

TRYING TO REASON WITH HURRICANE SEASON

Scott Welch — Chief Investment Officer, Model Portfolios
09/14/2023

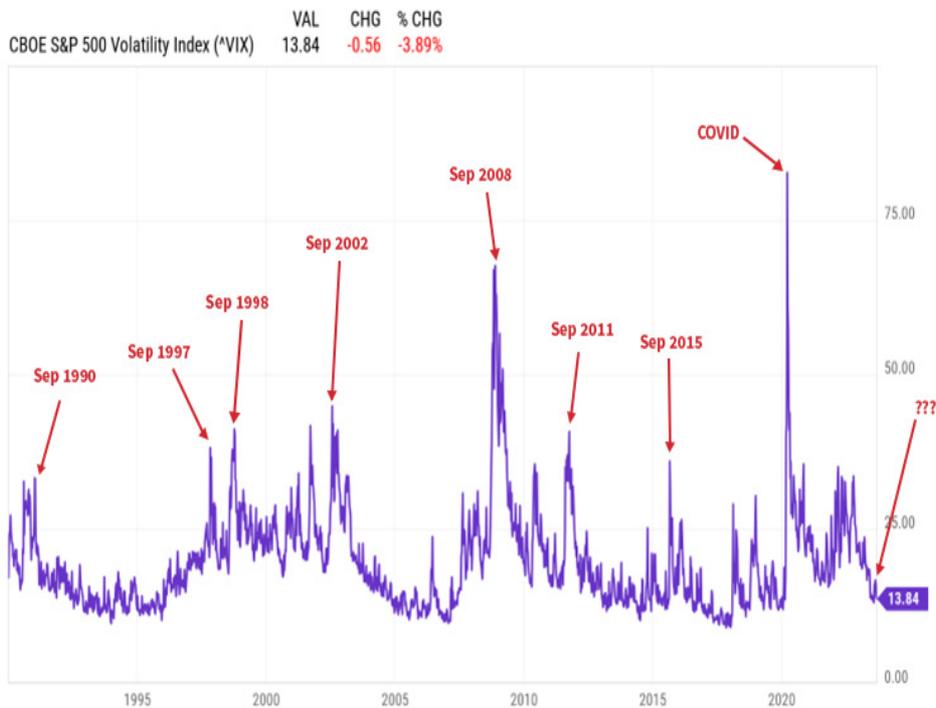
*And now I must confess
I could use some rest
I can't run at this pace very long
Yes, it's quite insane
Think I hurt my brain
But it cleans me out, then I can go on...*

(From "Trying to Reason with Hurricane Season" by Jimmy Buffett, 1974)

I certainly will miss Jimmy Buffett and his live summer concerts ("Parrot Heads" Forever!). It does seem fitting that if he had to pass away, it would be at the end of summer.

But Labor Day has now passed here in the U.S., and that historically has meant "hurricane season" weather-wise in the southeast U.S., as well as the proverbial "hurricane season" with respect to market [volatility](#).

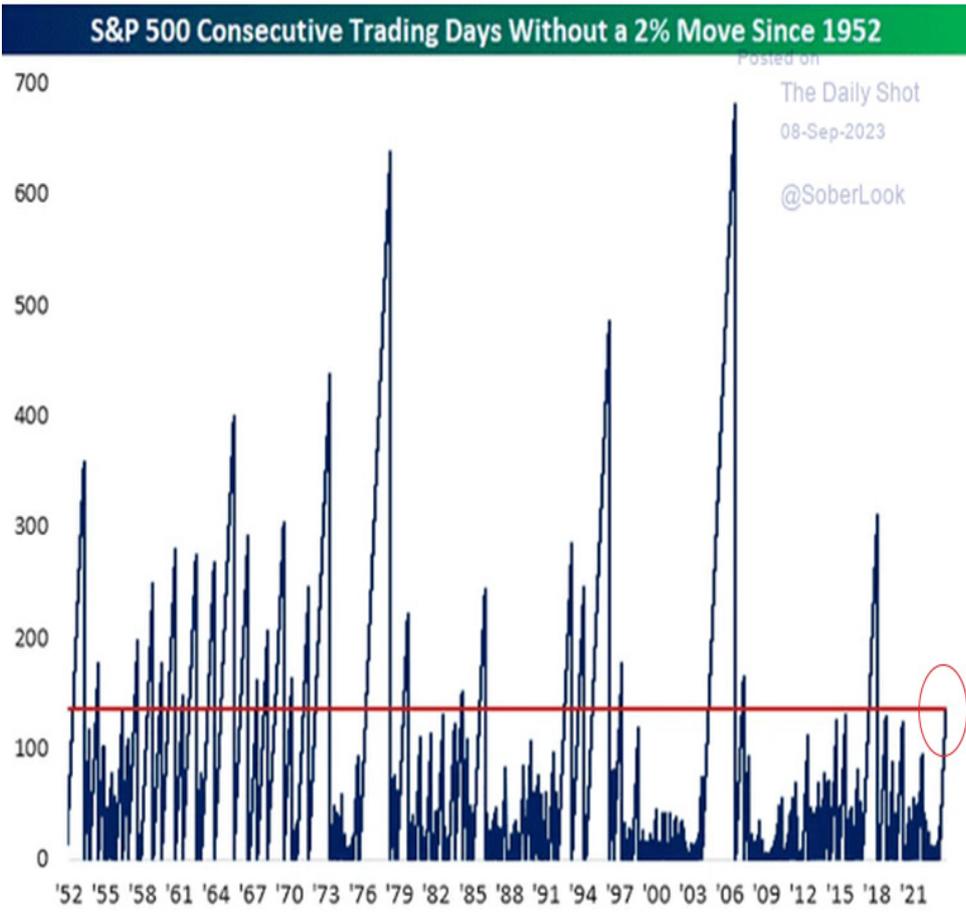
Let's take a look. By historical standards, the market seems frighteningly complacent...



