MANAGING PORTFOLIO VOLATILITY AS CORRELATIONS RISE

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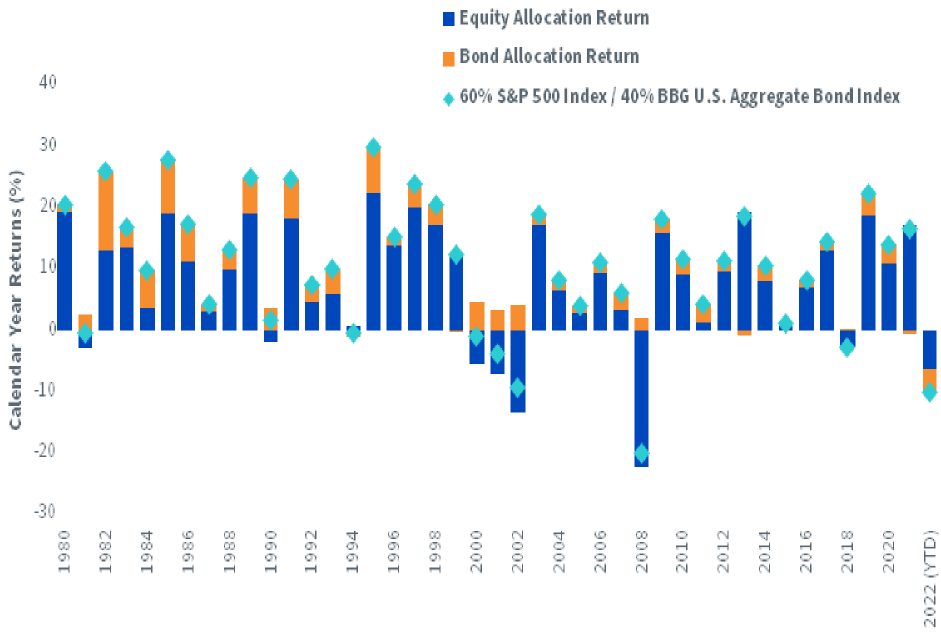
This article is relevant to financial professionals who are considering offering Model Portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

This year has offered no shortage of headaches, but the most acute source of pain for most traditional portfolios has been the positive correlation between falling stock and bond prices.

There is historical precedent for balanced 60/40 portfolios experiencing negative calendar year returns. What makes 2022 so uniquely challenging? So far, it is the first time in recent history when both stocks and bonds have had steep, simultaneous declines.

Calendar Year Returns of a Traditional 60/40 Portfolio



Sources: WisdomTree, Bloomberg, as of 8/19/22. Past performance is not indicative of future returns. Equity Allocation Return based on the S&P 500 Index. Bond Allocation Return based on the Bloomberg U.S. Aggregate Bond Index.

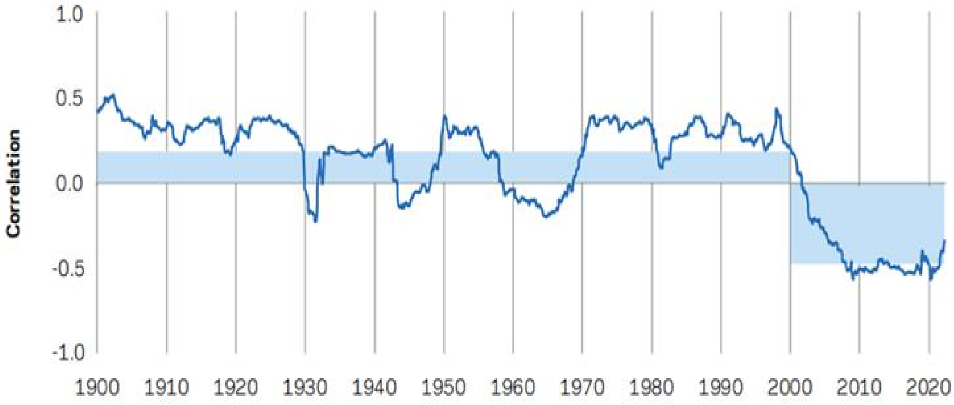
For index definitions in the chart above, please visit the glossary. You cannot invest directly in an index.

At WisdomTree, we remain strong believers in equities as a long-term driver of real portfolio growth and bonds as an important source of diversification and income.

But many investors view this year's relationship between stock and bond returns as potentially the start of a new correlation regime.

And history may support this view—in the 20th century, the average long-term correlation of stocks and bonds was positive, particularly in times of heightened inflation uncertainty.

Rolling 10-Year Correlation Between U.S. Equities and U.S. Treasuries 1/1/1900–3/31/2022



Source: AQR, "The Stock/Bond Correlation: Drivers and Implications," Q2 2022. Data sourced from Bloomberg, Global Financial Data. Based on overlapping three-month returns at a monthly frequency. Shading shows average correlations in the 20th and 21st centuries. U.S. Equities based on Global Financial Data (GFD) U.S. Equity Indices.

