

CURRENCY HEDGING AND VAULTING LOCATION: GOLD IN ALL ITS FLAVOURS

Gold is just Gold, right? Wrong! From buying the physical outright to being long a futures contract to buying exchange-traded commodities, there are many ways in which investors can get exposure to Gold. For each option you have sub-options. For example, exchange-traded commodities (ETCs) could be physical or synthetic; physical gold can be bought in various sizes with different premiums (due to size and location), and there are numerous futures markets with different contract terms. When it comes to ETCs, there is a bewildering choice of providers with varying features of products.

CHOICES, CHOICES, AND CHOICES

At WisdomTree we provide gold ETCs in all its flavours. From synthetic to physical, from short to leveraged exposure, we provide a variety because we acknowledge each investor's needs are different. Even within physically-backed gold ETCs, there are several options. There is a choice of where the metal is vaulted, and there is a choice of currency hedging.

A SELECTION OF WISDOMTREE'S PHYSICALLY-BACKED GOLD ETC PRODUCTS

	London Vaulted		Swiss Vaulted	
Unhedged	WisdomTree Core Physical Gold (WGLD)	JE00BN2CJ301 MER: 0.12%	WisdomTree Physical Swiss Gold (SGBS/GZUR)	JE00B588CD74 MER: 0.15%
	WisdomTree Physical Gold (PHAU/VZLD)	JE00B1VS3770 MER: 0.39%		
	Gold Bullion Securities (GBS/GG9B)	GB00B00FHZ82 MER: 0.40%		
Currency hedged	WisdomTree Physical Gold – GBP Daily Hedged (GBSP)	JE00B7VG2M16 MER: 0.15%		
	WisdomTree Physical Gold – EUR Daily Hedged (GBSE)	JE00B8DFY052 MER: 0.15%		

CURRENCY HEDGING

Some investors like to hold positions unhedged or hedge their entire portfolio separately outside of individual product decisions. Other investors are attracted to a currency hedge built into the product. Gold in US dollar terms appreciates when US dollar depreciates. But as sterling or euro-based investor, holding a gold position unhedged, one can miss out on some of gold's gains when the US dollar is depreciating. Even when an investor doesn't have a specific view on currency direction, currency hedging may simply remove an extra investment decision. After all, an unhedged position is like taking a commodity view plus a currency view.

VAULTING

London has a reputation for being the most liquid gold market in the world. With that can come the advantages of market depth and ease of trading. Spreads on trading can remain well contained as a result. Zurich is known as the second most liquid gold market in the world. Switzerland has a long history of political neutrality and safeguarding assets, which is seen by some as an advantage when thinking about where to vault a highly defensive asset like gold.

SWITCH TRADES

Our product range caters to all of these different needs. The advantage of having a menu of options doesn't stop there. Clients can decide to switch from one product to another through 'Switch Trades' if their investment objectives or needs change. When switching between ETCs with identical or similar exposure, clients can typically achieve the best execution by trading at over-the-counter (OTC) net asset value (NAV) convention.

Executing a switch trade in this manner has several potential benefits, including but not limited to:

- + Allowing clients to maintain intraday exposure
- + Reducing trading costs for clients not seeking to take a view on intraday market moves
- + Sell and buy legs of the trade executed at the same price, maintaining tracking and performance consistency

At WisdomTree, a dedicated capital markets team can help guide clients on making switches between products if this is their chosen course of action. With close market making contacts, our team can provide indicative pricing for any potential switches and walk a client through the process.

A ONE-STOP-SHOP FOR GOLD

Having a menu of options in the same ecosystem is useful. If a client's needs change, switching between products is usually more efficient than redeeming and creating afresh. Our capital markets team can assist on this process to make the experience as smooth as possible.

A DETAILED LOOK AT WISDOMTREE PHYSICALLY- BACKED CURRENCY- HEDGED GOLD ETC

The WisdomTree physically-backed Currency-hedged Gold ETCs are designed to offer security holders a simple, cost-efficient and secure way to access Physical Gold with currency hedging in different currencies. The products enable investors to gain exposure to the movement of Physical Gold spot price with a daily currency hedge against movements in the EUR/USD or GBP/USD exchange rates (less the applicable management fee and swap fee).

The ETC aims to offer the highest standards in terms of quality and safety:

- + 100% physically backed by gold bars held by a custodian where each physical bar is segregated, individually identified and allocated
- + Daily currency hedging with daily settlement of gain and losses – minimises tracking error and over-/under-hedging risks compared to traditional monthly hedging mechanism
- + Gold quality according to the London Bullion Market Association's (LBMA) rules for Good Delivery
- + Responsible gold – The ETC aims to allocate responsibly sourced gold bullion where possible, to promote high ethical standards for the ETC¹

WisdomTree ETCs deliver all these potential benefits to investors by tracking the relevant currency-hedged MS Long Gold Index that applies a classic daily foreign exchange (FX) hedge overlay on the London Bullion Market Association's gold position.

