A DRAWBACK OF LOW VOLATILITY STRATEGIES

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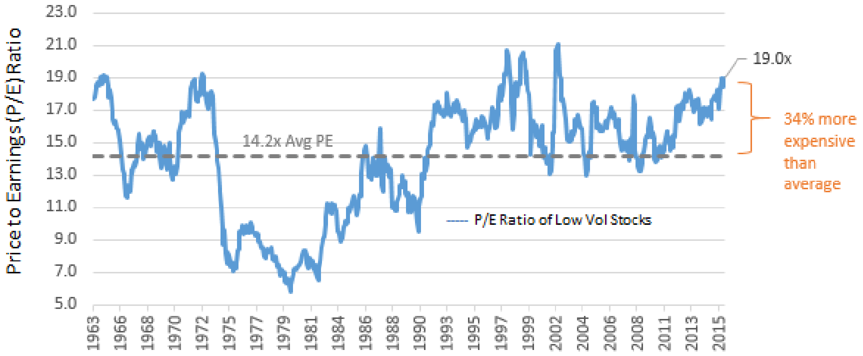
05/05/2016

One of the most exciting characteristics of exchange-traded funds (ETFs) is how trends of inflows and outflows paint a picture of investor behavior. Investors have a reputation for performance chasing, and what has been hot of late is minimum-volatility or low-volatility strategies. The inflows have followed very strong performance, and expectations are widely held that 2016 will be marked by continued volatility. Below we review a potential drawback of many low-volatility strategies and propose an alternative solution that may be more attractive today. **How Do Most Low-Volatility Strategies Work?** Broadly speaking, there are two common approaches to achieving low or minimum volatility: • **Method One:** Select stocks from a given universe that have exhibited relatively lower volatility of their returns when measured against the full universe. Putting the greatest weight in the least volatile qualifying stock and the smallest weight in the most volatile qualifying stock could emphasize the tilt toward lower volatility even further. • **Method Two:** Utilize a portfolio-optimization function to examine the variances and covariances of returns across all potential pairings of stocks within a particular universe such that, in totality, securities are selected and weighted with the sole goal of creating the portfolio with the lowest possible expected volatility. **Key Factor:** However the aim is achieved, an important fact about these strategies is that they are insensitive to the behavior of underlying corporate fundamentals—the story here is about looking at price behavior and relationships between movements of different stock prices rather than anything about the underlying fundamentals of the firms. **The Pitfall of Low Volatility Today: Valuations Low-Volatility Decile Average Price-to-Earnings (P/E) Ratio**



Source: O'Shaughnessy Asset Management, for period from 12/31/1963 to 12/31/2015. Universe refers to U.S.-listed stocks with appropriate 12-month price history for volatility calculation. Cited with permission. Past performance is not indicative of future results.

The Factor Investor blog published a nice piece on the historical valuations of the lowest-volatility stocks. Currently, the lowest-volatility decile of stocks has a P/E ratio that is 34% more expensive than its 52-year historical average.[1] **An Alternative Approach to Lower Volatility and Focus on Valuations** In late 2015, WisdomTree launched an alternative strategy, the WisdomTree Dynamic Long/Short U.S. Equity Fund (DYLS), that incorporates a multifactor, sector-neutral portfolio that focuses on valuations and quality characteristics of individual stocks, while weighting the constituents by their low-volatility characteristics. DYLS, together with the Index it is designed to track before fees and expenses, adds a dynamic market hedge that we believe has the potential to lower the volatility of the Fund by adjusting its market hedge ratio based on trends in underlying fundamentals. The description above has a lot to it, so let's zone in on the details of how DYLS works: 1) **Sector-Neutral Approach:** A number of low-volatility strategies have sector weights that materially drift from the market. The strategy targets sector exposure of the 500 largest stocks by market capitalization and selects stocks from every sector to achieve that sector-neutral exposure. 2) **Grading Stocks Based on Valuation and Quality Characteristics:** Unlike most volatility-reduction strategies that focus on historical volatility only, this strategy grades stocks in every sector with a unique, sector-specific model that looks at valuation criteria such as dividend yield, price-to-earnings ratio, price-to-book ratio, as well as quality measures like return on equity, return on assets and operating profit margins. A result of this stock selection strategy is that the portfolio exposure does not represent strictly a value or a quality strategy; it equally balances characteristics of both valuation and quality criteria to determine the most attractive stocks. The fundamental comparison of the stocks in DYLS to the S&P 500 Index shows how there is a blend of lower valuations, higher historical earnings growth, higher return on equity, higher return on assets and higher margins. **DYLS vs. the S&P 500 Index from a Fundamental Perspective**

