WHY ALLOCATING TO CASH MAY NOT BE THE BEST STRATEGY

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07/12/2017

In my experience, a large majority of investor portfolios that I come across are strategically allocated anywhere from 1% to 10% in cash. Quite often the objective for this strategic cash allocation is to disinvest a fraction of portfolio beta and, therefore, reduce overall volatility. An allocation to cash makes sense—particularly to fund spending requirements over the short term—but of course, the greater the more defensive positions, the less potential upside participation there is.

What if there were "asset allocation" strategies that reduced volatility but still participated on the upside?

In February 2016, WisdomTree launched a strategy called the WisdomTree CBOE S&P 500 PutWrite Strategy Fund (PUTW) that tracks the CBOE S&P 500 PutWrite Index (PUT). This strategy is designed to collect premiums by selling cash-collateralized S&P 500 Index put options every month. Thus, when complemented with an equity portfolio, it can help reduce portfolio beta and potentially provide higher risk-adjusted returns.

My analysis below proposes an allocation to the Put Write Fund as an alternative to cash or short-duration fixed income to attain higher upside participation while managing volatility in a way that looks similar to allocations of cash and equities. With PUT having nearly 10 years of live track record, we now have the luxury of analyzing results backed by a longer period of time.

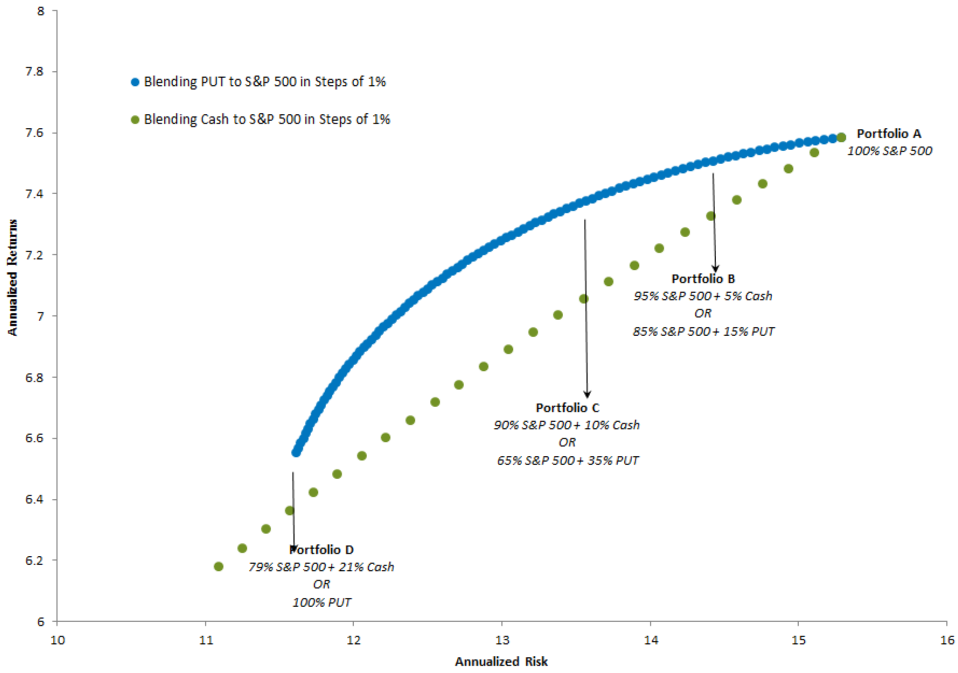
PUT—Measuring Risk Reduction Properties by Comparing to S&P 500 and Cash Blends

In the chart below, we are starting with a 100% allocation to the S&P 500 (Portfolio A, top right) and then either blending cash (dotted green line) or PUT (blue curve) in increments of 1%. What we see in this chart is that for every cash allocation, investors could have improved their total returns by blending the S&P 500 with PUT instead of cash.

An investor allocating 5% to cash could have achieved similar volatility with higher returns by allocating 15% to PUT. A few other key cash allocations and corresponding PUT allocations are listed below.

- Portfolio A: 100% S&P 500
- Portfolio B: 5% allocation to cash/95% to S&P 500 had similar risk as 15% PUT/85% S&P 500
- Portfolio C: 10% allocation to cash/90% to S&P 500 had similar risk as 35% PUT/65% S&P 500
- Portfolio D: 21% allocation to cash/79% to S&P 500 had similar risk as 100% PUT

Allocating to PUT could Offer Better Risk/Reward Than Cash for Equity Investors (Overall Period 6/30/2007–5/31/2017)



Source: Bloomberg, as of 5/31/2017. Past performance is not indicative of future results. You cannot invest directly in an index.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns

