

# DIVERSIFY WITH LIQUID ALTERNATIVES

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What makes analyzing [alternatives](#) especially challenging is that individual options—even when they are in the same category—can be positioned in very different ways. Furthermore, exposures for any individual strategy can significantly change over time. All this analysis and monitoring can be a daunting task for even the most sophisticated investors. We believe it is imperative to focus on the goal or portfolio objective to be achieved when considering [liquid](#) alternative investments. One result of this analytical framework: A diversified portfolio of liquid alternatives could make more sense than an individual strategy. **Goals of Alternatives** while there are numerous goals for alternative investments, and they are often subject to differences of opinion, we are looking to help people come to a potentially useful analytical framework for analyzing these investments. We see three main types: 1) **Growth Options**: Alternatives in the growth category typically seek to produce attractive total returns from capital appreciation, income generation or some combination of the two. They aim to accomplish this goal by exposing investors to “unique” [beta](#), which in simple terms is a market exposure significantly different from equities, bonds or cash.

- Unique beta with a *capital appreciation* goal could include such investment strategies as [venture capital](#), [buyouts](#), growth equity, long-biased equity [hedge](#) and activist event driven.
- Unique beta with an *income* goal could include investments such as private lending and strategies that seek to sell [volatility](#), which means that assets sold have the potential to increase in price at times when market volatility is increasing.

2) **Uncorrelated Options**: Alternatives in this category attempt to generate a steady, positive return stream that is uncorrelated with stocks, bonds or cash. The purpose is to introduce to a portfolio a return stream that would not be influenced by the behavior of returns in more traditional asset classes, thereby lending the potential to lower overall portfolio volatility. In technical language, the goal is to have no beta exposure at all.

- Uncorrelated alternatives can be constructed to be [market-neutral](#).
- Uncorrelated alternatives may consist of market timing indicators that vary the asset class exposures over time, meaning that a signal could be utilized with the consequence being either a [long position](#) or a [short position](#) in a particular asset. [Managed futures](#) are one of the more widely known examples in this category.

3) **Defensive Options**: Alternatives in this category attempt to mitigate the risk of major [drawdowns](#) in negative market environments. These strategies are generally focused on having higher potential returns during big declines in either the stock or bond market.

- Some strategies designed to achieve this goal are short-biased stock or bond exposures or buying assets that have the potential to increase in value during increased market uncertainty and negative sentiment.

WisdomTree’s **Alternatives Toolkit** wisdomTree has a broad set of options in alternative investment strategies. Below, we organize them into the three broad categories that we defined above. We believe they can represent interesting complements to existing strategies that might be a bit more illiquid. **Growth Options** •

**WisdomTree Dynamic Long/Short U.S. Equity Fund (DYLS):** DYLS tracks the returns, before expenses, of the [WisdomTree Dynamic Long/Short U.S. Equity Index](#), which has the potential to be 100% exposed to equities in an unhedged manner. • **WisdomTree CBOE S&P 500 PutWrite Strategy Fund (PUTW):** PUTW tracks the returns of the [CBOE S&P 500 PutWrite Index](#) before expenses. It is important to note that the [put options](#) being sold in the Fund have the potential to increase in price if volatility is increasing. **Uncorrelated Option** • **WisdomTree Managed Futures Strategy Fund (WDTI):** WDTI tracks the returns, before expenses, of the [Diversified Trends Indicator™ \(DTI®\)](#), which tends to have short positions in commodity or financial [futures](#) exhibiting declining price trends and long positions in commodity or financial futures exhibiting appreciating price trends. **Defensive Option** • **WisdomTree Dynamic Bearish U.S. Equity Fund (DYB):** DYB tracks the returns, before expenses, of the [WisdomTree Dynamic Bearish U.S. Equity Index](#), which has the potential to be, at most, 25% exposed to equities, as it is always at least 75% [hedged](#). On the other hand, it has the potential to be 100% short equities. **Three Categories in the Alternatives Toolkit**

Categories	Strategies
Growth	DYLS, PUTW
Uncorrelated	WDTI
Defensive	DYB

Source: WisdomTree.

