SOLVING THE PORTFOLIO PARADOX: WISDOMTREE'S EFFICIENT CORE FUNDS

Jeremy Schwartz — Global Chief Investment Officer
05/24/2021

There's a paradox in portfolio construction.

Traditionally, investor portfolios contained dedicated allocations to equities and fixed income, seeking capital appreciation provided by the former and risk mitigation provided by the latter.

The inherent trade-off between risk and return created the foundation for the portfolio management industry and prompted the timeless question: "How can I grow my investments during bull markets while seeking to mitigate risk during bear markets?"

Opportunity Costs

Historically, an allocation to one asset came at the expense of the other's benefits. Investors intent on growing their portfolios may be comfortable adopting more equity exposure to participate further in market rallies. But risk-averse investors dread the thought of losing investment value during a market correction, and steer toward the perceived safety and income generation historically provided by fixed income.

Likewise, large drawdowns are difficult to overcome and waste time that is better spent continuing to grow investments instead of attempting to recover.
Consider an investor that loses 50% of portfolio value in one period due to severe market volatility. That same portfolio then needs to double in value just to restore the value it had before the initial market shock.

Thus, the portfolio paradox was born: equity upside coupled with downside risk mitigation seems fundamentally incompatible.

Buy 10, Get 60

WisdomTree developed a potential solution to this mystery in 2018 with the launch of the WisdomTree U.S. Efficient Core Fund (NTSX), offering a way to participate in equity bull markets with the potential to reduce drawdowns during sharp, sudden reversals.

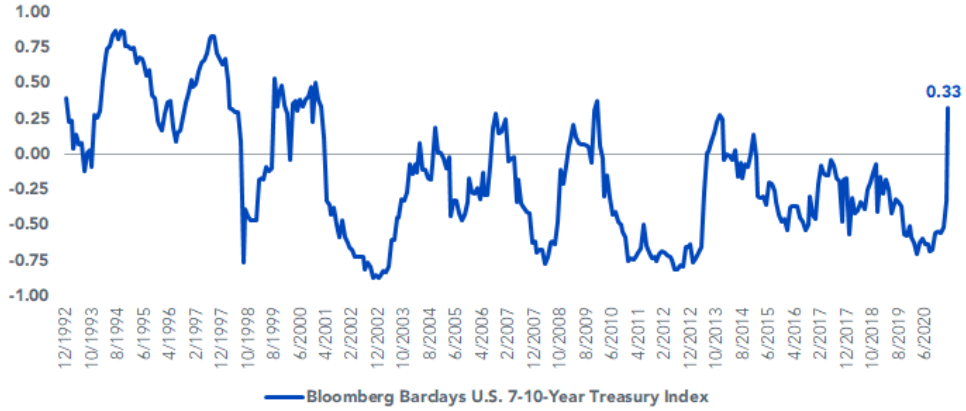
The WisdomTree U.S. Efficient Core Fund gains equity exposure by investing 90% of assets in the 500 largest U.S. stocks by market capitalization, with the remaining 10% cash used to collateralize 60% notional exposure to laddered U.S. Treasury futures. This means that investors can receive more fixed income exposure than the would normally receive if they invested in U.S. Treasury Bonds directly.

The result is a capital efficient strategy, where investors can achieve the potential drawdown protection offered by fixed income without dollar-for-dollar exposure or sacrificing equity allocations.

There's a compelling investment thesis for overlaying U.S. Treasury futures over an equity-dominant strategy in pursuit of risk mitigation.

Historically, intermediate U.S. Treasuries have exhibited reduced correlations across market cycles to U.S. equities (proxied by the S&P 500 Index), validating that fixed income can potentially be an effective diversifier for equity exposures. On a rolling 12-month basis, return correlations are often consistently negative as well.

Rolling 12-Month Correlation to S&P 500 Index



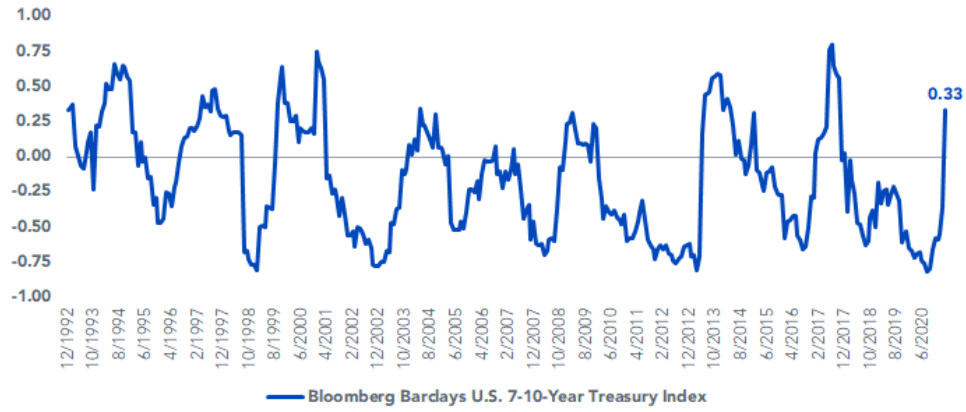
Sources: WisdomTree, Zephyr StyleADVISOR, as of 3/31/21. Past performance is not indicative of future results. You cannot invest directly in an index.

But there's more to the story. The diversification benefit does not suddenly cease as soon as you look to invest abroad. In fact, it often holds up as well as it does in the U.S.