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What does this mean for investors with traditional asset allocations?

In our view, the risk of ongoing inflation uncertainty and unstable asset class correlations supports the case for additional sources of portfolio diversification.

WisdomTree's Volatility Management Model Portfolio—one of our "outcome-focused" Model Portfolios—is designed to act as a complement to a traditional portfolio by incorporating these alternative sources of potential return and potential risk mitigation.

One of the Funds included in the model is our own managed futures strategy, WTMF, which seeks to achieve uncorrelated returns by capturing rising and falling price trends across commodity, currency, equity and interest rate markets.

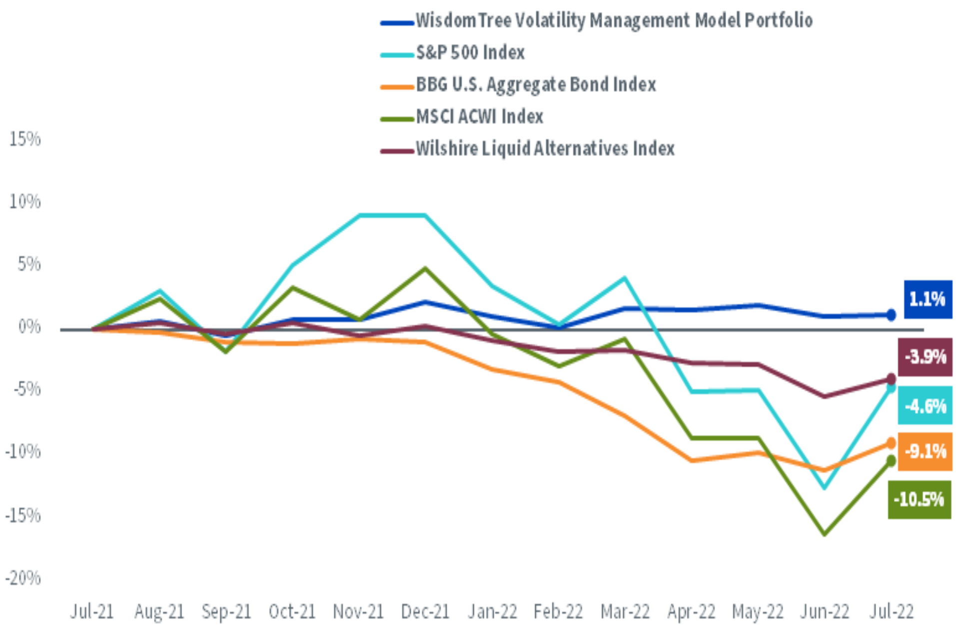
Importantly, trend-following strategies like managed futures have a long track record of delivering strong performance in periods of elevated inflation risk, when traditional 60/40 portfolios have typically struggled (Hurst, Ooi and Pedersen, 2017).[1]

In addition to managed futures, the portfolio includes hedged equity[2] and diversified arbitrage[3] strategies.

While each allocation within the portfolio follows a unique and differentiated investment approach, the overarching goal of the Model Portfolio is to generate attractive, uncorrelated risk-adjusted returns.

In the 12 months ending July 31, 2022, the Volatility Management Model Portfolio has performed as intended—the portfolio has generated positive absolute returns while outperforming the broader liquid alternatives universe. For investors utilizing the Model Portfolio as a complement to a 60/40 allocation, it has dampened volatility at a time when equity and fixed income markets each experienced steep declines.

Cumulative 1-Year Performance as of July 2022



Sources: WisdomTree, Bloomberg, as of 8/31/22. **Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and the 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.** The Model Portfolio performance results shown are theoretical and do not reflect an investor's actual experience with owning, trading or managing an actual investment. Thus, the performance shown does not reflect the impact that economic and market factors had or might have had on decision-making if actual investor money had been managed and allocated per the Model Portfolio. The actual performance achieved in seeking to follow the Model Portfolio may differ from the theoretical performance shown for a number of reasons, including the timing of implementation of trades (including rebalancing trades to adjust to Model Portfolio changes), market conditions, fees and expenses (e.g., brokerage commissions, deduction of advisory or other fees or expenses charged by advisors or other third parties to investors, strategist fees and/or platform fees), contributions, withdrawals, account restrictions, tax consequences and/or other factors, any or all of which may lower returns. While Model Portfolio performance may have been better than the benchmark for some or all periods shown, the performance during any other period may not have been, and there is no assurance that Model Portfolio performance will be better than the benchmark in the future. Model Portfolio performance calculations assume the reinvestment of dividends, are pre-tax and are net of Fund expenses. ETF shares are bought and sold at market price (not NAV) and are not individually redeemable 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.

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For most recent month-end and standardized performance of the Model and underlying Funds, please click here.

