DID WE FORGET ABOUT DIVERSIFICATION AGAIN?

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When building strategic allocations, most investors start with a belief that it is not good to have all your eggs in one basket. But over time, without a proper rebalancing framework, portfolios drift due to momentum and new allocations often incorporate a recency bias (i.e., based on recent performance).

This recency bias—prior to market events of the last few weeks—led some investors to be over-weight in the U.S. equity market and avoid traditional portfolio "diversifiers." With volatility picking back up, it is a good time to review whether portfolios are properly diversified.

The managed futures asset class made a name for itself in 2008 when it provided downside protection during one of the worst sell-offs in history. When making new investments the first few years after the crisis, everyone always seemed to ask "what was the performance in 2008?" because the pain from that year was still fresh. Fast forward a few more years, and the question became "what was the performance since the low?" because people became more focused on keeping up with the strong upward returns.

It had been around 400 days since the S&P 500 Index saw a 5% pullback and 500 days since there was a 10% correction, allowing markets to compound higher and pushing volatility to record lows.[1] It's no surprise that looking at the performance of a low or negatively correlated asset class against equities in a strong bull market might lead you to conclude there is no longer a need for that asset class, but the recent sell-off might have reminded people again about the importance of diversification.

The WisdomTree Managed Futures Strategy Fund (WTMF) seeks to achieve positive total returns that are not directly correlated to broad equity or fixed income markets and to profit in rising or falling markets. This is achieved through an investment mechanism that can go long or short in a basket of commodities, interest rates and currencies. WTMF uses a quantitative composite momentum framework to determine whether to go long/short an asset class and resets its exposure on a monthly basis. It also employs risk controls by removing the most volatile contracts and scaling the positions based on conviction of the composite momentum framework.

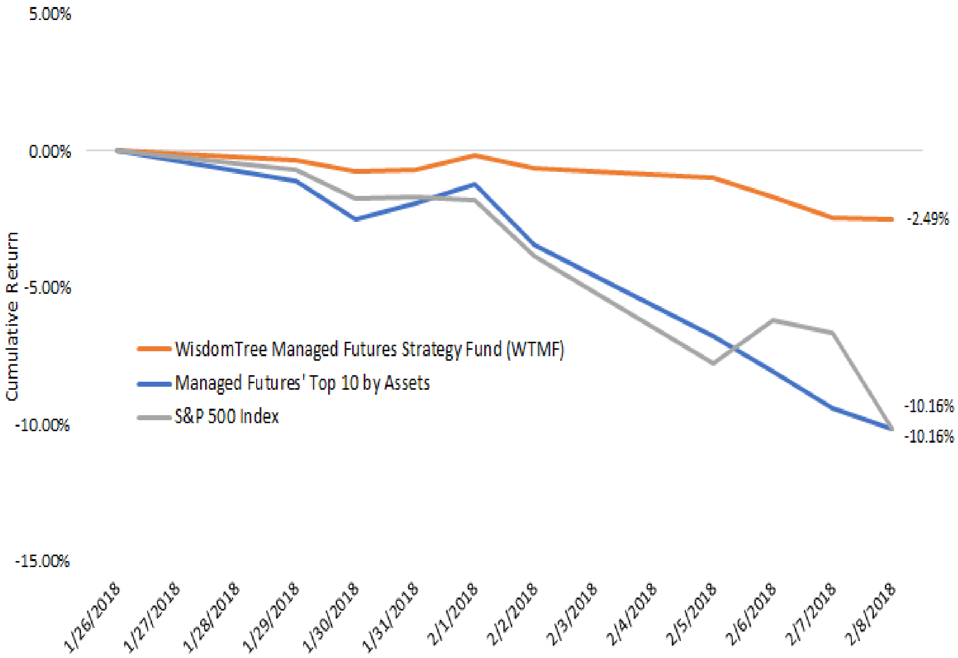
The managed futures asset class is broadly defined and processes may differ between strategies, but one major difference between WTMF and some of its largest competitors regards the inclusion of equity futures. WTMF does not include equity futures as part of its allowable universe, as we felt that it could potentially increase correlations to equity markets at a time you least want that. This can be most evident during a sharp equity reversal, like we experienced recently, in which a trend-following strategy can't adjust quickly enough and is caught on the wrong side of the trade.

In the chart below, we look at the recent performance of WTMF versus the average performance of the 10 largest competitors in the Morningstar U.S. Managed Futures Category. As you can see, many of the largest funds failed to provide adequate downside protection relative to the S&P 500 Index.

The largest managed futures funds had average declines over these two weeks that mirrored the S&P 500 returns, showing a high beta to equities.

And although WTMF was not positive, it substantially outperformed its peers and the equity markets, which is what we would expect during quick market corrections.

Performance During Recent Market Correction



Sources: WisdomTree, Bloomberg, Morningstar, for the period 1/26/18–2/8/18. 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. Performance data for the most recent month-end is at the standardized performance link below. You cannot invest directly in an index. Period chosen to represent a 10% correction in the S&P 500 Index. Managed Futures' Top 10 by Assets represents the daily average performance of the top managed futures funds by strategy assets in the U.S. Managed Futures Morningstar Category. © Morningstar, Inc., 2018. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance, rankings and ratings are no guarantee of future results. As noted in the document, here is the short-term performance disclosure: a fund's performance, especially for very short time periods, should not be the sole factor in making your investment decision.

For standardized performance of WTMF, click here.

Recently, we wrote about the recent uptick in managed futures performance due to its ability to capitalize on recent trends in oil, currency and interest rate markets. This recent pull back provides another example why this strategy might make sense for those looking to increase their diversification and downside protection.

[1]Sources: WisdomTree, Bloomberg, as of 2/8/18.

Important Risks Related to this Article

Diversification does not eliminate the risk of experiencing investment losses.

There are risks associated with investing, including the possible loss of principal. An investment in this Fund is speculative and involves a substantial degree of risk. 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 non-correlation) 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 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. 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.

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You cannot invest directly in an index.

DEFINITIONS

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

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

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

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.

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.

Bullish : a position that benefits when asset prices rise.

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).

Composite Momentum Framework : is a framework that incorporates three momentum signals across different time horizons to create a composite momentum signal.