IMPLEMENTING "EFFICIENT CORE" PORTFOLIOS

Scott Welch – Chief Investment Officer, Model Portfolios,Bradley Krom – U.S. Head of Research,Joseph Tenaglia – Director, Model Portfolios
05/16/2022

This article is relevant to financial professionals who are considering offering Model Portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

WisdomTree introduced the idea of "efficient core" portfolios last fall. Given today's rapidly changing market regime, it is time for an update.

First, a quick reminder of the structure behind our capital efficient suite of individual products (using NTSX as the example). Put simply, if you have $100 to invest, you can invest $67 of it into NTSX and have the equivalent exposure to $100 worth of an S&P 500/Treasury portfolio, leaving you with $33 left to explore more alpha-seeking, yield-seeking or diversifying exposures within your overall portfolio.

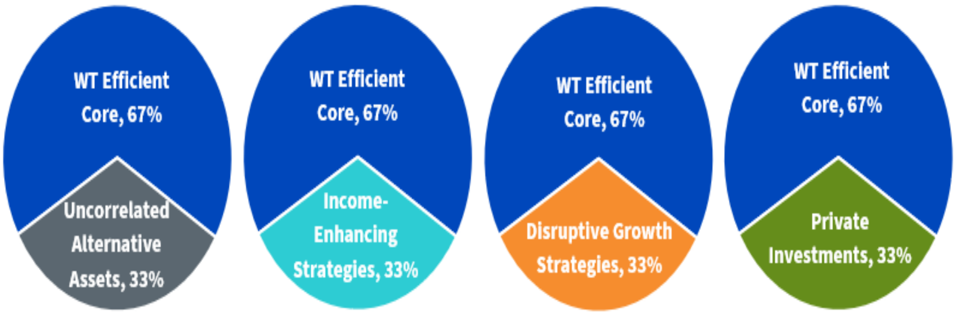
How the Capital Efficient Strategies Are Constructed

- **Equity component:** For every $100 invested in the ETF, $90 is invested in equity exposure via the WisdomTree U.S. Efficient Core Fund (NTSX). The equity component is a portfolio of 500 large-cap U.S. stocks, weighted by market capitalization to provide broad exposure to U.S. equities.
- **Cash component:** For every $100 invested in the ETF, $10 is held in short-term collateral that earns returns comparable to U.S. Treasury bills.
- **Bond futures ladder:** To help magnify the potential benefits of the asset allocation, $60 of bond futures are overlaid on top of the $90 of equity exposure and $10 of cash collateral.
    - Treasury futures are laddered (equal-weighted) across the 2-, 5-, 10- and 30-year segments of the yield curve to diversify interest rate risk.
    - The average effective duration for the fixed income portion of NTSX is typically 7–7.5 years and is meant to offer the duration profile of traditional aggregate bond indexes.

In addition to NTSX, the other strategies currently available in our Efficient Core suite include NTSI (the EAFE version of NTSX), NTSE (the EM version), GDE (a gold plus equity version) and GDMN (a gold plus gold miners version).

In that introductory blog post from last fall, we provided some hypothetical examples of how advisors might allocate the freed-up capital.

1. Uncorrelated alternative assets to reduce volatility and/or add in additional potential sources of return.
2. Income-enhancing strategies to boost incremental yield on top of a 100% portfolio.
3. Maximum growth satellites to allocate to longer-term thematic and high-growth industries, sectors and firms.
4. Private investments for longer-term growth allocations.

