ALTERNATIVE UNIVERSE: COME SAIL AWAY

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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.

A gathering of angels
Appeared above my head
They sang to me this song of hope
And this is what they said

(They said) come sail away, come sail away
Come sail away with me (lads)
Come sail away, come sail away
Come sail away with me…

I thought that they were angels
But much to my surprise
We climbed aboard their starship
We headed for the skies

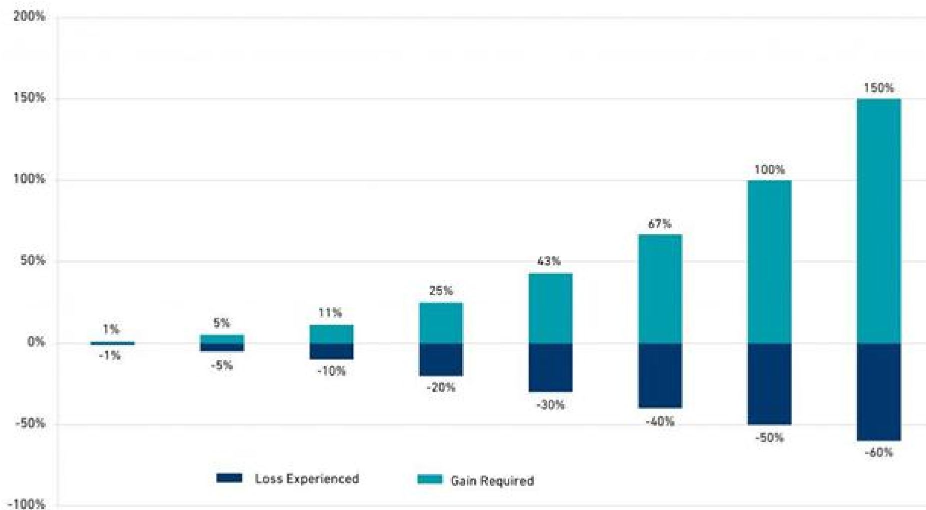
(Singing) come sail away, come sail away
Come sail away with me (lads)
Come sail away, come sail away
Come sail away with me…

(From "Come Sail Away," by Styx, 1977)

As we mentioned before, advisors are showing an increased interest in including lower-correlated (i.e., alternative) strategies in their client portfolios. The current virus-induced market disruptions and corresponding increased volatility have reminded advisors of the value of building more diversified portfolios in an attempt to improve consistency. It has been a very long time since the *rule of compounding* needed to be remembered—that is, if you don't lose as much in down markets, you don't need to gain as much in up markets to still come out ahead in the long run, because of the power of compounding:

The Power of Compounding

WisdomTree®



Source: 361 Capital, 4/18. For illustrative purposes. Gain Required represents the investment return required break even after experiencing a loss.

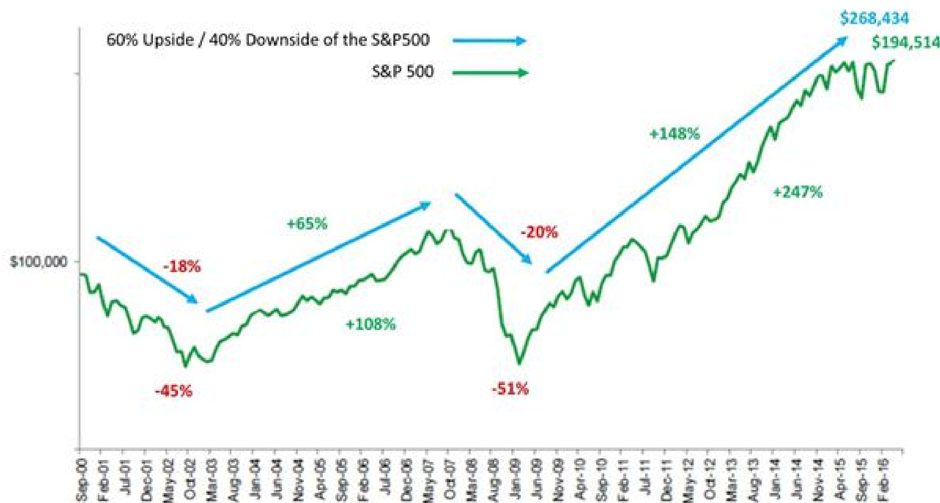
We have also written about [the importance of focusing on the long term]() when investing in a portfolio. Are we contradicting ourselves?

We don't think so, and the reason is *investor psychology* and *investor behavior*. It is not that the market has not always recovered from downturns over different periods of time—it has. But in disruptive markets many investors find it <u>very</u> difficult to maintain the discipline required to realize long-term recoveries.

