you always layer it on top of your equity exposure. **International Equity Volatility (12/31/1969–3/31/2016) Average Annual Standard Deviation (Currency + Equity), Incremental Contribution to Average Annual Standard Deviation (Equity, Currency)**



Period	Volatility of MSCI EAFE in U.S. dollars (unhedged)	Volatility of MSCI EAFE expressed in local currency terms	Volatility of embedded EAFE currency exposure	Volatility increase attributable to currency	Correlation between currency and equity expressed in local terms
Full Period 12/31/1969 to 03/31/2016	17.0%	14.4%	8.4%	2.6%	0.04
Last 20 Years 03/31/1996 to 03/31/2016	16.9%	14.9%	7.4%	2.0%	0.05
Last 5 Years 03/31/2011 to 03/31/2016	15.6%	12.6%	6.6%	3.0%	0.24

Sources: WisdomTree, Bloomberg, as of 3/31/16.

For definitions of terms in the chart visit our glossary. I believe the long-run, strategic portfolio framework with the most sound underpinnings for international allocations incorporates one of two mindsets: 1) Strategically hedging currencies in the developed world as a baseline allocation all the time. This strategy, for broad baskets of international

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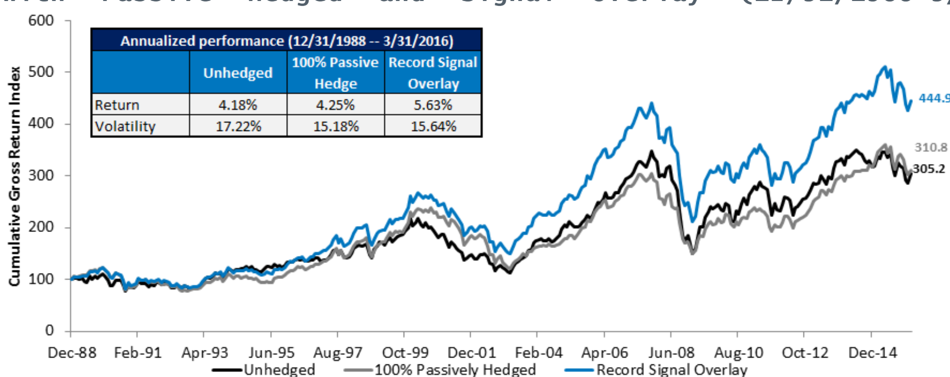
equities, can lower the volatility profile of international investing and means an investor does not have to worry about fluctuations in exchange rates. **Volatility Reduction:** Over the last 47 years, currency has added 260 basis points (bps) to the volatility of stocks in the MSCI EAFE Index, despite having nearly zero correlation to those stocks.[1] The evidence shows that, far from being an actual diversifier to a portfolio, foreign currency exposure is nothing more than a bet on foreign currencies appreciating in value. Sometimes the bet pays off, sometimes not. If an investor wants to eliminate the need to make any calls or bets on currency directions, strategically hedging currency risk all the time is the most natural approach to achieving this goal, in my opinion. *Note, I believe most investors still think of this backwards, claiming the decision to "currency hedge" is the "active bet" they must make. But remember, currency hedging just seeks to neutralize exposure so that a portfolio doesn't stand to benefit when the euro rises or doesn't get hurt when the euro falls.* 2) Dynamically Hedged currency exposure to adapt unhedged positions when hedging looks less attractive. Of course, there are times when foreign currencies will appreciate in value. But can you time those adaptive hedging moves yourself? Research we have conducted with Record Currency Management shows that it's possible to add value over passive hedging (or unhedging) all the time. Over the last 28 years, determining when to currency hedge using a three-factor model of interest rate differentials, momentum and currency valuations has added more than 140 bps annually to the returns of a broad international hedged-equity strategy while maintaining the vast majority of the volatility reduction of strategic passive hedging.[2] This research led us to offer a family of dynamic currency-hedged Indexes that represent this exposure for broad international allocations, European allocations and Japanese allocations. **Unhedged MSCI EAFE Index with Passive Hedged and Signal Overlay (12/31/1988–3/31/2016–USD Based)**



Annualized performance (12/31/1988 -- 3/31/2016)	Unhedged	100% Passive Hedge	Record Signal Overlay
Return	4.18%	4.25%	5.63%
Volatility	17.22%	15.18%	15.64%

Sources: WisdomTree, Record Currency Management, as of 3/31/16. Past performance is not indicative of future results. You cannot invest directly in an index.

Most investors remain unhedged for their broad-based allocations to the foreign large-cap asset class. To me, this is the least sensible and defensible strategy over the long run. We know currency adds to an investor's risk profile, and we believe there should be no "expected return" from these currencies (the "uncompensated risk" of currency). The case for currency hedging remains as strong today as ever. This case mostly relies on being able to achieve a potentially lower risk profile when investing internationally. The case is enhanced by the fact that the European and Japanese central banks have instituted negative interest rates, while the U.S. central bank is on a gradual glide path to raising interest rates. Far from being a cost to hedge the euro and yen, an investor is increasingly being paid interest rate differentials between the U.S. and the foreign central banks. The amount an investor is being paid to hedge using one-month forward contracts is approaching 75 bps in the euro area and almost 70 bps in Japan.[3] **On a Tactical Basis, Hedging Is Still Attractive** Interest rate differentials are perhaps the most powerful motivating force for long-run capital flows. The U.S. has among the highest interest rates in the developed world. In Japan, not only is there a negative short-term yield, the 10-year government bond has a negative yield. These low yields

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increasingly encourage Japanese corporations, pension funds and citizens to look for opportunities to earn higher yields around the globe. The U.S. is likely going to be a recipient of these flows for an extended period. While I remain tactically bullish on the dollar based on the longer-term trend in interest rates, it's not necessary to be a U.S. dollar bull to adopt currency-hedged strategies. An investor just needs to accept the proposition that currency adds to the risk profile of international investments for no expected long-term benefit. I believe that, as investors come to realize how much uncompensated risk they may be taking and that foreign equities could continue to look attractively priced compared to U.S. equities, investors may continue to shift portfolios toward either strategic or dynamic currency-hedged international strategies.

[1]Sources: WisdomTree, Bloomberg, as of 3/31/16. [2]Sources: WisdomTree, Record Currency Management, as of 3/31/16. [3]Sources: WisdomTree, Bloomberg, as of 3/31/16.

Important Risks Related to this Article

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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DEFINITIONS

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

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

Bullish : a position that benefits when asset prices rise.

Standard deviation : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

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

Basis point : 1/100th of 1 percent.

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.

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.

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.

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

1-Month Currency Forward : A binding one month contract in the foreign exchange market that locks in the exchange rate for the purchase or sale of a currency on the following one month.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

10-year government bond : a debt instrument backed by a government guarantee with an original maturity of 10 years.