

---

# HOW TO DIVERSIFY A 60/40 ALLOCATION WITH DYNAMIC EQUITIES

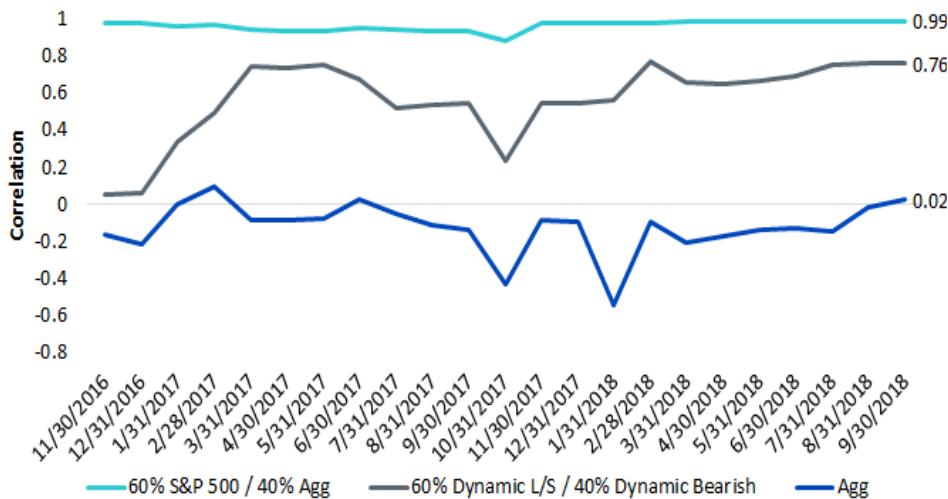
Bradley Krom – U.S. Head of Research  
10/22/2018

If there is one thing to be learned from this year's drawdowns in U.S. equities, it's that traditional 60/40 portfolios<sup>1</sup> do a comparatively poor job of limiting portfolio losses in the short run. In our view, this is primarily a function of low [interest rates](#) starting to rise. On the one hand, the amount of income a bond portfolio is able to generate is constrained, thus limiting expected total returns. On the other, rapidly rising rates have triggered a shift in equity risk premiums that result in lower prices for stocks and bonds. For that reason, investors have sought to increase exposure to alternative strategies that can generate returns in rising and falling equity/interest rate environments. Below, we highlight how investors can combine a dynamic long/short equity strategy<sup>2</sup> with a dynamic [bearish](#) strategy<sup>3</sup> to potentially achieve returns comparable to traditional portfolios but with significantly different drivers and [correlations](#).

## The Challenges of 60/40

As we've mentioned previously, [the performance of 60/40 has been pretty tough to beat](#). With the benefit of hindsight, we know that the [S&P 500](#) has generated returns of 11.97% per year over the last 10 years with abnormally low levels of [volatility](#).<sup>4</sup> However, what happens to investor portfolios when volatility increases and/or equities correct for more than a couple of months? In our view, investors have been lulled into a sense of complacency with 60/40. While they may feel like they're diversified between stocks and bonds, the fact is that their portfolio remains dangerously exposed to equity market returns. In the chart below, we show that the current rolling 12-month correlation between 60/40 and the S&P 500 Index is at 0.99.

## Rolling 12-Month Correlations to S&P 500 Index



Sources: WisdomTree, Zephyr StyleADVISOR, as of 9/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

