IS THERE A CURRENCY HEDGED SMART BETA ALTERNATIVE TO EAFE?

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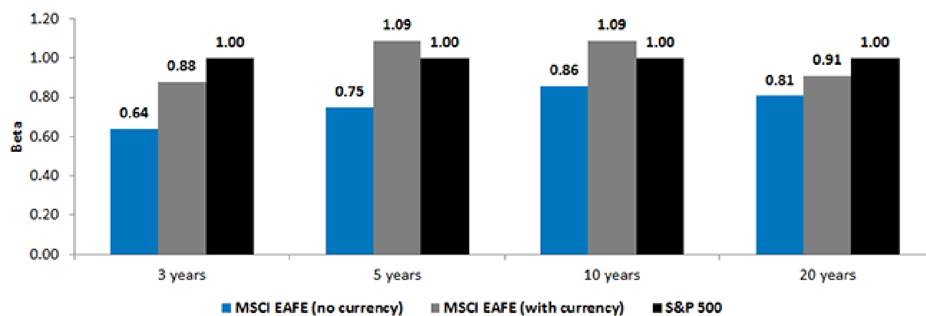
When I speak at investment conferences across the country, the subject of the clever but polarizing phrase "smart beta" often comes up. Once the obligatory comments are made about how much people hate the phrase or how hard it is to define, the conversation typically turns to the category of passive investment choices that the term attempts to summarize. For WisdomTree, when we talk about smart beta, what we are really talking about is a new generation of index-based products that empower investors to explore the core of their portfolios in an attempt to generate better risk-adjusted returns compared to traditional benchmarks. On the international front (EAFE), this means re-examining basic beliefs about whether to take on currency risk in an investor's core international equity exposure. In recent months, as the dollar has rallied dramatically against both the yen and the euro, interest has turned to strategies that give U.S.-based investors ways to own foreign stocks, while neutralizing foreign currency fluctuations that may move against them. This makes sense. Currency exposure is a separate and distinct source of risk in an investor's portfolio. Currency-hedged portfolios give investors a way to benefit from international equity performance without being penalized by—or rewarded for—movements in foreign currencies. Over the last 20 years, exposure to developed world currencies has not added to overall stock returns, although it has added volatility. By examining the historical returns of the MSCI EAFE Index —both with and without exposure to currency—we can examine what happens to the risk/return profile of international stocks when the currency impact is removed. In the table below, we see how significantly the beta of MSCI EAFE is reduced (in blue) when currency is removed from the equation.

Currency Consistently Added to Risk and Beta of International Stocks



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	Returns			Volatility Levels			Incremental Risk from Currency	Correlation Between EAFE Currency & S&P 500
	MSCI EAFE w/ Currency	MSCI EAFE No Currency	EAFE FX	MSCI EAFE w/ Currency	MSCI EAFE No Currency	EAFE FX		
12/31/69-5/31/15	9.1%	7.8%	1.2%	17.0%	14.4%	8.4%	2.6%	0.09
3-Year	15.6%	21.9%	-5.1%	10.8%	7.9%	5.5%	2.9%	0.37
5-Year	9.9%	11.6%	-1.5%	15.7%	11.1%	7.3%	4.6%	0.56
10-Year	5.6%	6.2%	-0.6%	18.2%	14.5%	7.6%	3.6%	0.46
20-year	5.2%	6.1%	-0.8%	16.6%	14.6%	7.5%	2.0%	0.21

Sources: WisdomTree, Bloomberg, as of 5/31/15. Past performance is not indicative of future results. You cannot invest directly in an index. Incremental risk: Difference in volatility between MSCI EAFE w/ Currency and MSCI EAFE No Currency. EAFE FX refers to the underlying currency exposure of the MSCI EAFE 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 terms and indexes in the chart, visit our glossary. If an investor had targeted the local returns of EAFE for the past three, five, 10 or 20 years, the returns would have been higher without the currency exposure than with it. Moreover, currency exposure added several percentage points of incremental volatility to international equity exposure in each period shown above, going back to 1970. And while having the currency exposure may have provided some diversification benefit several decades ago, the correlation between the EAFE currencies and the S&P 500 has been rising in the past decade compared to where it had been over the past 20 or 40 years. All this raises a question: Should investors be 100% *unhedged* in their core international equity exposure, especially given the low cost of hedging developed world currencies today with interest rates in Japan and Europe at or below 0%? One way to help generate higher risk-adjusted returns is by reducing overall volatility. The other is by generating returns that exceed those of a comparable cap-weighting index. In WisdomTree's case, we have been doing so with several of our broad-based Indexes that have some of the longest track records in the fundamentally weighted indexing space. **Smart Beta International Equities: Real-Time Results** For example, the WisdomTree DEFA Index, a broad measure of the dividend-paying segment of developed equity markets outside the U.S. and Canada, has outperformed the MSCI EAFE Index by 90 basis points (bps) on an annualized basis since its inception in June 2006 for more information on the WT DEFA Index, click to this recent blog post. For investors looking to access the same equity methodology of the WisdomTree DEFA Index while mitigating the impact of foreign currency movements, WisdomTree recently launched a currency-hedged version of the WisdomTree DEFA Index called the WisdomTree International Hedged Equity Index. The WisdomTree International Hedged Equity Index mitigates the impact of 12 distinct foreign currencies, and it does so with an estimated annual cost to hedge of just 0.13%. Because the Index of some 2,300 dividend-paying stocks is dividend weighted and rebalanced annually, it will have different country and sector weights than the MSCI EAFE Index. The International Hedged Equity Index also exhibits a higher trailing dividend yield–3.98% as of June 19, compared to a trailing dividend yield of 3.12% for the MSCI EAFE Index. **Conclusion: Creating Higher Risk-Adjusted Returns over Time Can Create Value for Investors** Using dividend-paying stocks and dividend weighting, the WisdomTree DEFA Index has helped to generate higher returns compared to the MSCI EAFE Index over the last nine years. If WisdomTree can reduce volatility even further by removing the impact of foreign currencies, the WisdomTree International Hedged Equity Index may represent a valuable tool for investors looking to push the efficient frontier even more to the north/northwest quadrant.[1] For investors interested in the strategy, the WisdomTree International Hedged Equity Fund is designed to track the performance of the WisdomTree International Hedged Equity Index before fees and expenses. [1]Describes the capability to potentially maximize returns for any given level of risk.

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DEFINITIONS

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

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

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.

EAFE : Refers to the geographical area that is made up of Europe, Australasia and the Far East.

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

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

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.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

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 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.

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.

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

Basis point : 1/100th of 1 percent.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.