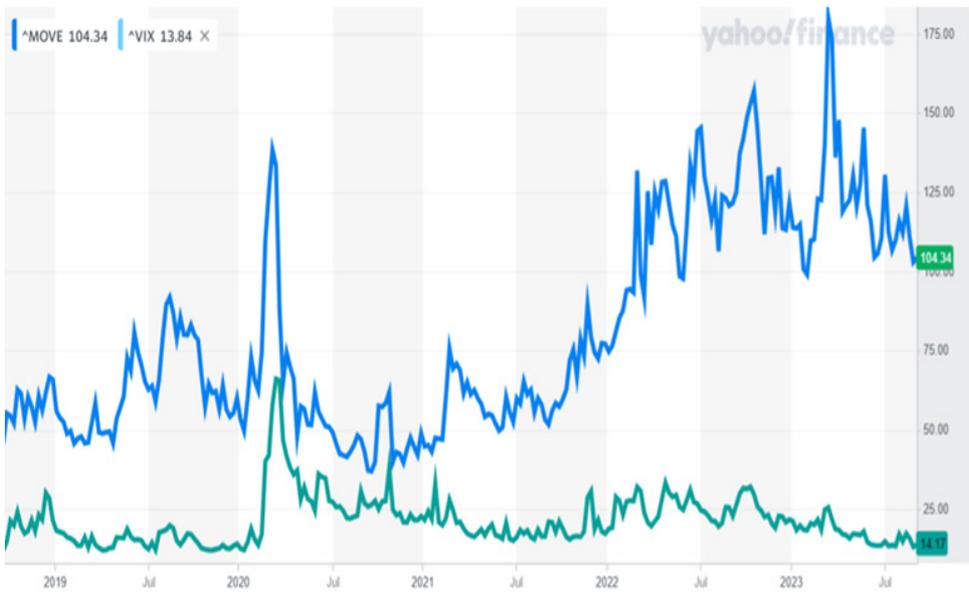
Sep 08 2023, 4:34PM EDT. Powered by [YCHARTS](#)

Source: YCharts: 1/2/90-9/7/23. You cannot invest in an index, and past performance does not guarantee future results.

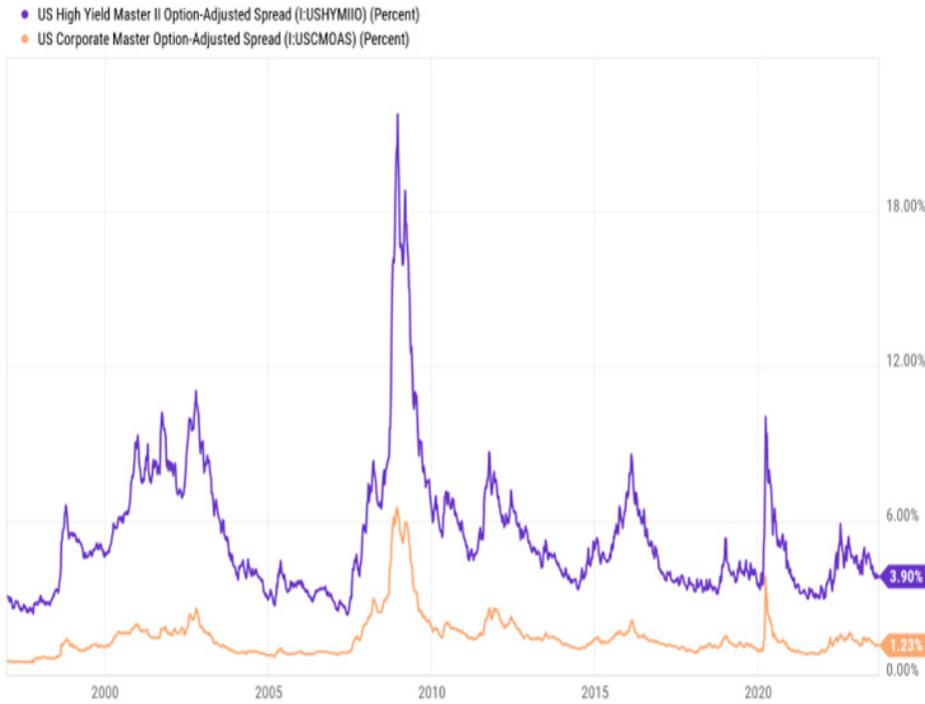
Another way to illustrate this is to measure how many consecutive trading days there have been without a 2% daily market move. The current market is as "quiescent" as it has been since before COVID-19 hit.



