

# GO LONG (AND SHORT) IN ONE ETF

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With the U.S. equity markets enjoying a tremendous positive run over the last six to seven years, with few drawdowns passing the 10% threshold, some investors are looking for [alternative investment](#) solutions designed to [hedge](#) market risk. The problem is that many of these investment options are quite expensive, and high fees create high hurdles rates for [active managers](#). In the traditional open-ended mutual funds, Morningstar has a category for long/short equities; the median annual net expense ratio is more than 1.75%, and the median annual gross expense ratio is close to 3%.<sup>1</sup> [Hedge funds](#) often can be pricier, with incentive and performance fees added on top of traditional expense ratios. WisdomTree is challenging the traditional alternative community with a systematic, [liquid](#) long/short exchange-traded fund (ETF)—[WisdomTree Dynamic Long/Short U.S. Equity Fund \(DYL5\)](#) priced at 0.48% and based on a proprietary quantitative model.<sup>2</sup> We believe this Fund provides a [passive](#) long/short approach—generating [alpha](#) at the core long portfolio with [fundamentally](#) driven stock selection, while also having the ability to hedge market risk dynamically on the short side. Below we discuss the two components of the strategy.

**Generating Alpha at the Core** The long portion of the Index comprises approximately 100 stocks with the best grades (as defined below), is weighted to reward lower-[volatility](#) stocks and is rebalanced quarterly<sup>3</sup>.

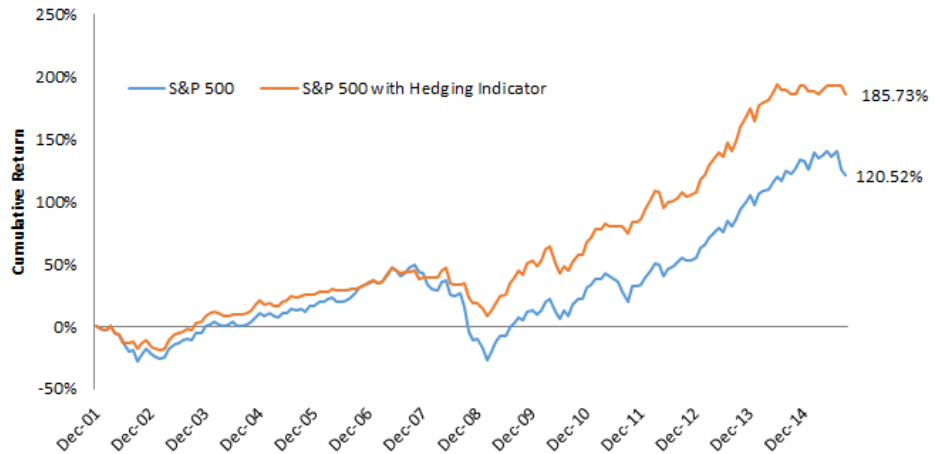
- **Fundamental Selection**—Stocks are graded on a combination of [growth](#) and [value](#) indicators, and the most attractive stocks within each sector are selected for inclusion. Each sector has its own unique factor scoring system. A subset of the variables, including valuation and growth and quality factors, is also analyzed.
- **Stock Weighting**—In each sector, the Index assigns higher weights to stocks that exhibit lower volatility characteristics, as measured by the stock’s [standard deviation](#) and [beta](#) to the market.
- **Incorporating a Dynamic Hedge Ratio** The short component of the Index is determined by a hedge indicator that considers a combination of both growth and value indicators:
  - **Growth:** Looks at [operating profit margins](#), [net income profit margins](#) and profit quality (or [operating cash flow](#) over [operating income](#))
  - **Value:** Looks at price to book and [price to cash flow](#). Profits are a key driver of the market. So when the growth fundamentals, or profits, of the investment universe are deteriorating, the dynamic indicator would look to hedge the portfolio. Similarly, as valuations become more stretched, adding risk to the portfolio, the indicator would look to hedge as well. Over time, being able to limit or buffer losses during unfavorable markets has been critical to increasing portfolio returns while seeking to reduce risk.