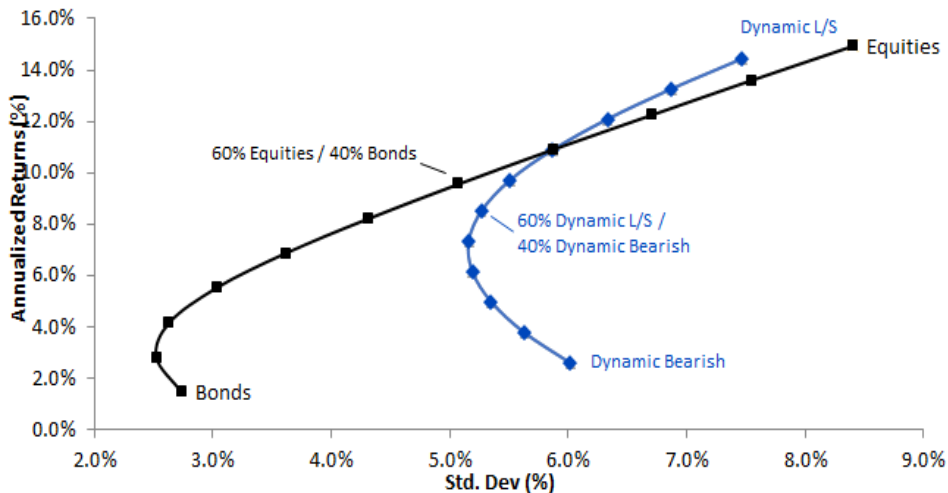
While bonds show effectively zero correlation with stocks, our concern is that with the Fed continuing to normalize policy, the risk of negative returns from fixed income is elevated. In our view, a combination of alternative strategies can be used to reduce correlation with the S&P while generating returns that don't rely on rising equity markets or falling bond yields.

**Dynamic Long/Short and Bearish**

Dynamic strategies seek to add value through security selection and by their ability to dynamically add and subtract exposure to equity market [beta](#). When underlying fundamentals are strong, our dynamic long/short Index is long. When fundamentals become mixed, a partial [hedge](#) is applied. When fundamentals are weak, a full market hedge seeks to protect investors from downdrafts in the equity market while still delivering excess returns through security selection. In the case of our bearish strategy, when fundamentals are poor, all equity exposure is eliminated while those proceeds are invested in [U.S. Treasury bills](#). This high-quality cash position combined with a short position in equity futures allows investors to potentially profit from a decrease in equity prices.

Below, we contrast combinations of these alternative strategies that can serve as a starting point for a [liquid alternatives](#) portfolio.

**Dynamic Strategy Blends vs. Traditional Asset Blends**  
11/30/15–9/30/18



Sources: WisdomTree, Zephyr StyleADVISOR, as of 9/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

### Contrasting 60/40s

While traditional 60/40 has outperformed our alternative 60/40 portfolio with slightly less volatility, we continue to like this combination given the potential to generate positive returns when equity markets fall or interest rates rise. Given that these portfolios rely on fundamentals to dynamically adjust their beta exposure to the market, they offer the potential to tap in to outperform during market [corrections](#). Since the end of 2015, these dynamic strategies generally have been net long the market on account of strong fundamentals. However, they have also reduced exposure three separate times when valuations became extended and earnings growth momentum slowed. As a result, our alternative 60/40 portfolio has been able to capture much of the market’s upside while providing comparable volatility to a portfolio that includes fixed income assets.

### Conclusion

In sum, while simply constructed portfolios have delivered above-average performance in recent years, it seems unlikely that the pace of such gains can be sustained. The later we continue into the economic cycle, the greater the chance we experience a sustained market correction. In our view, combining traditional assets with dynamic equity strategies could provide opportunities for returns despite a fall in equity prices. By combining long/short and bearish strategies together, investor exposures can be dynamically adjusted based on underlying market fundamentals.

<sup>1</sup>Sixty percent equity and 40% fixed income proxied by the [S&P 500 Index](#) and the [Bloomberg Barclays U.S. Aggregate Index](#).

<sup>2</sup>Proxied by the [WisdomTree Dynamic Long/Short U.S. Equity Index](#).

<sup>3</sup>Proxied by the [WisdomTree Dynamic Bearish U.S. Equity Index](#).

<sup>4</sup>Source: Bloomberg, as of 9/30/18.

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.

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](http://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, Jianing Wu, and Brian Manby 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

**Interest rates**: The rate at which interest is paid by a borrower for the use of money.

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

**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.

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

**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.

**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.

**U.S. Treasury Bill**: A short-term debt obligation backed by the U.S. government with a maturity of less than one year.

**Liquid alternative**: An alternative investment, one that is not one of the three traditional asset types (stocks, bonds and cash), that can be bought and sold on a daily basis.

**Correction**: A drop of 10% or greater in an Index or stock from a recent high.

**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.