For transparency purposes, the index value is calculated every day using the gold price of the 3 pm London Bullion Market Association (LBMA) Afternoon Auction and FX forward and spot prices to reflect the currency hedging overlay. The costs from WisdomTree in the ETC are therefore the management fee and swap fee.

¹ In 2012, the London Bullion Market Association (LBMA) implemented its Responsible Gold Guidance. This is a mandatory framework for all Good Delivery listed refiners wishing to sell into the London Bullion Market designed to combat money laundering, terrorist financing and human rights abuses globally.

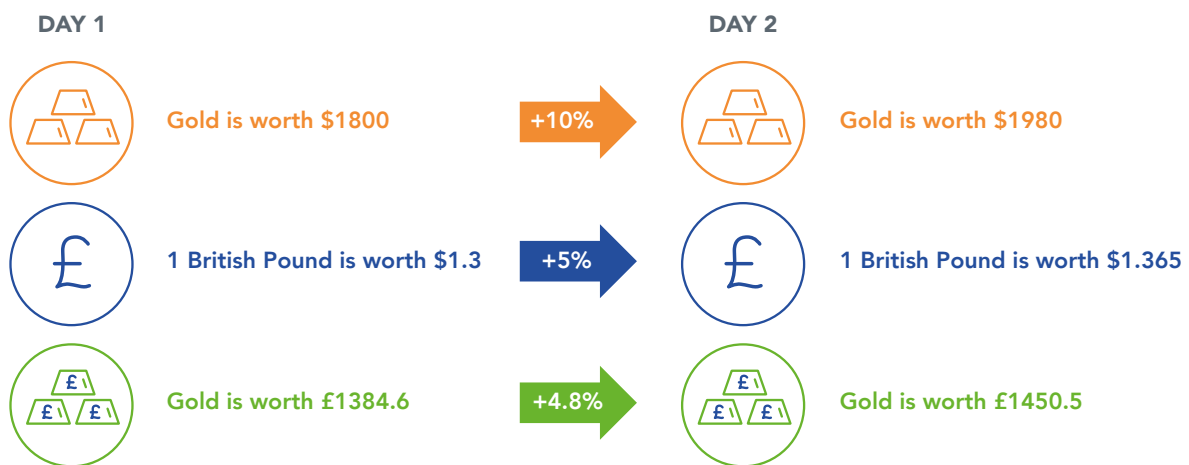
WHY HEDGE CURRENCY MOVEMENTS?

The currency-hedging objective aims to protect clients’ gold investment, which is usually denominated in US dollars, from the exchange rate fluctuations between the client’s currency of choice and the US dollars².

Without currency hedging, a euro-based (respectively sterling-based investor) in gold would be impacted by gold’s movement in US dollars as well as the euro’s movements (respectively the British Pound) versus the US dollars. As illustrated in Figure 1, if over a given day, gold is up 10% (in US dollars), but the British pound strengthens by 5% against the US dollars on the same day. At the end of the day, a sterling based investor in gold would have benefitted only from a 4.8% rise (in British pounds). The movement of the British pound versus the US dollar has counterbalanced the increase in Gold. Currency hedging allows removing most of the FX movements out fo the equation.

This type of situation is not an exception. The US dollars and Gold have historically been negatively correlated, so in most cases, the currency will dampen gold moves for non US dollar-based investors. Therefore, when the price of one ounce of gold in US\$ is up, on average, the currency-hedged investment captures more of that increase.

FIGURE 1: AN EXAMPLE OF THE BEHAVIOUR OF AN UNHEDGED GOLD INVESTMENT



Source: WisdomTree. For illustrative purposes only.

HOW DOES CURRENCY-HEDGING WORK?

