# IS NOW THE TIME TO CONSIDER LONG/SHORT ALTERNATIVES?

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*Forbes* recently published an article, "Scary Results at Long-Short Equity Funds," in its August 23, 2016, issue. The author doesn't pull any punches in describing the dismal results, writing:[1]

> Important question: Do you really want hedge-fund-like returns? Take a look at them before signing up. Morningstar counts 133 publicly offered funds in its "long-short equity" category, holding a combined $34 billion. Results: awful. The average return for the bunch has been 2% a year over the 36 months to June 30. You could have had 11.7% a year from a stock index fund.

One obstacle these long /short funds face is fees. Again, quoting the author:

> Those 133 strivers … have "proprietary" models, "high conviction investments" and "patent pending" strategies—and charge accordingly. The average expense ratio runs to 1.9% a year. That's 38 times as high as for a stock index fund.

Extending on this analysis, below we show the category returns in 2016 and over longer-term periods. The average long/short equity fund had a negative return in 2016 through July, while the S&P 500 had a return of 7.7%. Going back 10 years, the average fund underperformed the S&P 500 by over 200 basis points (bps) per year.

| Performance as of 7/30/2016 | | | | | |
|---|---|---|---|---|---|
| | YTD | 1-Year | 3-Year | 5-Year | 10-Year |
| S&P 500 Index | 7.66% | 5.61% | 11.16% | 13.38% | 7.75% |
| Morningstar Long/Short Equity | -0.09% | -3.96% | 2.19% | 4.17% | 5.61% |

Sources: WisdomTree, Morningstar as of 7/30/16. Morningstar Long/Short Equity includes exchange-traded funds as well as mutual funds in the Morningstar Long/Short Equity Category. Past performance is not indicative of future results. You cannot invest directly in an index.

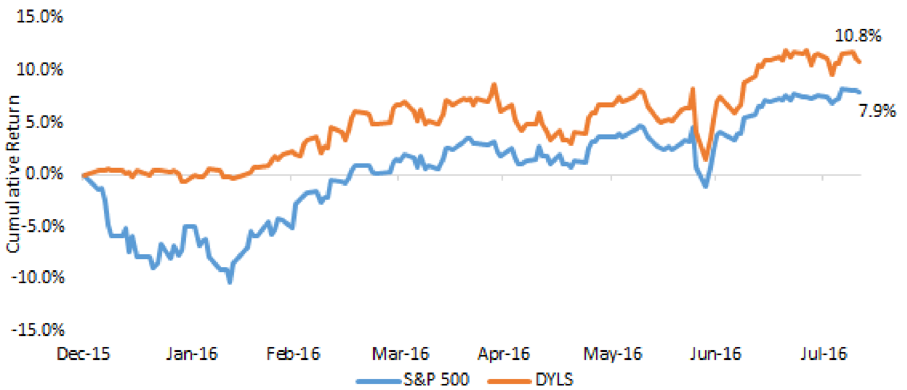


The disappointing returns for the category cited above do not refute the role or stated goal for these strategies. With stock markets and bond markets at all-time highs, investors are perhaps appropriately looking for solutions that can help lower portfolio volatility and navigate adverse moves in the market. But does one need to rely on an active approach, which typically carries higher fees and therefore higher hurdle rates?

**A Systematic, Exchange-Traded Fund (ETF) Approach to Long/Short Investing**

Late last year, WisdomTree launched a long/short equity Fund in the ETF structure. Our thought process: we saw the high fees in traditional active long/short strategies and wanted to build a rules-based systematic ETF that attempts to deliver value through both stock selection and a dynamic hedging of market risk at a low cost[2] for this category, with the expense ratio of 0.48%. We believe the WisdomTree Dynamic Long/Short Equity Fund (DYLS) could currently be one of the lowest-cost funds in the long/short equity category. In what has been a difficult environment for the traditional long/short equity funds this year—with performance of the average long/short fund showing negative returns in 2016—DYLS has had returns over 10% through August 10, 2016, while the S&P 500 was up approximately 8%. For standardized performance of DYLS, visit the WisdomTree Dynamic Long/Short Equity Fund page.

**DYLS vs. S&P**




Sources: WisdomTree, Bloomberg, 12/31/15–8/10/16. Double-digit returns were achieved primarily during favorable market conditions. Investors should not expect that such favorable returns can be consistently achieved. A fund's performance, especially for very short time periods, should not be the sole factor in making your investment decision.

**Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com.**

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

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.

**500 YTD** **Quality and Value Selection, with No Inherent Sector Bets** DYLS implements a stock selection strategy that incorporates a value and quality discipline to forming the portfolio. One of the features of its underlying Index methodology, though, is a sector-neutral starting point and sector-driven stock selection strategy. Despite employing a strategy that selects stocks selling at relatively lower price multiples with higher-quality characteristics, the incorporation of a sector-neutral weighting scheme leaves no inherent sector bets being made in DYLS. This sector neutrality mitigates the risk from value stocks or quality stocks falling out of favor in a given market cycle and really focuses on the value-added side of the value/quality factors for picking stocks. We also believe that employing unique models for every sector helps differentiate this strategy from other "smart beta" funds, which typically look at quality or value stocks using a single framework across all stocks. Further, within each sector, there is a low-volatility weighting emphasis. **How Dynamic Hedging Could Have Helped Protect a Portfolio in Early 2016** In the chart above on performance in 2016, one can see DYLS had a relatively flat performance in January and February, while the market swooned 10% and then rallied back in March. DYLS uses a dynamic hedging indicator that was fully hedged for January and February, and the hedge came off on March 2. The full market hedge in DYLS that was incorporated in January and February has been a key differentiator for its performance. The indicators we use have remained unhedged since March, so DYLS has participated in the market's gains since March 2. The dynamic hedging process employed by DYLS looks at trends in underlying profit margins and quality of profits, combined with overall market valuations. The model for hedging is completely rules-based. When our fundamental indicators show more risk building up in the market, a hedge will be put back in place. Given the indicator is based on trends in profits and valuations, it is certainly possible for a hedge to come back in place. This should help lower overall volatility compared to "vanilla" long-equity strategies but probably has a slightly higher overall equity market exposure than the typical long/short fund in the active space, in our view. While the period is quite limited, with less than one year of real-time performance results, our hedging indicator has coincided quite accurately with market performance in 2016, giving a nice start to DYLS. In a year marked by disappointing performance for many long/short active strategies, investors may consider a relatively low-cost ETF option like DYLS. [1]William Baldwin, "Scary Results At Long-Short Equity Funds," Forbes, 8/23/16. [2]Ordinary brokerage commissions apply.

Important Risks Related to this Article

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You cannot invest directly in an index.

## DEFINITIONS

**Hedge fund like returns** : exhibiting returns sharing characteristics of many actively managed hedge fund strategies.

**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).

**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.

**Basis point** : 1/100th of 1 percent.

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

**Active** : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

**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.

**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.

**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.

**Smart Beta** : A term for rules-based investment strategies that don't use conventional market-cap weightings.

**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.

**Profit margins** : Net 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.