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# DYNAMIC-FX-HEDGING-PERFORMANCE-SHOWS-ENCOURAGING-RESULTS

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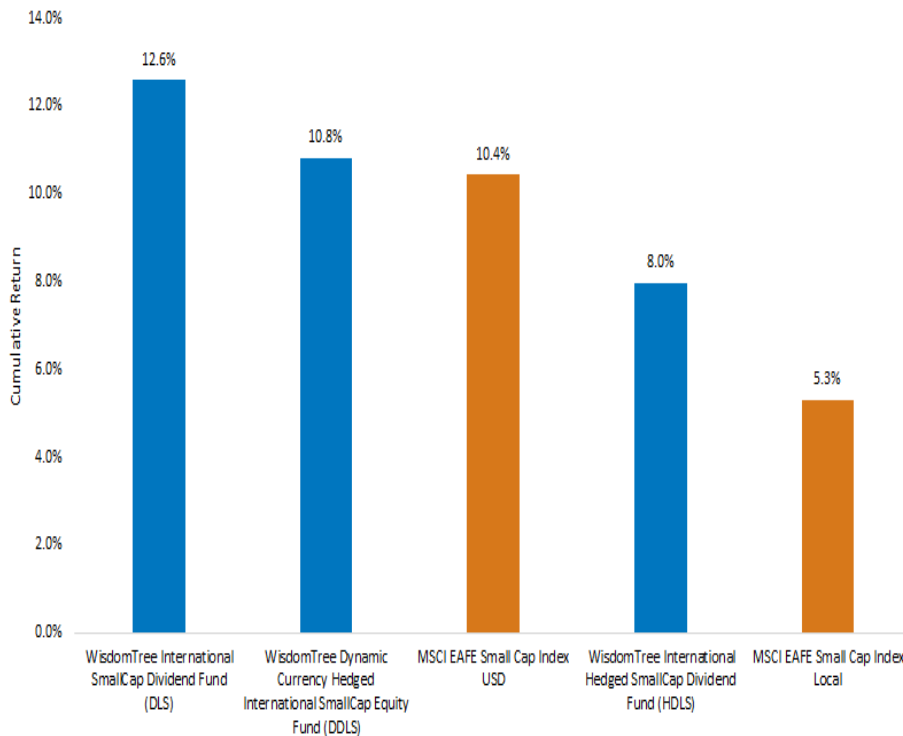
I have been focused on the [opportunities presented by international stocks](#) in some of our latest research. After a decade of U.S. equity market outperformance, [it may be time for the developed world to outperform](#) over the next decade. Once one decides to allocate more weight to international stocks, there are a number of important follow-on questions on implementation: Should one invest by region, tilt weight to various size segments, take foreign [currency risk](#)?

I have previously [profiled three versions of our international small-cap dividend strategy](#). The main idea: Ten years ago WisdomTree introduced the first international small-cap ETF in the U.S., but in the last two years we launched versions that offer a passive [currency hedge](#) to neutralize currency impact, and in 2016 a more dynamic process that aims to add value by adjusting the [hedge ratio](#) based on a multi-factor, [dynamic hedging](#) process.

We have nine months of real-time results for this international family of dynamically hedged ETFs, and we can evaluate how they've done during a period of perplexing currency moves and [volatility](#).

Below we show the results for the [WisdomTree Dynamic Currency Hedged International Small Cap Equity Fund \(DDL5\)](#) compared to the [MSCI EAFE Small Cap Index](#) in local currency and in U.S. dollars, along with fully hedged and unhedged versions of the same WisdomTree strategy.

International Small-Cap Equity Cumulative Returns (1/7/16-9/30/16)



Sources: WisdomTree, FactSet, Bloomberg, as of 1/7/16–9/30/16. You cannot invest directly in an index.

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](http://www.wisdomtree.com).

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

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.

Click each ticker for standardized performance of [DDL](#), [HDLS](#) and [DLS](#).