**How We Think about**

**Allocating across These Categories** A critical consideration regards whether an investor’s objective is more conservative or more aggressive. For more conservative asset allocation models, we think it could make sense for about half of the exposure to come from strategies that we would consider in the growth category, but tilted more toward income as opposed to capital appreciation. The other half could be split between uncorrelated and defensive categories. Upon moving up the asset allocation model risk spectrum toward the more aggressive end, an investor can add exposure to the growth category in strategies tilted more toward capital appreciation.

**Important Risks Related to this Article**

Diversification does not eliminate the risk of experiencing investment losses. Using an asset allocation strategy does not assure a profit or protect against loss. Investors should consider their investment time frame, risk tolerance level and investment goals.

DYLS and DYB invest in derivatives, including as a substitute to gain short exposure to equity securities. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. Derivatives used by the Funds to offset their exposure to market volatility may not perform as intended. The Funds may engage in “short sale” transactions and will lose value if the security or instrument that is the subject of a short sale increases in value. A Fund that has exposure to one or more sectors may be more vulnerable to any single economic or regulatory development. This may result in greater share price volatility. The composition of the Indexes is heavily dependent on quantitative models and data from one or more third parties, and the Indexes may not perform as intended. The Funds invest in the securities included in, or representative of, their Indexes regardless of their investment merit, and the Funds do not attempt to outperform their Indexes or take defensive positions in declining markets.

PUTW will invest in derivatives, including S&P 500 Index put options (“SPX puts”). The value of the SPX puts in which the Fund invests is partly based on the volatility used by market participants to price such options (i.e., implied volatility). The options values are partly based on the volatility used by dealers to price such options, so

increases in the implied volatility of such options will cause the value of such options to increase, which will result in a corresponding increase in the liabilities of the Fund and a decrease in the Fund's NAV. Options may be subject to volatile swings in price influenced by changes in the value of the underlying instrument. The potential return to the Fund is limited to the amount of option premiums it receives; however, the Fund can potentially lose up to the entire strike price of each option it sells.

An investment in WDTI is speculative and involves a substantial degree of risk. One of the risks associated with the Fund is the complexity of the different factors that contribute to the Fund's performance, as well as its correlation (or noncorrelation) to other asset classes. These factors include use of long and short positions in commodity futures contracts, currency forward contracts, swaps and other derivatives.

The Fund should not be used as a proxy for taking long-only (or short-only) positions in commodities or currencies. The Fund could lose significant value during periods when long-only indexes rise (or short-only) indexes decline. The Fund's investment objective is based on historic price trends. There can be no assurance that such trends will be reflected in future market movements. The Fund generally does not make intramonth adjustments and therefore is subject to substantial losses if the market moves against the Fund's established positions on an intramonth basis. In markets without sustained price trends or markets that quickly reverse or "whipsaw," the Fund may suffer significant losses. The Fund is actively managed; thus, the ability of the Fund to achieve its objectives will depend on the effectiveness of the portfolio manager. Due to the investment strategy of certain Funds, they may make higher capital gain distributions than other ETFs.

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## DEFINITIONS

**Alternative Investment**: An investment that is not one of the three traditional asset types (stocks, bonds and cash). Alternative investments typically include hedge funds, managed futures, real estate, commodities and derivatives contracts.

**Liquidity**: The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

**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.

**Venture Capital**: Capital funded to startup companies in its early stages with long term growth potential.

**Buyouts**: The acquisition of a targeted firm by purchasing shares of the company to obtain ownership.

**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.

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

**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.

**Market neutral**: Strategy that seeks to avoid market risk by hedging a percentage equal to total long exposure.

**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).

**Managed futures**: An alternative investment strategy in which futures contracts are used as part of the investment strategy.

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

**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.

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