New Markets, Similar Results

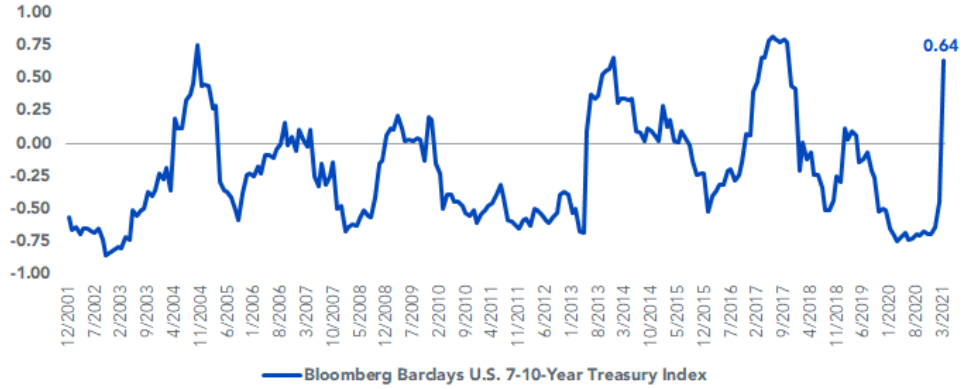
The reduced—and often negative—correlation to equity markets has been evident in developed and emerging equity markets. Once again, U.S. Treasury notes fluctuate throughout market cycles, but delivered strong diversification potential when compared to the MSCI EAFE Index and the MSCI Emerging Markets Index.

Rolling 12-Month Correlation to MSCI EAFE Index



Sources: WisdomTree, Zephyr StyleADVISOR, as of 3/31/21. Past performance is not indicative of future results. You cannot invest directly in an index.

Rolling 12-Month Correlation to MSCI Emerging Markets Index



Sources: WisdomTree, Zephyr StyleADVISOR, as of 3/31/21. Past performance is not indicative of future results. You cannot invest directly in an index.

Over longer periods, such as the past 20 years, the negative relationship is even more notable when you consider that this includes three periods of significant market stress: the burst of the 2001 tech bubble, the 2008 global financial crisis and the onset of the COVID-19 pandemic.

20-Year Correlation of Monthly Returns as of 3/31/2021			
	S&P 500 Index	MSCI EAFE Index	MSCI Emerging Markets Index
Bloomberg Barclays U.S. 7-10-Year Treasury Index	-0.35	-0.28	-0.24

Sources: WisdomTree, Zephyr StyleADVISOR, as of 3/31/21. Past performance is not indicative of future results. You cannot invest directly in an index.

Solutions for Developed & Emerging Markets

The unique diversification potential of intermediate U.S. Treasuries inspired us to extend our capital efficient approach to developed and emerging markets. As a result, we're excited to introduce the WisdomTree International Efficient Core Fund (NTSI) and the WisdomTree Emerging Markets Efficient Core Fund (NTSE).

Both are constructed using the same ideas as the U.S.-focused NTSX.

They first invest 90% of assets in the 500 largest stocks by market capitalization in the developed and emerging markets regions, respectively. The remaining 10% held as cash is used to collateralize 60% notional exposure to laddered U.S. Treasury futures, once again providing capital efficiency through greater equity exposure coupled with potential drawdown risk mitigation via fixed income.

The enhanced exposure may be a benefit to investors who don't need to sacrifice existing developed or emerging markets allocations in favor of fixed income or invest more capital to implement a more elaborate strategy.

Quick Facts			
	WisdomTree U.S. Efficient Core Fund	WisdomTree International Efficient Core Fund	WisdomTree Emerging Markets Efficient Core Fund
Ticker	NTSX	NTSI	NTSE
Exchange	NYSE	NYSE	NYSE
Expense Ratio	0.20%	0.26%	0.32%
Structure	Open-End ETF	Open-End ETF	Open-End ETF
Exposure	90% equities, 10% Cash, 60% U.S. Treasury Futures	90% equities, 10% Cash, 60% U.S. Treasury Futures	90% equities, 10% Cash, 60% U.S. Treasury Futures
Rebalancing	Quarterly	Quarterly	Quarterly

Source: WisdomTree.

Navigating Potential Market Uncertainty

Financial markets are ever-changing, and it's nearly impossible for investors to adapt to these changes in real time. That's why prudent asset allocation is necessary so that investors can try to navigate their portfolios from periods of volatility before they even appear.

We believe a large-cap equity strategy, overlaid with U.S. Treasury futures as a risk mitigator, can potentially deliver both capital appreciation and a level of downside risk management throughout market cycles when investing in the U.S. and abroad.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. No level of diversification or non-correlation can ensure profits or guarantee against losses.

Risks related to NTSX, NTSE and NTSI: While the Funds are actively managed, their investment processes are 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 Funds invest 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 Funds' 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 Funds 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 perception of an issuer's creditworthiness.

Additional risks specific to NTSI: Investments in non-U.S. securities involve political, regulatory and economic risks that may not be present in U.S. securities. For example, foreign securities may be subject to risk of loss due to foreign currency fluctuations, political or economic instability, or geographic events that adversely impact issuers of foreign securities.

Additional risks specific to NTSE: Investments in non-U.S. securities involve political, regulatory and economic risks that may not be present in U.S. securities. For example, foreign securities may be subject to risk of loss due to foreign currency fluctuations, political or economic instability, or geographic events that adversely impact issuers of foreign securities. Investments in securities and instruments traded in developing or emerging markets, or that provide exposure to such securities or markets, can involve additional risks relating to political, economic or regulatory conditions not associated with investments in U.S. securities and instruments or investments in more developed international markets.

Please read each 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.

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)

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, 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

Drawdowns : Periods of sustained negative trends of return.

Collateral : something pledged as security for repayment in the event of a loss.

Notional : The dollar value of the derivative contract.

Ladder : A fixed income strategy that seeks equal allocations across the yield curve in order to limit reinvestment risk.

U.S. Treasury futures contract : A standardized contract to buy or sell a Treasury security on a specified date at a predetermined price.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

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.