# HOW TO USE OUR LIQUID ALTERNATIVE STRATEGIES

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The equity markets continue to scale new heights, but anxiety around the market's position reigns. The political season tends to add to investor worries, as do the overall market valuation levels, which many feel are stretched. Investors have looked to long/short strategies as a way to diversify their long-only positions, but these funds—which may consist of mutual funds, hedge funds, or even exchange-traded funds (ETFs)—can also present many challenges, including high fees, opaque strategies, inconsistent performance, and sometimes lockups or gates that prevent liquidity.

**WisdomTree Liquid Alternative: Systematic Long/Short Investing**

WisdomTree launched a pair of liquid alternative ETFs that utilize the same underlying investment process and technology powering the strategies, with the primary difference being the net equity exposure of the Funds. The two ETFs are comprised of two components:

**1)A long portfolio:** The long portfolio is a basket of 100 low-valuation quality stocks with a low low volatility weighting process and a sector-neutral approach. This sector neutrality means there are no inherent sector bets being made in the long portfolio compared to traditional U.S. large-cap equity indexes like the S&P 500 Index.

**2)A dynamic short portfolio:** On a monthly basis, the strategies re-evaluate and deploy a dynamic market hedge that aims to lower overall market volatility and/or benefit from market declines.

- The **WisdomTree Dynamic Long/Short Equity Fund (DYLS)** has exposure that ranges from being fully invested with no hedge in place to fully market neutral –or 0 beta with a full hedge in place. A 50% hedge scenario is also possible.

- The **WisdomTree Dynamic Bearish U.S. Equity Fund (DYB)** has exposure ranges from a net positive beta of 0.25 (fully invested in a portfolio of equities with a 75% market hedge in place)—during times that our signals suggest are more positively inclined—to fully short the market (-1 beta) during times we see as more challenging. There is also a market-neutral scenario in which the portfolio is long a basket of stocks with a full market hedge.

- While the underlying equity portfolio is the same and the market hedging signals are also the same, the net exposures of these two Funds are very different. DYB could potentially have a zero or negative net equity beta over time (due to it being short the market potentially ¼ of the time), while the net equity beta of DYLS is likely to be a long net of .6 to .7.

**How Combining DYB and DYLS Can Target Specific Net Equity Beta**

Research we have seen on long/short hedge funds suggests that over time these hedged funds target or have typically delivered a net equity beta exposure of 0.51. Equally weighting a blend of DYB and DYLS may result in a fairly similar net exposure of close to 0.5.

I'll illustrate how this has worked in the nine months of real time these two Funds have been trading in the markets.

- Currently, an equal-weighted allocation to DYB and DYLS would imply a 0.625 equity beta. DYLS has beta of 1 as it's fully invested, and DYB has beta of 0.25 given it's 75% hedged, hence so the average is .625.
- In January and February of this year, the positioning in these Funds was more bearish; DYLS was fully hedged (net 0 equity beta) and DYB was fully short the market (-1 equity beta). At that stage, the equal-weighted allocation to DYLS and DYB had a net equity beta of -0.5. For the full year in 2016 as of August 31, the net equity beta of this 50/50 blend between DYLS and DYB has been 0.38, and we expect this to be symbolic of its exposure in the long run.

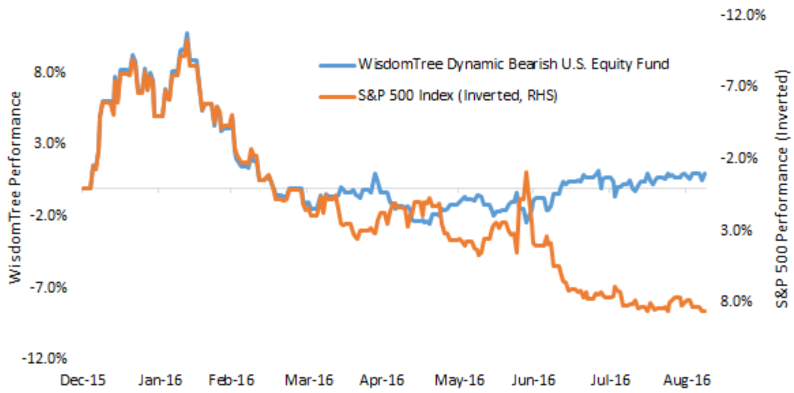
**Net Equity Beta**

| Net Equity Beta | | | |
|---|---|---|---|
| | DYLS | DYB | 50/50 Blend |
| January | 0 | -1 | -0.5 |
| February | 0 | -1 | -0.5 |
| March | 1 | 0.25 | 0.625 |
| April | 1 | 0.25 | 0.625 |
| May | 1 | 0.25 | 0.625 |
| June | 1 | 0.25 | 0.625 |
| July | 1 | 0.25 | 0.625 |
| August | 1 | 0.25 | 0.625 |
| September | 1 | 0.25 | 0.625 |
| **Average** | **0.78** | **-0.0278** | **0.375** |

One of the reasons we launched DYB is that systematic strategies that are fully short the market over long periods are likely to be big long-run losers. But we think there are times when short strategies can help lower portfolio volatility, and there is a worthwhile goal of hedging market declines when risk levels become more extreme. The trick is to identify when those times are in order to navigate the markets skillfully.

In 2016, DYB has been able to outperform a strategy that was fully short the market all year, due to its net beta of 0.25, which has been in place since March 2. The strategy in DYB was fully short the market, and increased in value with the inverse S&P 500 Index in January and February. Click here for standardized performance of DYB.

**Outperformance of DYB.**




Sources: WisdomTree, Bloomberg from 12/31/2015 – 9/7/2016.

**Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and 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. Performance data for the most recent month-end is available at www.wisdomtree.com.**

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Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

The timing signals in DYLS and DYB have been impressive in 2016—and we do not expect to time the markets as well as the last nine months have gone. Given the complexity of many long/short active strategies and how opaque the underlying process is for them, we think having a rules-based, transparent ETF strategy that can help lower portfolio volatility is a very important development for the marketplace. If you're worried about overall market volatility and are looking for hedging vehicles, DYB and DYLS are two strategies worth considering.

[1]William Baldwin, "Scary Results at Long-Short Equity Funds," Forbes, 8/23/16.

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You cannot invest directly in an index.

## DEFINITIONS

**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).

**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.

**Net Equity Exposure** : The difference between a fund or portfolio's long and short equity exposure.

**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.

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

**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.

**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.

**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.

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