**Index Component Exposure** The Index contains both long and short components. The net short exposure will change monthly based on an evaluation of the market environment. Based on the growth and value indicators of the market, the component weights will be one of the following: **Dynamic Hedge Component Exposure**

Value/Growth Indicators	Long Portfolio	Dynamic Hedge Ratio (% Portfolio Short)	Signal Reading (% of time)
Attractive	Long Stock Portfolio	0%	64%
Mix	Long Stock Portfolio	50%	16%
Poor	Long Stock Portfolio	100%	20%
Rebalance or Changes	Quarterly	Monthly	

Sources: WisdomTree, Alpha Vee, 12/31/01–9/30/15. Note: This does not represent the returns to the WisdomTree Dynamic Long/Short U.S. Equity Index nor does it represent a back test of that Index.

Timing market hedges can be one of the most challenging tasks for any strategy. A number of investors use [momentum](#) models to add a hedge, while this strategy uses fundamental characteristics of stocks earnings, their earnings quality and ultimately their relative valuations. Looking at how applying signals from the dynamic hedge indicator would have been applied to the [S&P 500 Index](#) the hedging indicator could have improved the S&P 500 returns by 201 [basis points \(bps\)](#) per year over the period studied, while also lowering volatility by almost 30%, or 413 bps per year, compared to the traditional S&P 500 Index. **Incorporating a**



**Dynamic Hedge Indicator**

Full Period	Cumulative Return	Average Annual Return	Standard Deviation
S&P 500	120.52%	5.92%	14.58%
S&P 500 with Hedging Indicator	185.73%	7.93%	10.45%
Hedging Indicator Value Added	65.21%	2.01%	-4.13%

Sources: WisdomTree, Alpha Vee, 12/31/01–9/30/15. Past performance is not indicative of future results. You cannot invest directly in an index. Note: This does not represent the returns to the WisdomTree Dynamic Long/Short U.S. Equity Index nor does it represent a back test of that Index.

WisdomTree is excited to bring its first low-cost<sup>4</sup>, systematic long/short ETF to the market. The WisdomTree Dynamic Long/Short U.S. Equity Fund (DYLS) is designed to track the [WisdomTree Dynamic Long/Short U.S. Equity Index](#) before fees and expenses. We believe the fundamental stock selection model could add value in the long run, and we also believe it was important to launch a hedged strategy after significant gains have been made in the market continuously since 2009. WisdomTree believes this strategy has potential to serve as a core allocation to help reduce risk during meaningful drawdowns, something we have not seen in quite some time.

<sup>1</sup>Source: WisdomTree, Morningstar, as of 9/30/15. Expense ratios for Morningstar categories are median values. <sup>2</sup>WisdomTree Dynamic Long/Short U.S. Equity Fund Net Expense Ratio reflects a contractual waiver of 0.5% through 12/15/16. <sup>3</sup>Components must be listed on a U.S. exchange, domiciled in the U.S., have a market cap of \$2 billion and share price of at least \$3 at time of screening. <sup>4</sup>Ordinary brokerage commissions apply.

**Important Risks Related to this Article**

There are risks associated with investing, including possible loss of principal. The Fund will 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 Fund to offset its exposure to market volatility may not perform as intended. The Fund 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 Index is heavily dependent on quantitative models and data from one or more third parties, and the Index may not perform as intended. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit, and the Fund does not attempt to outperform its Index or take defensive positions in declining markets. Please read the Fund’s prospectus for specific details regarding the Fund’s risk profile.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.

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.

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You cannot invest directly in an index.

## 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.

**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.

**Active manager** : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

**Hedge fund** : A hedge fund resembles a pooled investment vehicle administered by a professional management firm. It is often structured as a limited partnership or limited liability company. Hedge funds invest in a diverse range of markets and use a wide variety of investment styles and financial instruments.

**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.

**Passive** : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

**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.

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

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

**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.

**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.

**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.

**Operating profit margin** : Operating 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.

**Net income profit margin** : 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.

**Operating cash flow** : Measure of the amount of cash generated by a company's normal business operations, calculated by adjusting net income for items like depreciation and changes in inventory and receivables.

**Operating income** : Profit after operating expenses and depreciation.

**Momentum** : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

**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.

**Basis point** : 1/100th of 1 percent.