COMPLEMENTING AN EFFICIENT CORE STRATEGY WITH MANAGED FUTURES

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A traditional 60/40 portfolio aims to provide investors with exposure to equities with downside mitigation through an allocation to Treasuries.

Historically, the practice of incorporating additional Treasury exposure to help hedge an equity portfolio has worked well, due to correlations between Treasuries and the S&P 500 Index being low or negative most of the time. This is a critical factor in the performance of a traditional 60/40 portfolio.

More recently, with fears of inflation looming, Treasury yields near all-time lows and equity valuations stretched, fleeting moments of equity downturns coupled with rising rates give cause for a valid concern: What is the best way to hedge a portfolio?

We've made the case for the efficient use of capital through a leveraged 60/40 portfolio, building on the seminal research of Cliff Asness.

A leveraged 60/40 portfolio, combined with an alternative asset class such as managed futures, can allow investors to deploy their capital more efficiently than with traditional asset allocation.

The Challenges of Adding Alternatives to a Traditional 60/40 Portfolio

Historically, incorporating alternative strategies such as a managed futures fund into a traditional 60/40 portfolio has come at the cost of lowered absolute performance. While adding an uncorrelated asset class can reduce volatility and drawdowns, absolute returns tend to be negatively impacted. With rates near all-time lows, adding an alternative asset class has become attractive for both diversification and return potential.

Of particular interest is the correlation between a traditional 60/40 portfolio and the BarclayHedge U.S. Managed Future s Industry BTOP50 Index (Managed Futures Index), which seeks to replicate the managed futures asset class focusing on trading style and overall market exposure. A managed futures strategy will invest in a variety of asset classes like commodities, currencies, treasuries and equities using futures contracts and, in some cases, will employ long/short strategies.

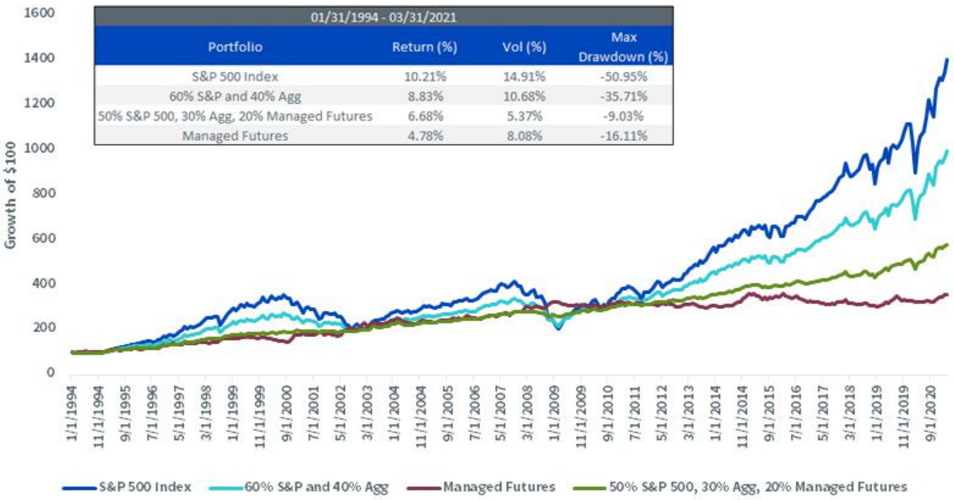
Due to the diverse set of risk factors, the resulting strategy tends to have significantly reduced correlation to the components of a traditional 60/40 portfolio.

A lower correlation between portfolio components implies that the volatility of the combined allocation should be lower than its parts. As shown in the figure below, the trailing correlation between a 60/40 portfolio and the Managed Futures Index has been weak, and at times negative. Throughout the entire period, the average 36-month correlation was approximately 0.1.

Trailing 36-Month Correlation

Sources: WisdomTree, FactSet, Barclays, 01/31/1994–3/31/2021. Stocks are represented by the S&P 500 Index. Bonds are represented by an equally-weighted combination of short-, medium- and long-term Treasuries. The 60/40 portfolio is a combination of 60% S&P 500 and 40% bonds, rebalanced back to 60/40 every month. Managed Futures are represented by the BarclayHedge U.S. Managed Futures Industry BTOP50 Index. Past performance is not indicative of future results. You cannot invest directly in an index.

In the chart below we compare the performance of a traditional 60/40 portfolio—comprising a 60% investment in the S&P 500 Index and a 40% investment in the Bloomberg Barclays U.S. Aggregate Index (Agg)—to a portfolio that allocates 50% in the S&P 500, 30% in the Agg and 20% in the Managed Futures Index.



