

COMPLEMENTING AN EFFICIENT CORE STRATEGY WITH MANAGED FUTURES

Alejandro Saltiel — Head of Indexes, U.S., Matthew Aydemir — Research Analyst

06/02/2021

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 Futures 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.

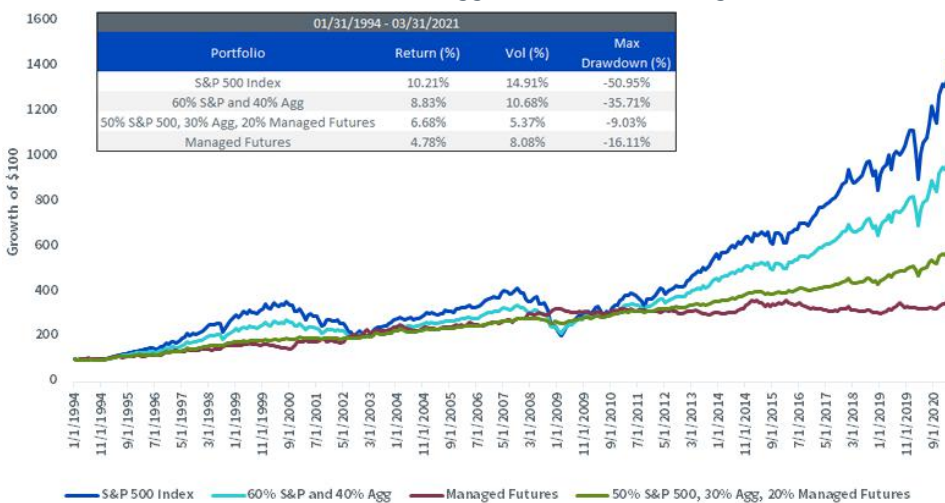
A lower correlation between portfolio components implies that the volatility of the combined allocation should be lower than its parts. As shown in the figure below, the trailing correlation between a 60/40 portfolio and the Managed Futures Index has been weak, and at times negative. Throughout the entire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



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%.

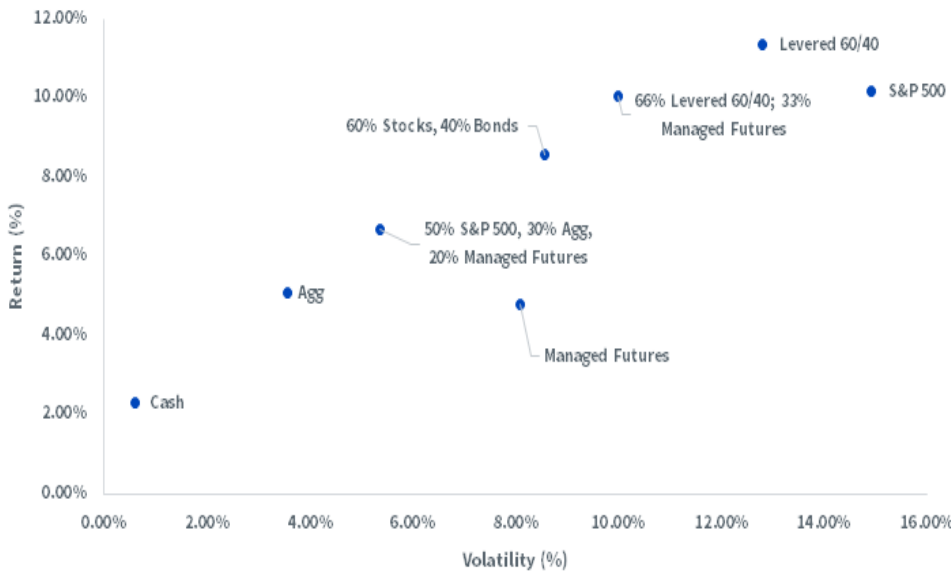
Improving Capital Efficiency while Seeking Diversification

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.

Important Risks Related to this Article

While the Funds are actively managed, their investment processes are expected to be heavily dependent on quantitative models and the models may not perform as intended. Equity securities, such as common stocks, are subject to market, economic and business risks that may cause their prices to fluctuate. The Funds invest in derivatives to gain exposure to U.S. Treasuries. The return on a derivative instrument may not correlate with the return of its underlying reference asset. The Funds’ use of derivatives will give rise to leverage. Derivatives can be volatile and may be less liquid than other securities. As a result, the value of an investment in the Funds may change quickly and without warning and you may lose money. Interest rate risk is the risk that fixed income securities, and financial instruments related to fixed income securities, will decline in value because of an increase in interest rates and changes to other factors, such as perception of an issuer’s creditworthiness.

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.

Related Blogs

+ [Solving the Portfolio Paradox: WisdomTree’s Efficient Core Funds](#)

+ [An Update to Cliff Asness's Study on the Benefits of a Levered 60/40](#)

Related Funds

+ [WisdomTree Emerging Markets Efficient Core Fund](#)

+ [WisdomTree International Efficient Core Fund](#)

+ [WisdomTree U.S. Efficient Core Fund](#)

For more investing insights, check out our [Economic & Market Outlook](#)

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, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch 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

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.