HOW TO MANAGE RISING VOLATILITY

Gaurav Sinha – Associate Director, Asset Allocation and Modern Alpha
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Markets are hard, and experienced investors usually do not confuse lack of volatility with stability. Markets are inherently volatile, which can lurk behind the prevailing calm.

The bigger question is: How should an investor deal with rising volatility?

One way of reducing systematic risk is by decorrelating your portfolio to major asset classes by using a multiasset long/short exposure.

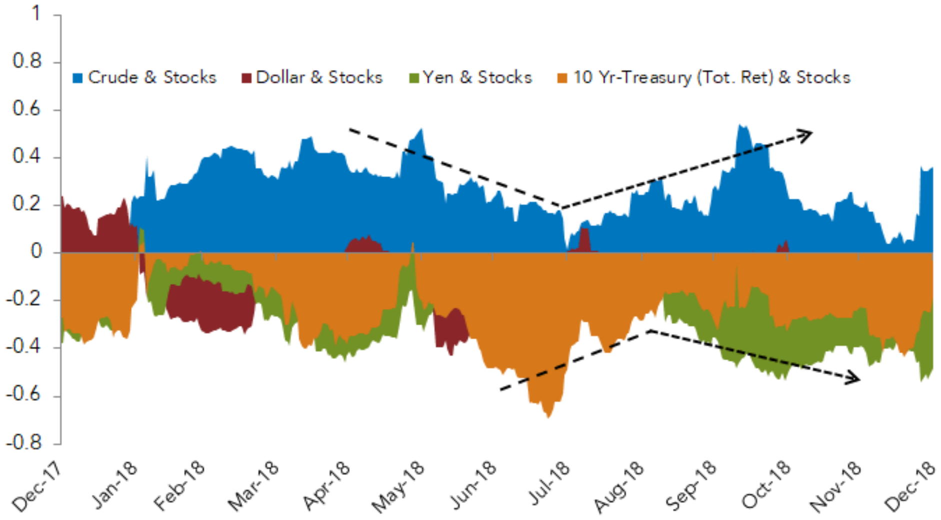
Below, I highlight a multiasset long-short strategy that aims to reduce beta, with a key exception.

Spiking Correlations in Times of Stress

Last year was a wild ride for stocks. Big swings meant cross-asset correlations got stronger.

Rising Correlations Post Brexit Fears

60-Day Rolling Asset Correlations



Source: Bloomberg. Period covered is 12/31/17–12/31/18. Past performance is not indicative of future results. Universe for the chart above consists of WTI crude oil, S&P 500 for stocks, U.S. dollar and Japanese yen for currencies and U.S. 10-Year Treasuries. You cannot invest directly in an index.

Two patterns are obvious:

- Cross-asset correlations were high last year.
- After a period of cooling off, there was jump in stock correlations across these four major assets.

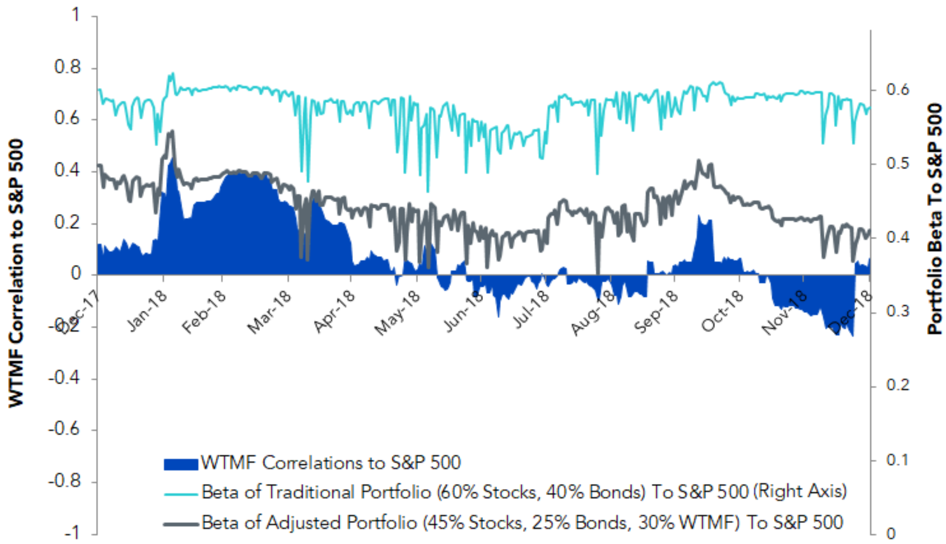
Jittery markets usually increase correlations across assets. That makes it hard for investors to remain diversified.

Multiasset Long-Short Solution to Lower Portfolio Beta

The [WisdomTree Managed Futures Strategy Fund (WTMF)] seeks to provide total returns in volatile markets, uncorrelated to the averages. It does this by going both long and short in various commodities, [interest rates] and currencies.

The chart below shows WTMF in 2018 consistently had near-zero correlations (blue area, left axis), even during the volatile fourth quarter, when most asset classes correlated.

WTMF's Diversification Lowering Beta of a Traditional 60/40 Approach



Source: Bloomberg. Period covered is 12/31/17–12/31/18. Past performance is not indicative of future results. You cannot invest directly in an index. In the traditional and adjusted portfolios, stocks are represented by the S&P 500 and bonds are represented by the Bloomberg Barclays Capital U.S. Aggregate Bond Index.