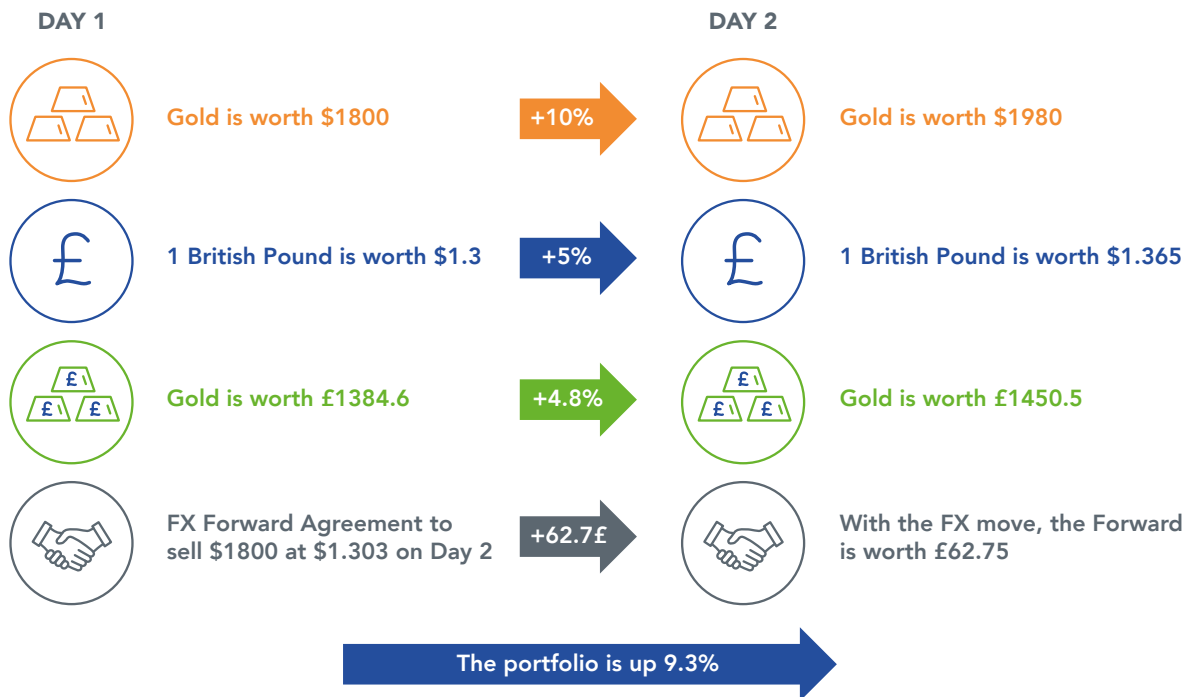
There are multiple ways to hedge an asset against currency risk. The most common, especially in investment products, is to use FX Forwards. FX Forward are a contractual agreement between a buyer and a seller to exchange a set amount of currency versus another currency at a pre-agreed rate on a future date. In effect, they allow investors to “lock-in” exchange rate and protect against future movement in the currency.

Taking our example above, we can add an FX forward to illustrate how this would change the investment’s behaviour.

On Day 1, we assume that on top of its investment in gold, our sterling-based investor also enters into an FX forward with a maturity of a day (up to day 2) that allows him to sell \$1800 at a pre-agreed price of \$1.303 per British pound. On Day 2, because the exchange rate is now worth \$1.365, the FX forward is worth $\$1800 \times (1/1.303 - 1/1.365)$, i.e. £62.75. So the overall investment is now worth £1513 on Day 2. An increase of 9.3%. The result is a lot closer to the 10% performance of gold in US dollars.

² Additional fees may apply. Investors should speak to their broker/adviser to determine the full impact of any fees.

FIGURE 2: AN EXAMPLE OF THE BEHAVIOUR OF A GOLD INVESTMENT HEDGED WITH FX FORWARD



Source: WisdomTree. For illustrative purposes only.

However, it is not equal to 10%. There is still residual noise coming from 2 primary sources:

1. The FX forward rate is not equal to the FX spot rate. There are costs embedded in an FX forward which are going to impact the performance of the product. In the above example, it is the difference between \$1.3 and \$1.303
2. The notional of the FX forward has to be set when entering the contract while the amount of US dollars to hedge will only be known at the maturity of the contract. The difference between the notional of the FX forward (\$1800 in the above example) and the value of the asset to be hedged (\$1980 in the above example), remains unhedged

The FX forward rate is determined around a parity relationship among the spot exchange rate and differences in interest rates between the two relevant countries, reflecting an economic equilibrium in the foreign exchange market plus a bid/ask spreads charged by the seller (i.e. the bank). The spot rates and FX forward rates used in the Morgan Stanley indices and therefore in the WisdomTree Gold ETCs are observed on fixings.

However, the forward rate still differs from the spot rate due to the differential between the two relevant interest rates creating sometimes a drag and sometimes a lift to the portfolio depending which country pays the higher short term rate.

WHY USE DAILY HEDGING COMPARED TO MONTHLY HEDGING?

In short, the objective is to minimise the noises described above and, in particular, the noise coming from the approximation around the notional value.

When entering the FX forward, the longer the instrument’s maturity, the larger the probability that the notional will differ significantly from the asset’s real value to hedge. The gold price will, in all likelihood, have moved more in a month than in a day. So, by rolling FX forward every day, we minimise the portion of the investment that remains unhedged or over hedged.

Similarly, for the forward rate itself, when entering into an FX forward, the seller (usually a bank) takes a risk, and that risk increases with the maturity. So the longer the maturity of the FX forward, the larger the cost that may be incurred. For both reasons, WisdomTree uses a daily hedging mechanism.

Furthermore, until maturity, an FX forward has a mark to market value which by definition is not invested in gold. Using daily FX forwards, and settling the profit and loss (PnL) resulting from those FX forwards maturing at the end of each day makes sure that gold physically backs the ETC's totality.

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