Issues Often Cited with "Alternatives"

The category of "alternatives" is overly broad and often carries with it a negative connotation. Below we explore some of the issues most often cited with these strategies, and how the Volatility Management Model Portfolio addresses each:

Issue	WisdomTree Volatility Management Model Portfolio
High Fees	ETF-centric to optimize fees and taxes
Poor Liquidity	Constructed using vehicles with daily liquidity
Concentration Risk	"Open architecture" and diversified across multiple investment managers and strategies

Another important drawback to alternatives as an asset class has been its historical underperformance relative to equities. It is fair to say that, since the great financial crisis, diversification away from U.S. equities and bonds has generally not rewarded investors.

But with today's market conditions, are we now in a world where diversification matters again? In this environment, investors may well benefit from access to alternative sources of return.

Funding an Allocation to Volatility Management

While we can all agree that diversification sounds great, most investors still need a healthy allocation to equities and bonds to accomplish long-term return objectives and generate necessary income. Where can a new allocation to Volatility Management be sourced from?

For years, some of the world's largest institutional investors have prudently utilized leverage in portfolio construction with the aim of reducing equity market volatility without sacrificing long-term expected returns.

With our "Efficient Core" strategy, NTSX, individual investors now have access to a modestly leveraged 60/40 "core" allocation, freeing up capital to invest in diversifying strategies such as those found in our Volatility Management Model Portfolio.

Conclusion

While we believe that traditional 60/40 portfolios remain a viable and effective long-term strategy for many investors, those most focused on volatility and downside protection were likely met with an unwelcome surprise this year.

If 2022 is a sign of what's to come, bonds may not provide the level of equity market diversification that investors have come to rely on over the past several decades.

An allocation to diversifying strategies like those in our Volatility Management Model Portfolio can potentially provide differentiated sources of returns while also mitigating exposure to increasingly high levels of equity and interest rate risk in traditional portfolios.

Important Risks Related to this Article

Diversification does not eliminate the risk of experiencing investment losses.

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WTMF: There are risks associated with investing, including the possible loss of principal. An investment in this Fund is speculative, involves a substantial degree of risk and should not constitute an investor's entire portfolio. 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 non-correlation) to other asset classes. These factors include the use of long and short positions in commodity futures contracts, currency forward contracts, swaps and other derivatives. Derivatives can be volatile and may be less liquid than other securities and more sensitive to the effects of varied economic conditions. In addition, bitcoin and bitcoin futures are a relatively new asset class. They are subject to unique and substantial risks and, historically, have been subject to significant price volatility. While the bitcoin futures market has grown substantially since bitcoin futures commenced trading, there can be no assurance that this growth will continue. 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 intra-month adjustments and therefore is subject to substantial losses if the market moves against the Fund's established positions on an intra-month 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 this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

NTSX: There are risks associated with investing, including the possible loss of principal. While the Fund is actively managed, the Fund's investment process is expected to be heavily dependent on quantitative models, and the models may not perform as intended. Equity securities, such as common stocks, are subject to market, economic and business risks that may cause their prices to fluctuate. The Fund invests in derivatives to gain exposure to U.S. Treasuries. The return on a derivative instrument may not correlate with the return of its underlying reference asset. The Fund's use of derivatives will give rise to leverage, and derivatives can be volatile and may be less liquid than other securities. As a result, the value of an investment in the Fund may change quickly and without warning, and you may lose money. Interest rate risk is the risk that fixed income securities, and financial instruments related to fixed income securities, will decline in value because of an increase in interest rates and changes to other factors, such as the perception of an issuer's creditworthiness. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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.

View the online version of this article here.

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You cannot invest directly in an index.

DEFINITIONS

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.

Stock : A stock (also known as equity) is a security that represents the ownership of a fraction of a corporation. This entitles the owner of the stock to a proportion of the corporation's assets and profits equal to how much stock they own. Units of stock are called "shares."

Bond : A fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental).

60/40 Portfolio : A portfolio of 60% equities and 40% fixed income.

Inflation : Characterized by rising price levels.

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

Commodity : A raw material or primary agricultural product that can be bought and sold.

Currency : Currency in which the underlying index returns are calculated. Euros: The returns are calculated, and there is no currency conversion; resulting statistics result purely from the returns of the equities. U.S. dollars: The returns are calculated and then converted into U.S. dollars; resulting statistics are the result of a combination of the euro’s performance against the U.S. dollar and the returns of the underlying equities.

Negative equity : Negative equity occurs when the value of real estate property falls below the outstanding balance on the mortgage used to purchase that property. Negative equity is calculated simply by taking the current market value of the property and subtracting the amount remaining on the mortgage.

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

Arbitrage : The simultaneous purchase and sale of the same asset in different markets in order to profit from tiny differences in the asset's listed price.

Risk-adjusted returns : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.

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

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.