Equity Fundamental Statistic	DYLS	S&P 500 Index
Dividend Yield	2.47%	2.16%
Trailing 12-Month P/E Ratio	15.40x	19.18x
Return on Equity (based on Forward 12-month Earnings Estimates)	17.33%	16.37%
Net Income Growth over Trailing 12 Months	14.30%	-0.38%
Operating Income Growth over Trailing 12 Months	11.29%	1.06%
Average Annual Dividend Growth for Past 5 Years	16.98%	12.40%
3-Year Average Return on Equity	32.25%	19.89%
3-Year Average Return on Assets	8.92%	6.47%
Return on Invested Capital	14.97%	11.91%

Source: Bloomberg, with data as of 4/26/16. Past performance is not indicative of future results.
You cannot invest directly in an index.

Click here for standardized performance of DYLS. 3) Within each sector, once the most attractive stocks are selected, they are weighted not by market capitalization but rather in a manner that gives higher weights to lower-volatility stocks. 4) The fourth element of the strategy incorporates a dynamic hedge on the market that leaves the net equity exposure of the portfolio ranging from being fully invested to half hedged or fully hedged. The strategy was fully hedged in January and February, and during the market volatility experienced during that period, DYLS performance remained relatively flat. The market hedge came off in March as the strategy participated in the gains of the market in March. It is our expectation that the stock selection and weighting system that favors lower-priced, higher-quality and lower-volatility companies could help lower the volatility compared to the market by 10% to 15%. Adding a dynamic market hedge that aims to reduce the net market exposure approximately one-quarter to one-third of the time may result in lowering the overall portfolio volatility.[2] We expect the net beta, or market exposure of DYLS compared to the S&P 500, to be about 0.7 or less over longer periods.[3] We encourage those investors looking for a lower-volatility approach but worried about the extended valuations in some of the popular minimum-volatility strategies to consider DYLS. Moreover, DYLS, with a long short approach, was launched with an expense ratio of 0.48%, what we consider to be a low-cost[4] leader in these market-hedged or long/short approaches. [1]Source: O'Shaughnessy Asset Management, for period from 12/31/1963 to 12/31/2015. Cited with permission. [2]Sources: WisdomTree, Alpha Vee, with data from

12/31/01 to 3/31/16. [3]Subject to change. [4]Ordinary brokerage commissions apply.

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DEFINITIONS

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

Portfolio-Optimization : refers to the process of determining weights of different assets in a portfolio where some characteristic/s are being maximized subject to a trade-off.

Variance : a measure of the spread between values in a data set.

Covariance : A measure of the degree to which returns on two risk assets move together with one anothe.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

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.

Decile : each of ten equal groups into which a data set can be divide.

Sector-Neutral : refers to a sector weight constraint that aims to match that of a respective benchmar.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Dynamic Hedge : Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of time.

Hedge Ratio : The specified percentage of currency exposure being hedged, with 0% indicating that none of the currency exposure is being hedged and 100% indicating that all of the currency exposure is being hedged.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Price-to-book ratio : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.

Operating profit margin : Operating income divided by total sales. Higher values indicate a greater fraction of each dollar of sales being left to the firm and its owners after expenses are accounted for.

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 tim.

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.

Net beta : market exposure of a portfolio relative to a benchmark.

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).

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.