

---

# HOW DOES A DYNAMIC PORTFOLIO STACK UP VS. 60/40?

**Bradley Krom — Director, Research**  
10/26/2017

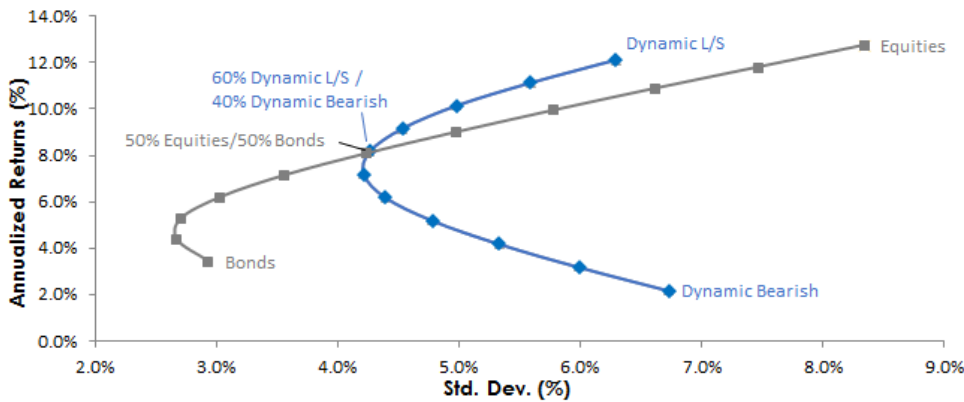
[Implied volatility](#) is low, but [realized volatility](#) is even lower. Many equity investors are concerned about [valuations](#), but strong earnings growth has led to double-digit returns year-to-date.<sup>1</sup> In fixed income, the [Federal Reserve \(Fed\)](#) has continued along its path of tightening, but rates are lower year-to-date at tenors greater than five years. Overall, a seemingly naive 60% equity/40% fixed income portfolio<sup>2</sup> has delivered enviable performance. During these periods, it's imperative that investors resist the temptation to be lulled into complacency. Over the last several years, we've seen an increased interest in strategies that can serve as alternatives to a standard equity and bond portfolio. While these strategies can be used in isolation, we've found that creating a portfolio of alternative assets can provide a wider range of risk and return profiles. Below, we highlight how investors can combine a dynamic [long/short equity strategy](#)<sup>3</sup> with a dynamic [bearish](#) strategy<sup>4</sup> to achieve returns comparable to traditional portfolios but with significantly different drivers and [correlations](#).

## Dynamic Long/Short and Bearish

At their core, 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. For 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.

As one of my colleagues wrote previously, [we consider them as complements to more specifically target a desired lower beta to the market](#). Below, we highlight a variety of combinations in these alternative strategies that can serve as a starting point for a liquid alternatives portfolio.

**Dynamic Strategy Blend vs. Traditional Asset Blends**  
11/30/15–8/31/17



Sources: WisdomTree, Zephyr StyleADVISOR, as of 8/31/17. Past performance is not indicative of future results. You cannot invest directly in an index.

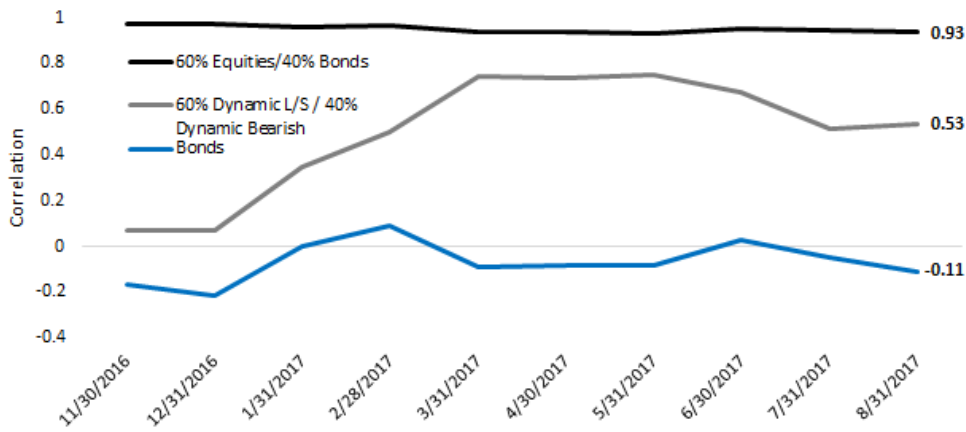
### Rethinking 60/40

While many investors think of 60/40 as being an appropriate starting point for equity and bond allocations, this can also serve as an interesting starting point for a liquid alts portfolio. Although returns from this portfolio remain heavily dependent on equity performance, they are not necessarily dependent on higher equity price. In effect, if fundamentals begin to deteriorate, it's possible that investors could still generate positive returns when traditional asset prices fall. In the live performance history above, both dynamic components delivered positive total returns with less volatility than the equity market. Volatility was significantly greater than fixed income strategies over this time, but investors were able to achieve comparable returns and risk by owning dynamic long/short and bearish in a 60%/40% ratio. In our view, this could serve as an interesting starting point for investors looking to establish a new liquid alts portfolio.

### The Risk of 60/40

Although these historic rules of thumb for asset allocation have delivered strong returns in recent years, a major problem with these approaches is that they remain highly correlated to equity market risk. Put another way, returns from these portfolios have been strong because equities have compounded at 13% per year<sup>5</sup>. Fixed income has exhibited very little correlation to the equity market, with yields <3%, but any returns in excess of that number solely depend on interest rates remaining stable or declining. This bet seems optimistic if the global economy continues to expand and [inflation](#) ever rises above currently benign levels. Similarly, correlations in these portfolios will remain tied to the equity market unless investors significantly reduce exposure to equity market beta. In our view, dynamic strategies have the potential to achieve this objective much more so than dramatically increasing exposure to fixed income in the midst of a central bank [tightening](#) cycle.

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



Sources: WisdomTree, Zephyr StyleADVISOR, as of 8/31/17. Past performance is not indicative of future results. You cannot invest directly in an index.

In sum, although simply constructed portfolios have delivered above-average performance in recent years, it seems unlikely that the pace of such gains can be sustained. When a market correction inevitably occurs, clients could be exposed to more risk than they had intended. 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>As measured by the [S&P 500 Index](#), as of 8/31/17.

<sup>2</sup>Equity and fixed income proxied by the S&P 500 Index and the [Bloomberg Barclays U.S. Aggregate Index](#).

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

<sup>4</sup>Proxied by the [WisdomTree Dynamic Bearish U.S. Equity Index](#).

<sup>5</sup>From 11/30/15 through 8/31/17.

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, Kara Marciscano, 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

**Implied volatility** : The estimated volatility of a security's price. Implied volatility is a way of estimating the future fluctuations of a security's worth. It is backtracked from live option prices with a future maturity date.

**Realized Volatility** : The daily standard deviation of returns of an underlying asset, index, instrument, security, or ET.

**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.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**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).

**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.

**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.

**Treasury Bill** : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).

**Inflation** : Characterized by rising price levels.

**Tighten** : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

**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.

**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.