This is where lower-correlated strategies can make a difference. By improving the consistency of performance (go up less in up markets but, more importantly, lose less in down markets), many investors find it easier to maintain discipline with their long-term plans. This has potentially powerful cumulative effects:

Why Limiting Volatility (Downside Risk) is So Important

S&P 500 performance versus 60% upside / 40% Downside Capture (8/31/00-9/30/16)



Source: Crestmont and Morningstar as of 9/30/16. Past performance does not guarantee or indicate future results.

Source: Linden Investment Consultants, data through 9/30/16. This is for illustration purposes only. You cannot invest in an index. Past performance does not guarantee future results.

For definitions of terms in the chart, please visit our [glossary]().

Alternative investments cover a wide variety of strategies: equity [long]()/[short](), [event-dri]()

ven, global macro, managed futures, short-biased, arbitrage, market neutral, and others. The commonality among them is that they do not simply rely on stock or bond beta to generate performance. This is precisely why they tend to have lower correlations to traditional markets.

Historically, these strategies were found primarily in hedge funds and were available only to qualified purchasers[1]. Following the "Great Financial Collapse," the market saw an avalanche of mutual funds and, more recently, ETFs that seek to deliver these strategies to more retail investors.

It is important to note that some of these strategies depend on illiquidity and/or leverage to generate performance. As such, not all alternative investment strategies lend themselves to the mutual fund or ETF structure.

At WisdomTree, we offer an explicit **Volatility Management** model portfolio to help advisors do exactly this—create a more diversified overall portfolio for their clients and hopefully improve the consistency of performance. This model is part of our **Outcome-Focused** category of model "sleeves" designed to solve for very specific investment objectives.

The "Vol Man" model is very straightforward. It currently consists of equally weighted positions in four ETFs. Despite the small number of holdings, we believe it delivers a nicely diversified lower-correlated allocation to broader portfolios:

1. **One of the ETFs** runs a long-short equity portfolio that can be considered a low beta or even "short-biased" strategy.
2. **A second ETF** strategy engages in merger arbitrage—that is, going long on companies being acquired and going short on companies that are acquiring in an attempt to capture the (typical) price movements of both companies as the deal moves toward closing.
3. **The WisdomTree CBOE S&P 500 PutWrite Strategy Fund (PUTW)**: As the name suggests, PUTW goes long on the S&P 500 Index and then sells put options against that Index. The premium earned helps to partially offset a downturn in the Index. As such, it is a form of "hedged equity."
4. **The final ETF strategy** runs a different form of hedged equity. It holds primarily long-dated U.S. Treasuries (the most traditional "hedge" to the equity markets), and then complements that position with long-dated call options (LEAPS) on the S&P 500 Index.

The positions in this model have reasonably low correlation to each other and, when combined, fairly low correlation to traditional stocks and bonds. So, the addition of this portfolio sleeve to a more traditional stock and bond portfolio has the potential to improve the diversification of the overall portfolio.

When markets go straight up, as they did for most of the past 10 years, people can lose sight of the value of diversification. But with a potentially new, more volatile market regime upon us, we believe better diversification can be a powerful tool in helping investors to maintain their investment discipline and advisors to deliver a more differentiated investment experience.

[1]Qualified purchasers can be either family-owned companies or individuals who own at least $5 million in investments. Qualified purchasers may also be entities or individuals who invest a minimum of $25 million in private capital on other people's behalf or for their personal financial accounts.

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There are risks associated with investing, including the possible loss of principal. Diversification does not eliminate the risk of experiencing investment losses. Using an asset allocation strategy does not ensure a profit or protect against loss.

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You cannot invest directly in an index.

DEFINITIONS

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.

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

Diversification : A risk management strategy that mixes a wide variety of investments within a portfolio.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Short (or Short Position) : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

Macro : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

Managed futures : An alternative investment strategy in which futures contracts are used as part of the investment strategy.

Arbitrageur : A person who attempts to profit from price inefficiencies in the market by making simultaneous trades that offset each other and seek to capture a risk free profit.

Market neutral : Strategy that seeks to avoid market risk by hedging a percentage equal to total long exposure.

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.

Illiquidity : The state of a security or other asset that cannot easily be sold or exchanged for cash without a substantial loss in value. Illiquid assets also cannot be sold quickly because of a lack of ready and willing investors or speculators to purchase the asset. The lack of ready buyers also leads to larger discrepancies between the asking price (from the seller) and the bidding price (from a buyer) than would be found in an orderly market with daily trading activity.

Merger Arbitrage : An event-driven investment strategy that involves exploiting pricing inefficiencies that exist between markets for the same security after a company merger or acquisition, in order to generate a profit.

Put options : an option to sell assets at an agreed price on or before a particular date.