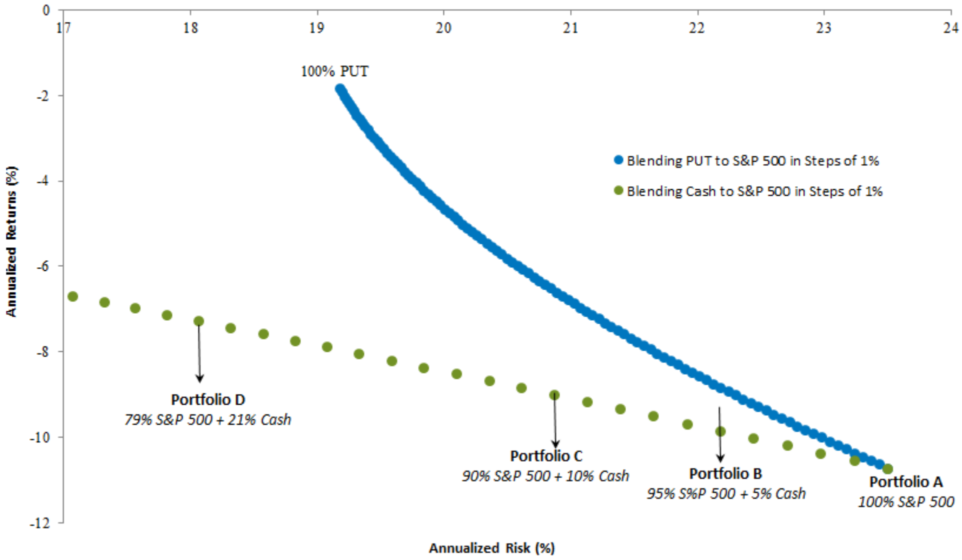
Therefore, different investors could have attained similar risk characteristics with better returns by allocating a different proportion of equity allocations to PUT. In addition, no matter what proportion was allocated to PUT, it would have had better returns than any combination of S&P and cash!

What Happens on a Downside?

So far, so good. But investors also keep cash to protect downside, thus unless these PUT blends do well on the downside, they are not a true match to cash allocations. The chart below zooms into the two-year period of 2008–2009, i.e., the peak of the financial crisis. During that time, the S&P 500 lost over 20% of its value.

Here again, we clearly see PUT (blue curve) as an alternative to cash (dotted green line) could have generated higher returns, providing a much-needed cushion to investors' equity portfolios.

PUT Provided Better Risk/Return During Stress Times (Dec 2007–Dec 2009)



Source: Bloomberg, as of 05/31/2017. Past performance is not indicative of future results. You cannot invest directly in an index.

Summarizing Risk/Return of Blends Above

In the table below, we quantify and compare our key portfolios above for overall period as well as for the period of the financial crisis. Not only did PUT alternatives have better returns for the entire period, but they also outperformed their cash peers during stress times.

For example, Portfolio C, with 10% Cash/90% S&P 500 vs. 35% PUT/65% S&P 500:

- Overall period – PUT alternative outperformed by 31 basis points (bps) annualized, with very similar risk
- Financial crisis – PUT alternative outperformed by 142 bps annualized, with slightly higher risk

		Overall Period 06/30/2007–05/31/2017			Financial Crisis 12/31/2007–12/31/2009		
		Annualized Ret. (%)	Annualized Risk (%)	Sharpe	Annualized Ret. (%)	Annualized Risk (%)	Sharpe
Portfolio A	100% S& P 500	7.58	15.29	0.50	-10.74	23.51	-0.46
Portfolio B	95% S&P 500 + 5% Cash	7.33	14.41	0.51	-9.86	22.18	-0.44
	85% S&P 500 + 15% PUT	7.51	14.47	0.52	-9.39	22.55	-0.42
Portfolio C	90% S&P 500 + 10% Cash	7.06	13.55	0.52	-9.02	20.88	-0.43
	65% S&P 500 + 35% PUT	7.37	13.52	0.54	-7.60	21.43	-0.35
Portfolio D	79% S&P 500 + 21% Cash	6.42	11.73	0.55	-7.30	18.07	-0.40
	100% PUT	6.55	11.62	0.56	-1.86	19.18	-0.10

Source: Bloomberg, as of 5/31/2017. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion

Blending in PUT produced results from a risk-reduction standpoint that look like allocating a portion of equities to cash. However, by allocating to cash, investors usually lose upside participation in the market. Utilizing PUT could have historically provided a better risk/return experience.

PUTW is a way for investors to gain access to PUT, which, as illustrated above, has the potential to offset a decline in the value of the S&P 500 to the extent of the premiums received. Thus, from an asset allocation perspective, blending PUTW with an equity portfolio could not just potentially lead to an overall lower beta, but—unlike cash—could also participate on the upside, thus offering investors a potential alternative for a cash-allocation-like volatility but with potentially higher returns.

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You cannot invest directly in an index.

DEFINITIONS

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

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

CBOE S&P 500 PutWrite Index (PUT) : Measures the performance of a hypothetical portfolio that sells S&P 500 Index (SPX) put options against collateralized cash reserves held in a money market account. The PUT strategy is designed to sell a sequence of one-month, at-the-money, S&P 500 Index puts and invest cash at one- and three-month Treasury Bill Rates. The number of puts sold varies from month to month but is limited so that the amount held in Treasury Bills can finance the maximum possible loss from final settlement of the SPX puts.

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.

Put options : an option to sell assets at an agreed price on or before a particular date.

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.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.