**Dynamic Hedging and WisdomTree [Dividend Weighting](#) Adding Value**

2016 has been a year when [dividend](#) weighting has helped add value over traditional [market cap weighting](#). On an unhedged basis, the WisdomTree International SmallCap Dividend Fund (DLS) has outperformed its benchmark by over 200 [basis points \(bps\)](#).<sup>1</sup>

In a year where [unhedged](#) strategies have beaten the local market returns by almost 5 percentage points, the dynamic currency-hedged version (DDL) has been able to almost keep pace with the unhedged strategy and outperform the local EAFE small-cap market return by over 550 basis points since its inception. This is showing value from adding currency exposure compared to the pure local market return, while helping to protect from the fall in value of one currency in particular: the British pound (GBP).

**Hedged GBP:** Our hedge ratio on the GBP has been 83.3% since 12/28/15, and this helped protect returns following the post-Brexit GBP collapse. Why did the dynamic process have an 83.3% hedge for the GBP heading into [Brexit](#)? The [momentum](#) and [interest rate](#) signals have both suggested a hedge for the GBP since the U.S. [hiked](#) its rates in December and U.S. investors were being paid a marginal amount to hedge the GBP, while the [value signal](#) has suggested a half-hedge. The GBP's decline in 2016 was one of its larger drops in history, and it is important to see that our hedging process was able to blunt the impact of its decline quite effectively—the exact goal of a hedging strategy.

**Gains in Currencies Such as the Yen:** While passive currency-hedged strategies could have been better served by being 100% hedged on the GBP—instead of the 83.3% of the dynamic model—dynamic hedging outperformed these hedged strategies so far in 2016, in large part because the yen has appreciated this year and dynamic hedging incorporated a 50% hedge ratio on the yen since late 2015, when the yen's momentum rolled over.

#### **Trend Toward FX Hedging Equities Still in the Early Innings**

Reiterating one of our core beliefs, in our view, developed world currencies offer higher expected risk levels with no expected return enhancement. Why would you accept these higher risk levels, unless you are good at timing when you want currency risk to be unhedged?

Adopting a dynamic approach with WisdomTree moves you away from subjective calls and into a disciplined, "[smart beta](#)" and factor approach to currency risk management. We believe our factors ("[carry](#)," "value" and momentum") bring potential to outperform both hedged and unhedged strategies over time by rotating currency hedges with their cycles.

DLS itself has a strong 10-year track record of delivering value added over its benchmark and peers in an unhedged format. With these latest additions, investors can target international exposure with increasing sophistication, and we think with prospects for a better risk/return experience over time.

<sup>1</sup>Source: Bloomberg, as of 1/7/16–9/30/16.

#### **Important Risks Related to this Article**

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The DDLS Fund invests in derivatives in seeking to obtain a dynamic currency hedge exposure. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. Derivatives used by the Fund may not perform as intended. A Fund that has exposure to one or more sectors may be more vulnerable to any single economic or regulatory development. This may result in greater share price volatility. The composition of the Index underlying the DDLS Fund is heavily dependent on quantitative models and data from one or more third parties, and the Index may not perform as intended. The Funds invest in the securities included in, or representative of, its Index regardless of their investment merit, and the Funds do not attempt to outperform their Indexes or take defensive positions in declining markets. Please read each Fund's prospectus for specific details regarding each Fund's risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

**IMPORTANT INFORMATION**

**U.S. investors only:** Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

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You cannot invest directly in an index.

## DEFINITIONS

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

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

**Hedge Ratio**: The specified percentage of currency exposure being hedged, with 0% indicating that none of the currency exposure is being hedged and 100% indicating that all of the currency exposure is being hedged.

**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.

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

**MSCI EAFE Small Cap Index**: A free float-adjusted market capitalization equity index that captures small-cap representation across developed market countries around the world, excluding the U.S. and Canada.

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

**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 term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

**Dividend**: A portion of corporate profits paid out to shareholders.

**Basis point**: 1/100th of 1 percent.

**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.

**Momentum Factor**: 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.

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

**Rate Hike**: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

**Value Signal**: Signal using purchasing power parity (PPP), an 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 in order to contribute to a view as to whether a currency might be under or overvalued.

**Carry**: The amount of return that accrues from investing in fixed income or currency forward contracts.