

# ADDRESSING MARKET VOLATILITY IN 2016

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Regardless of whether you believe markets are [efficient](#) or [return premiums](#) exist, in any given year [smart beta](#) indexes that focus on capturing return premiums or “factors” are either going to out- or underperform [market cap-weighted](#) indexes. Over long periods, we feel that focusing on [fundamentals](#) and rebalancing back to those fundamentals at periodic intervals can add [value](#) over complete market cycles, partly by tilting toward known return premiums. In 2015, value and size (i.e., [small caps](#)) underperformed, but momentum, [quality](#) and low [volatility](#) outperformed.<sup>1</sup> Now the question is what factors will perform best in 2016 and whether the answer changes depending on the direction of the market. WisdomTree recently created the [WisdomTree Dynamic Long/Short U.S. Equity Index \(WTDLS\)](#), designed to generate [alpha](#) at the core with a multi-factor stock selection model along with the ability to [hedge](#) market risk dynamically. **Key Features to WisdomTree Approach** WisdomTree has been a pioneer in fundamental indexing for almost a decade, typically focusing on signal factors such as value, quality and size; but now we are pleased to introduce this new multi-factor approach. The [WisdomTree Dynamic Long U.S. Equity Index \(WTDL\)](#) is the long component of WTDLS and comprises approximately 100 stocks with the highest combined fundamentals, which are low volatility weighted and rebalanced quarterly. • **Fundamental Selection:** Stocks are graded on a combination of [growth](#), quality and value factors, and the most attractive stocks in each sector are selected for inclusion. It is important to note that each sector has its own unique factor scoring system, because we believe a different set of fundamentals may potentially work better in one sector as opposed to another. By combining quality and value factors, which we believe complement each other, we hope to smooth the return variance in the short term, while still tapping into the long-term return premiums. • **Low-Volatility Weighting:** In each sector, the Index assigns higher weights to stocks that exhibit lower volatility characteristics, as measured by the stocks’ [standard deviation](#) and [beta](#) to the market. We know that low volatility weighting has historically worked as a single factor, so we believe applying it to a multi-factor selection model will also add value. • **Sector-Neutral Capping:** The Index targets a sector-neutral allocation when compared to the largest 500 U.S. stocks by market capitalization. We believe this keeps the Index properly diversified and eliminates the potential for the fundamental selection or low-volatility weighting to significantly over- or under-weight certain sectors. We are confident about the stock selection and weighting process, so we wanted to rely on that to drive the relative return differentials instead of taking sector bets against a cap-weighted index. To get a sense of the outcome from the selection and weighting process, we compared WTDL against popular market cap-weighted style and factor indexes. **Index**

Index Name	Dividend Yield	Price-to-Earnings Ratio (P/E)	Estimated P/E Ratio	Return on Equity (ROE)	Return on Assets (ROA)	Profit Margins	Long-Term Earnings Growth Expectations (Median)
WisdomTree Dynamic Long U.S. Equity Index	2.95%	15.4x	14.6x	25.30%	9.41%	10.20%	9.44%
S&P 500 Value Index	2.73%	15.2x	15.2x	9.95%	1.69%	7.16%	8.50%
S&P 500 Index	2.15%	18.3x	17.4x	12.57%	2.72%	8.33%	9.46%
S&P 500 Growth Index	1.59%	22.5x	20.2x	19.04%	6.20%	10.57%	10.15%
MSCI USA Momentum Index	1.23%	27.9x	22.1x	16.61%	6.30%	8.20%	11.53%
MSCI USA Barra Low Volatility Index	1.82%	16.8x	16.6x	16.42%	3.94%	10.95%	10.00%
MSCI USA Quality Index	1.84%	19.5x	18.4x	27.88%	11.43%	11.81%	10.00%

Sources: WisdomTree, Bloomberg, 12/31/15. 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.

## Valuations

terms and indexes in the chart, visit our [glossary](#).

• **Attractive across Multiple Valuation Measures:** We find it impressive, but not surprising, that WTDL scored high on multiple valuation measures. As of 12/31/2015, WTDL had the highest [dividend yield](#); it also showed similar [price-to-earnings \(P/E\) ratios](#) as the [S&P 500 Value Index](#), both indicators highlighting its tilt toward value. WTDL had the second-highest quality metrics, defined by [return on equity \(ROE\)](#) and [return on assets \(ROA\)](#), a very close second only to the [MSCI USA Quality Index](#), which focuses more directly on that

For definitions of

factor. Lastly, WTDL had higher [profit margins](#) than the [S&P 500 Index](#) and very similar growth expectations. **Dynamic Hedging Indicator** The above table highlights how WTDL had diversified exposure across multiple factors—but what if markets are choppy? For one thing, the low-volatility weighting methodology could help smooth the returns and lower market [drawdowns](#), but a primary driver will be the dynamic hedging indicator. The dynamic hedging indicator uses growth and quality indicators such as profit margins and popular valuation measures to determine the hedge ratio or [short](#) percentage. So when the fundamentals, or profits, of the universe are deteriorating, the dynamic indicator would look to hedge the portfolio or increase the short percentage. Similarly, as valuations become more stretched, adding risk to the portfolio, the indicator would look to hedge as well. While our hedging indicator will certainly not get every market downdraft timed perfectly, it did start getting more [bearishly](#) positioned toward the end of 2015 and signaled to be 100% hedge for January 2016, making the net equity exposure for WTDLS 0% (or market neutral). We believe the factor diversity and dynamic equity exposure this index provides deserve a second look, given the recent market volatility and uncertainty for 2016.

<sup>1</sup>Sources: WisdomTree, Bloomberg, 12/31/14–12/31/15. Refers to the relative underperformance of the [MSCI USA Value \(Value\)](#) and MSCI USA Small Cap (Size) and relative outperformance of MSCI USA Momentum (Momentum), [MSCI USA Quality \(Quality\)](#) and MSCI USA Barra Low Volatility (Low Volatility) indexes against the MSCI USA Index.

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## DEFINITIONS

**Efficient Market Hypothesis** : Current share prices correctly reflect all available information about publicly traded firms and continually incorporate the emergence of new information on a nearly instantaneous basis; there are no bubbles, and firms are neither expensive nor inexpensive.

**Return premium** : References the additional return generated by investing in securities with certain fundamental factors (or attributes) that have shown persistent outperformance over long periods.

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

**Market capitalization-weighting** : 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.

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

**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 time.

**Small caps** : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

**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 time.

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

**Alpha** : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

**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.

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**Standard deviation** : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

**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.

**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.

**Dividend yields** : Refers to the trailing 12-month dividend yield. Dividends over the prior 12 months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

**Price-to-earnings (P/E) ratio** : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**S&P 500 Value Index** : A market capitalization-weighted benchmark designed to measure the value segment of the S&P 500 Index.

**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.

**MSCI USA Quality Index** : refers to the MSCI USA Quality Index which is a large and mid cap US equity index aiming to capture the performance of quality growth stock. The Index screens its parent index, the MSCI USA Index for ROE, stable year-over-year earnings growth, and low financial leverage.

**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.

**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.

**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.

**Drawdowns** : Periods of sustained negative trends of return.

**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).

**Bear market** : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

**MSCI USA Value Index** : is a large and mid cap US equity index aiming to capture securities exhibiting overall value style characteristics. The Index screens for book value to price, 12-month forward earnings to price, and dividend yield as value characteristics.