At the same time, bond market volatility (as measured by the [ICE BofAML MOVE Index](#)) has moved steadily higher since early 2021 because of uncertainty over economic growth, [inflation](#) and [Fed](#) policy.



Finally, while we've seen volatility in the underlying rate market, [credit spreads](#) continue to trade well within their historical levels as bond investors, despite rising default rates and a steady flow of new issuance, seem to be comfortable with the overall strength of corporate [balance sheets](#).



Sep 11 2023, 11:42AM EDT. Powered by YCHARTS

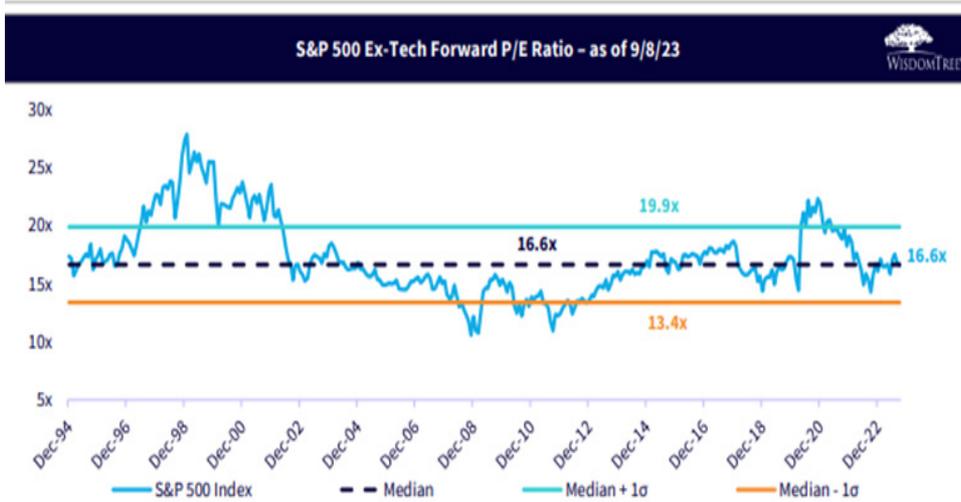
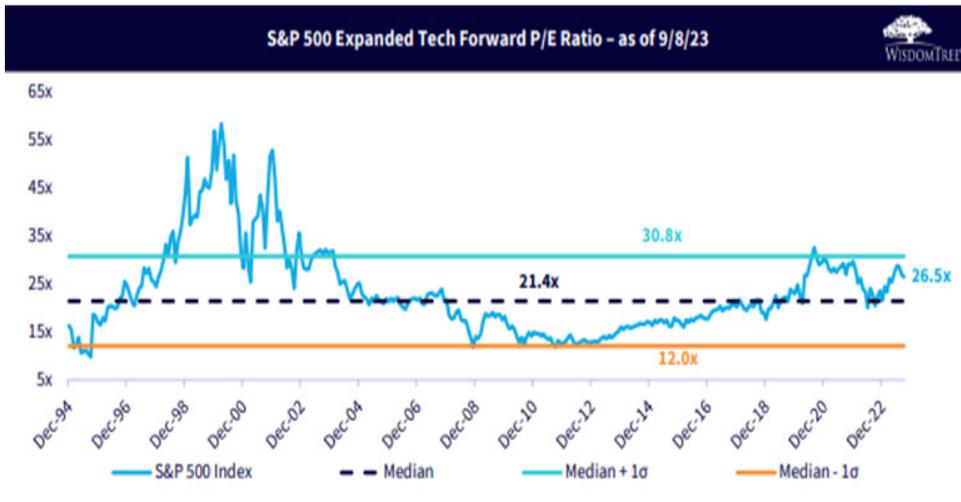
Source: YCharts, data through 9/8/23. You cannot Invest In an Index, and past performance does not guarantee future results.