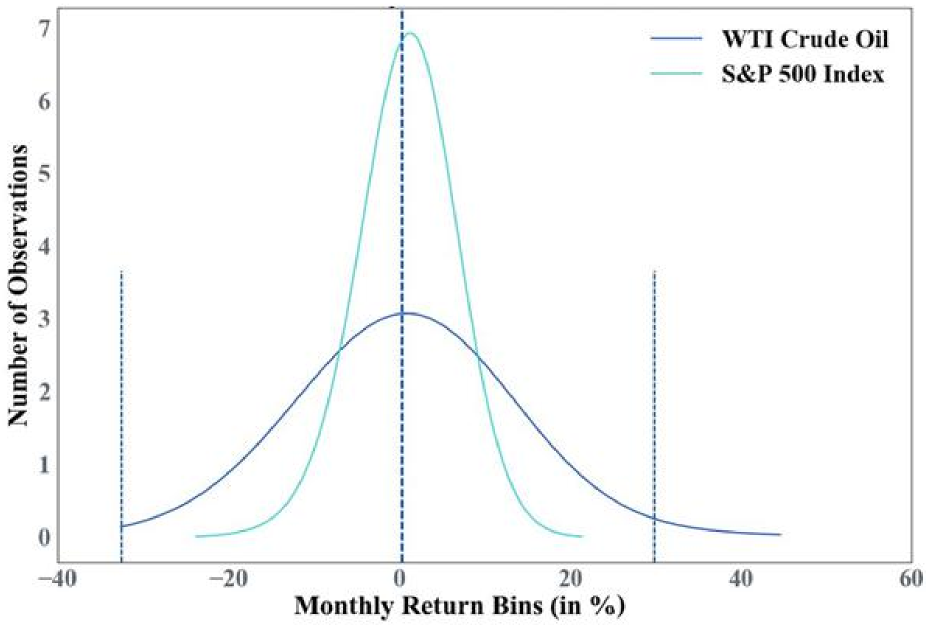
Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

For definitions of terms in the chart please visit our [glossary].
Please click [here] for standardized performance of WTMF.

There are two dozen [futures contracts] that the underlying index of WTMF monitors every month across commodities, interest rates and the energy complex. It then bets long or short in each, based on its set of signals. The exception is energy. This is a key differentiator of our managed futures approach compared with a lot of our competitors. In WTMF, energy is always either long or neutral—it doesn't short energy contracts, even if the signal says so. It does this because energy has significant geopolitical risk, which is uncertain and hard to predict.

Beyond just economic intuition, this tendency of the asset class to melt up is evident in its skewed distribution of its monthly returns, which have an asymmetric long right tail.

Monthly Return Distribution



Source: Bloomberg. Period covered is 2/29/1988–12/31/2018. Past performance is not indicative of future results.

The chart above compares the monthly distribution of S&P 500 and oil futures returns. Compared with the S&P 500, which has a relatively symmetric distribution, oil has a long right tail, implying a tendency of that asset class to melt up rather than melt down. Thus, to mitigate any potential losses due to an unexpected positive run up in oil, our managed futures fund, WTMF, avoids shorting oil even if trend signals are bearish; it simply goes net neutral in such a scenario. The same is true across other future contracts such as natural gas, gasoline, heating oil, etc., in the energy complex, which also shows similar melt-up tendencies as demonstrated by oil above.

Conclusion

Our managed futures strategy, WTMF, can be a great way to help reduce portfolio beta. It uses a quantitative, rules-based strategy giving market neutral allocation that reduces overall correlations and has built-in checks and balances to reduce risk within individual asset classes.

We think WTMF could be one answer to the age-old search by investors for an investment solution that offers total returns with lower volatility and higher diversification, especially during stressful times in the markets.

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Diversification does not eliminate the risk of experiencing investment losses.

There are risks associated with investing, including possible loss of principal. An investment in this Fund is speculative, involves a substantial degree of risk and should not constitute an investor's entire portfolio. One of the risks associated with the Fund is the complexity of the different factors that contribute to the Fund's performance, as well as its correlation (or noncorrelation) to other asset classes. These factors include use of long and short positions in commodity futures contracts, currency forward contracts, swaps and other derivatives. Derivatives can be volatile and may be less liquid than other securities and more sensitive to the effects of varied economic conditions. The Fund should not be used as a proxy for taking long-only (or short-only) positions in commodities or currencies. The Fund could lose significant value during periods when long-only indexes rise (or short-only) indexes decline. The Fund's investment objective is based on historic price trends. There can be no assurance that such trends will be reflected in future market movements. The Fund generally does not make intramonth adjustments and therefore is subject to substantial losses if the market moves against the Fund's established positions on an intramonth basis. In markets without sustained price trends or markets that quickly reverse or "whipsaw," the Fund may suffer significant losses. The Fund is actively managed; thus, the ability of the Fund to achieve its objectives will depend on the effectiveness of the portfolio manager. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of WTMF please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/alternative/wtmf

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.

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You cannot invest directly in an index.

DEFINITIONS

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

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.

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.

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

Futures/Futures Contract : Reflects the expected future value of a commodity, currency or Treasury security.

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.