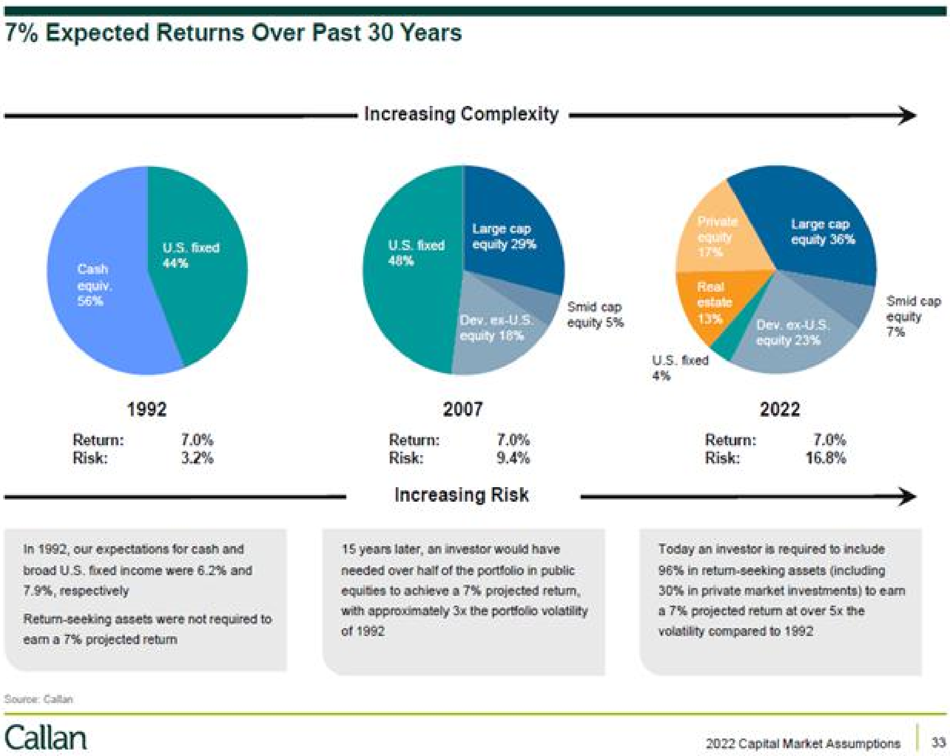


Why Now for Efficient Core Portfolios?

We seem to be at the beginning of a market regime that is different than most advisors have experienced in a long time—where it is not enough to simply allocate to long stocks and bonds to deliver the appropriate investment experience. U.S. and global stocks, as well as bonds, are down sharply year-to-date, so using just bonds to hedge equity risk is not working.

Given our view on rates (they will continue to rise), inflation (higher for longer than the consensus view) and what we believe will be consistently higher volatility in equity markets, we think this regime may be with us for quite some time.

From a longer-term perspective, meeting defined investor objectives with specific asset allocations has changed dramatically. Consider this chart, which is updated annually by investment consultant Callan Associates, based on their own capital market assumptions.



Assume the investment objective was an annualized 7% return. According to Callan's analysis, that objective could have been met in 1992 with a simple allocation to cash and bonds, resulting in an annualized standard deviation of 3.2%.

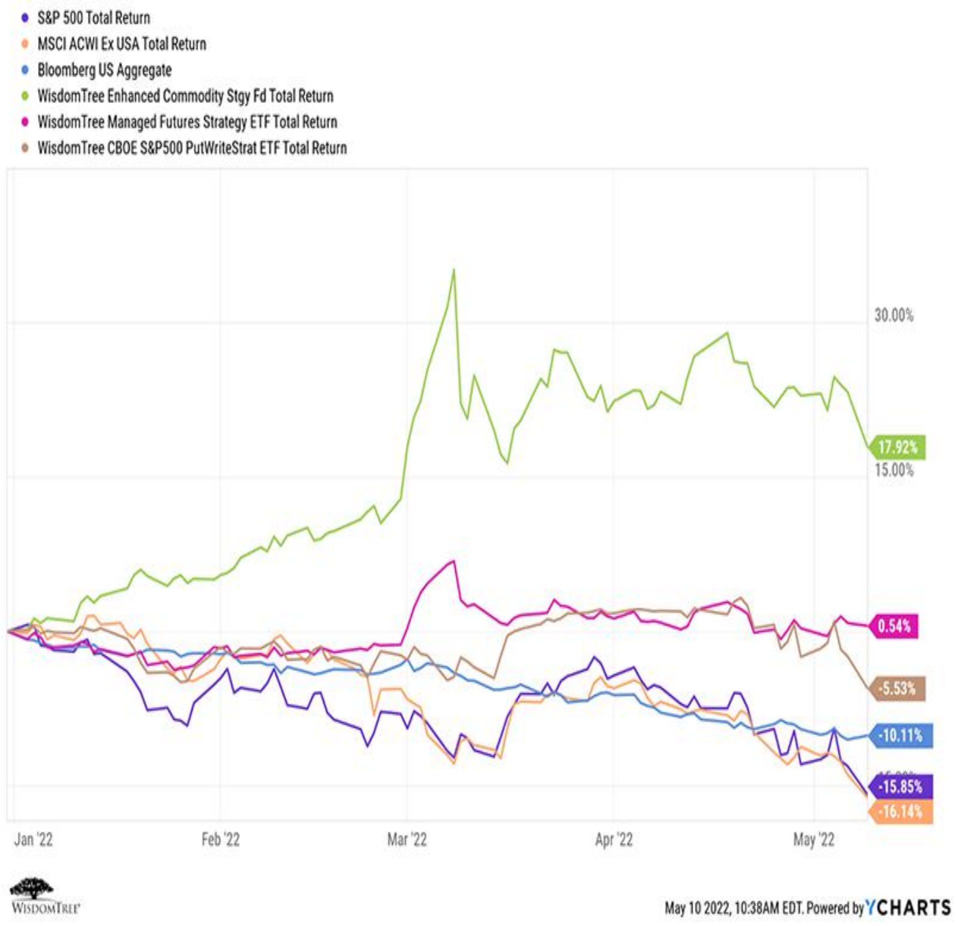
In 2007, 15 years later, the same return target would have required an allocation to global equities and bonds, resulting in a standard deviation of 9.4% (three times that in 1992).