01/31/1994 - 03/31/2021			
Portfolio	Return (%)	Vol (%)	Max Drawdown (%)
S&P 500 Index	10.21%	14.91%	-50.95%
60% S&P and 40% Agg	8.83%	10.68%	-35.71%
50% S&P 500, 30% Agg, 20% Managed Futures	6.68%	5.37%	-9.03%
Managed Futures	4.78%	8.08%	-16.11%

Sources: WisdomTree, FactSet, Barclays, 01/31/1994–3/31/2021. "Agg" is the Bloomberg Barclays U.S. Aggregate Index. Managed Futures are represented by the BarclayHedge U.S. Managed Futures Industry BTOP50 Index. Past performance is not indicative of future results. You cannot invest directly in an index.

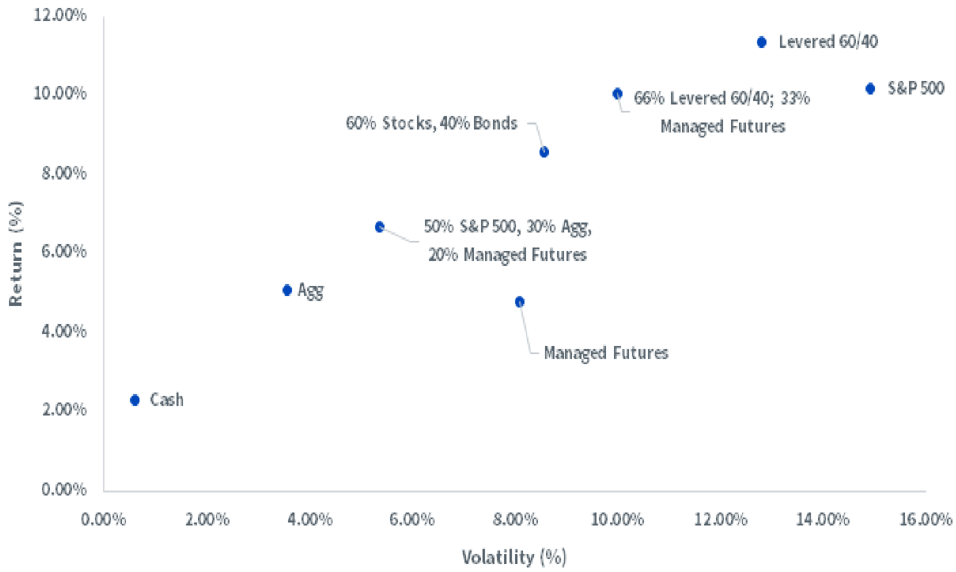
We can see a substantial volatility reduction by incorporating the managed futures proxy compared to the 60/40 portfolio. But what is particularly interesting is the significant reduction in downside risk. While the diversified 60/40 helped reduce the downside risk compared to an all-equity portfolio, incorporating the Managed Futures Index reduced the portfolio's maximum drawdown further to approximately 9%.

Improving Capital Efficiency while Seeking Diversification

Using WisdomTree's Efficient Core strategies—which employ accounting leverage on a traditional 60/40 allocation to gain a 90/60 exposure (1.5 times)—an investor can achieve their objective 60/40 allocation using only two-thirds of their capital. This frees up one-third of an investor's capital to pursue uncorrelated returns in a more efficient manner.

We have observed the risk mitigation benefits of incorporating an alternative strategy such as managed futures to a traditional 60/40 allocation, and we can extend this application using WisdomTree's Efficient Core strategies. In the chart below we can see how a portfolio that combines a leveraged 60/40 allocation with the Managed Futures Index stays within the capital market line (CML) and improves the absolute return of the traditional 60/40 strategy without giving up any risk-adjusted return. The resulting portfolio provides returns that historically have been very similar to that of the S&P 500, at substantially reduced volatility.

Risk vs. Return (1/31/1994–3/31/2021)



Sources: WisdomTree, FactSet, Barclays, 01/31/1994–3/31/2021. Stocks are represented by the S&P 500 Index. Agg is the Bloomberg Barclays U.S. Aggregate Index. Managed Futures are represented by the BarclayHedge U.S. Managed Futures Industry BTOP50 Index. Bonds are represented by an equally weighted combination of short-, medium- and long-term Treasuries. The 60/40 portfolio is a combination of 60% S&P 500 and 40% bonds, rebalanced back to 60/40 every month. The levered 60/40 portfolio invests 155% each month in the 60/40 portfolio, and-55% each month in the one-month T-bill, which is based on original research from Cliff Asness, "Why Not 100% Equities," The Journal of Portfolio Management, 1996. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion

The benefits of additional diversification through alternative strategies are well understood. Historically, the addition of these types of funds has been difficult to justify due to low absolute returns, and the lack of a need for an additional hedge. However, inflation concerns combined with low rates presents a potential opportunity to boost returns using efficient capital strategies while adding diversification through alternative strategies, with managed futures being an excellent example of such an alternative strategy.

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You cannot invest directly in an index.

DEFINITIONS

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.

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.

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.

Inflation : Characterized by rising price levels.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

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

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).

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Drawdowns : Periods of sustained negative trends of return.

Capital Market Line : A graphical representation of all the portfolios that optimally combine risk and return

Risk-adjusted returns : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.