So, What Should Advisors and Investors Be Thinking About?

While not every fall season (i.e., September through November) is marked by increased volatility, it happens frequently enough to be mindful of it. People are back at work and paying attention, and the markets are trading at higher volumes. We believe this fall will be no different. The markets strike us as very complacent in the face of uncertain economic conditions, rising rates, still-uncertain Fed policy and simmering geopolitical tensions.

In addition, as noted in my last blog post ([“Sing Me a Song of Valuation”](#)), U.S. equity market performance this year has been dominated by a small handful of high-flying [mega-cap](#) tech stocks, fueled by current investor fascination with [artificial intelligence \(“AI”\)](#).

These handful of stocks constitute roughly 25% of the entire S&P 500 market capitalization and have driven an overwhelming percentage of market performance. Consequently, they are trading at frothy valuations far higher than the rest of the market.



Sources: WisdomTree, FactSet, S&P. You cannot invest directly in an Index, and past performance does not guarantee future results. Historical forward P/E measured since 12/31/94. Expanded Tech includes the Information Technology sector, Interactive Home Entertainment subindustry, Interactive Media & Services subindustry, Amazon, eBay, Etsy and Netflix. Ex-Tech excludes the Expanded Tech companies.

Unfortunately, many of these high-priced stocks are the ones most at risk with rising interest rates and rising market volatility. If the market finds itself in another fall “hurricane season,” we may witness precipitous declines in some of these names, and because of their heavy market caps, any declines will reverberate across the entire Index performance, potentially dragging down more reasonably priced stocks as investor sentiment “rolls over” from “greed” to “fear.”

We are not offering this scenario as a “pound the table” conviction—economic growth may continue to rise, earnings may support higher market valuations, inflation and Fed policy may become more transparent, and momentum and investor sentiment can keep market rallies alive well past any contrary signals from underlying fundamentals.

But if advisors and investors want to potentially reallocate or at least develop contingency plans, here are some ideas.

1. Remember that “Quality Is Job One”. Our research suggests that quality is the most consistently performing risk factor (in comparison to [growth](#), [value](#), [size](#), [momentum](#), dividends, etc.)—it is rarely the best- or worst-performing factor over reasonable periods (e.g., a rolling 10-year horizon).

Quality can be defined in many ways, but we prefer to use as our starting point the “[DuPont Analysis](#)”, which defines quality companies as those with superior profitability (and therefore dividend sustainability), balance sheets, cash flow and operational efficiency compared to their industry peers. It makes sense intuitively that companies with these characteristics should be able to better withstand changing economic and market regimes, especially if sentiment turns negative.

Many of our products and most of our Model Portfolios use quality as the anchor risk factor and then we diversify across the others, depending on the product or model mandate.

2. Diversify. This seems to be an obvious comment, but as we’ve seen this year, sometimes investors can “fall in love” with certain stocks or markets and then “extrapolate now into forever,” assuming market conditions won’t or

can't change quickly, and they can just continue to ride their current winners. History has proven time and again this can be a very costly mistake, and this is why we diversify our Model Portfolios at both the asset class and risk factor levels.

We believe this gives the best potential to deliver consistent performance regardless of underlying market conditions or economic regimes. Remember the power of compounding—if you don't lose as much in down markets, you don't have to gain as much in up markets to still come out ahead. It can also reduce investor anxiety and, therefore, make it easier to stick to the long-term investment plan.

3. Consider allocating to less-traditional strategies or asset classes. Within certain of our models, we allocate to strategies like [floating rate Treasuries](#), [managed futures](#), [option-based strategies](#) and [global commodities](#). In addition to other characteristics like income generation or duration control, what these strategies have in common is their lower-correlation profiles in comparison to long stocks and bonds. In times of rising volatility, they can be effective diversifiers within an overall portfolio.

Conclusions

The time to plan for a hurricane is before it hits—once it does, it typically is very difficult to “reason” with. Jimmy Buffett may have been writing and singing about the weather in South Florida when he wrote “Trying to Reason with Hurricane Season,” but advisors and investors can benefit by applying some of the same lessons to their portfolios:

Well, the wind is blowin' harder now

Fifty knots or thereabouts

There's white caps on the ocean

And I'm watchin' for water spouts

It's time to close the shutters

It's time to go inside

[RIP and Godspeed, Jimmy...you brought smiles to millions of faces for more than 50 years, and somewhere out there in paradise, there are a cheeseburger and a margarita waiting for you.]

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.

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

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

ICE BofAML MOVE Index (MOVE) : A measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

Inflation : Characterized by rising price levels.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Artificial intelligence : machine analysis and decision-making.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.