Roll forward to 2022 and that same 7% return target requires an allocation to global equities, private investments and real estate, resulting in a standard deviation of 16.8% (roughly five times that in 1992).

In other words, it might benefit advisors to consider additional portfolio allocations to meet long-term client objectives. We certainly are receiving more inbound enquiries asking some variation of the question, "What else might I put into client portfolios, beside stocks and bonds?"

But how to fund them? Let's consider one simple hypothetical example, where the investment objectives are to hedge inflation and increase diversification within the portfolio.

Take a look at the YTD performances of (a) U.S. large-cap equities (as measured by the S&P 500), (b) large-cap non-U.S. equities (as measured by the MSCI ACWI ex-U.S.), (c) U.S. bonds (as measured by the Bloomberg Aggregate), (d) a global commodities strategy (using our own GCC at NAV), (d) a managed futures strategy (using our own WTMF at NAV) and (e) a variation of a hedged equity strategy that capitalizes on higher volatility (our own PUTW at NAV).[1]



Source: YCharts, YTD data through 5/9/22. You cannot invest in an index and past index performance does not guarantee future results. In this chart, the "WisdomTree Enhanced Commodity Strategy" trades under the ticker GCC, the "WisdomTree Managed Futures Strategy" under the ticker WTMF and the "WisdomTree CBOE S&P 500 PutWrite Strategy" under the ticker PUTW. **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.** 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.

For the most recent standardized performance, click the respective ticker: GCC, WTMF, PUTW.

The YTD performance differential between the core equity and bond exposures and the diversifying strategies is stark. Using the capital efficient strategies (NTSX and/or NT

SI and NTSE) and using the freed-up capital to allocate to these diversifying strategies may have dramatically improved both overall performance and the inflation-hedging profile of the portfolio.[2]

This is just a simple hypothetical example. The opportunities to "explore" appropriate allocations for the freed-up capital are almost limitless and completely dependent on the investment objectives for the overall portfolio.

A final thought is this—many advisors have been hesitant to make reallocations within their clients' portfolios because of unrealized capital gains, the result of a remarkable multi-year bull rally in both stocks and bonds.

As bad as this year has been for most allocations, the result is the ability to make portfolio reallocations while minimizing realized gains, or perhaps even capturing tax losses that can offset gains elsewhere in the portfolio (i.e., "tax alpha," which is real money back into the end clients' pockets).

Conclusions

We think the time has come to explore the possibilities of building efficient core portfolios. The market regime has changed and both advisors and clients are investigating innovative ideas.

One of the age-old questions we have always received as advisors is, "I like the idea of including non-core stocks and bonds into my portfolio, but how do I fund them?" We believe the efficient core portfolios can—well—efficiently address that question. You can still implement the core portfolio without having to pick and choose how to fund the portfolio satellite positions.

The primary point is the use of the WisdomTree Efficient Core suite of portfolios opens possibilities for advisors and investors to build truly customized portfolios in a highly capital-efficient manner, without sacrificing an underlying allocation to a traditional stock/bond portfolio.

[1] We use all WisdomTree strategies in this example for simplicity purposes. In actuality, all actual WisdomTree Model Portfolios are "open architecture" and contain both WisdomTree and third-party strategies.

[2] This is a hypothetical example for illustration purposes only and does not represent actual investment advice. Past performance does not guarantee future results.

resources advisors may consider, in providing services to their end clients. WisdomTree's Model Portfolios and related content are for information only and are not intended to provide, and should not be relied on for, tax, legal, accounting, investment or financial planning advice by WisdomTree, nor should any WisdomTree Model Portfolio information be considered or relied upon as investment advice or as a recommendation from WisdomTree, including regarding the use or suitability of any WisdomTree Model Portfolio, any particular security or any particular strategy. In providing WisdomTree Model Portfolio information, WisdomTree is not acting and has not agreed to act in an investment advisory, fiduciary or quasi-fiduciary capacity to any advisor or end client, and has no responsibility in connection therewith, and is not providing individualized investment advice to any advisor or end client, including based on or tailored to the circumstance of any advisor or end client. The Model Portfolio information is provided "as is," without warranty of any kind, express or implied. WisdomTree is not responsible for determining the securities to be purchased, held and/or sold for any advisor or end client accounts, nor is WisdomTree responsible for determining the suitability or appropriateness of a Model Portfolio or any securities included therein for any third party, including end clients.

Advisors are solely responsible for making investment recommendations and/or decisions with respect to an end client and should consider the end client's individual financial circumstances, investment time frame, risk tolerance level and investment goals in determining the appropriateness of a particular investment or strategy, without input from WisdomTree. WisdomTree does not have investment discretion and does not place trade orders for any end client accounts. Information and other marketing materials provided to you by WisdomTree concerning a Model Portfolio—including allocations, performance and other characteristics—may not be indicative of an end client's actual experience from investing in one or more of the funds included in a Model Portfolio. Using an asset allocation strategy does not ensure a profit or protect against loss, and diversification does not eliminate the risk of experiencing investment losses. There is no assurance that investing in accordance with a Model Portfolio's allocations will provide positive performance over any period. Any content or information included in or related to a WisdomTree Model Portfolio, including descriptions, allocations, data, fund details and disclosures, are subject to change and may not be altered by an advisor or other third party in any way.

WisdomTree primarily uses WisdomTree Funds in the Model Portfolios unless there is no WisdomTree Fund that is consistent with the desired asset allocation or Model Portfolio strategy. As a result, WisdomTree Model Portfolios are expected to include a substantial portion of WisdomTree Funds notwithstanding that there may be a similar fund with a higher rating, lower fees and expenses or substantially better performance. Additionally, WisdomTree and its affiliates will indirectly benefit from investments made based on the Model Portfolios through fees paid by the WisdomTree Funds to WisdomTree and its affiliates for advisory, administrative and other services.

Neither diversification nor asset allocation strategies assure a profit or protect against loss.

Neither WisdomTree Investments, Inc., nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax advice. All references to tax matters or information provided in this blog are for illustrative purposes only and should not be considered tax advice and cannot be used for the purpose of avoiding tax penalties. Investors seeking tax advice should consult an independent tax advisor.

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.

Related Blogs

+ And Now for Something Completely Different

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.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

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.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

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.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Collateral : something pledged as security for repayment in the event of a loss.

Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).

Inflation : Characterized by rising price levels.

Bond : A fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental).

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.

Stock : A stock (also known as equity) is a security that represents the ownership of a fraction of a corporation. This entitles the owner of the stock to a proportion of the corporation's assets and profits equal to how much stock they own. Units of stock are called "shares."

MSCI ACWI ex-U.S. Index : A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets excluding companies based in the United States.

Bloomberg Aggregate Bond Index : The Bloomberg Aggregate Bond Index or "the Agg" is a broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance.