Turbocharge your equity exposure with Efficient Core

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‘Efficient Core’ is an innovative investment concept recently introduced by WisdomTree. It consists of using the inherent diversification between equity and bonds to improve the risk-return profile of an equity exposure. In effect, Efficient Core strategies invest 90% of their capital in physical equities and then use the remaining 10% as cash collateral for a 60% exposure to government bonds future contracts. By bundling equity and bonds in a single strategy, this approach aims to deliver equity like returns with lower volatility and a higher Sharpe ratio.

Efficient Core—an equity replacement

By offering return enhancement, lower risk and a better Sharpe ratio, historically, compared to a 100% equity portfolio, Efficient Core can be used to replace existing equity exposures, such as investment in market cap weighted equity indices.

Figure 1 compares the historical return of Efficient Core strategies with the relevant equity benchmark in their geographies. In each of the regions, Efficient Core is proxied by a backtest consisting of investing 90% of the assets in the equity benchmark (S&P 500, MSCI World, MSCI Emerging Market, Nikkei 225 or Europe STOXX 600) and adding 60% exposure to a basket of government bonds futures contract of different maturities in the relevant currency (US Treasury futures contract for US Efficient Core, German government bond futures contracts for Europe Efficient Core etc.).

We observe that, in the 5 regions illustrated below, the Efficient Core strategy has delivered higher annualised returns and lower volatility to the benchmark.

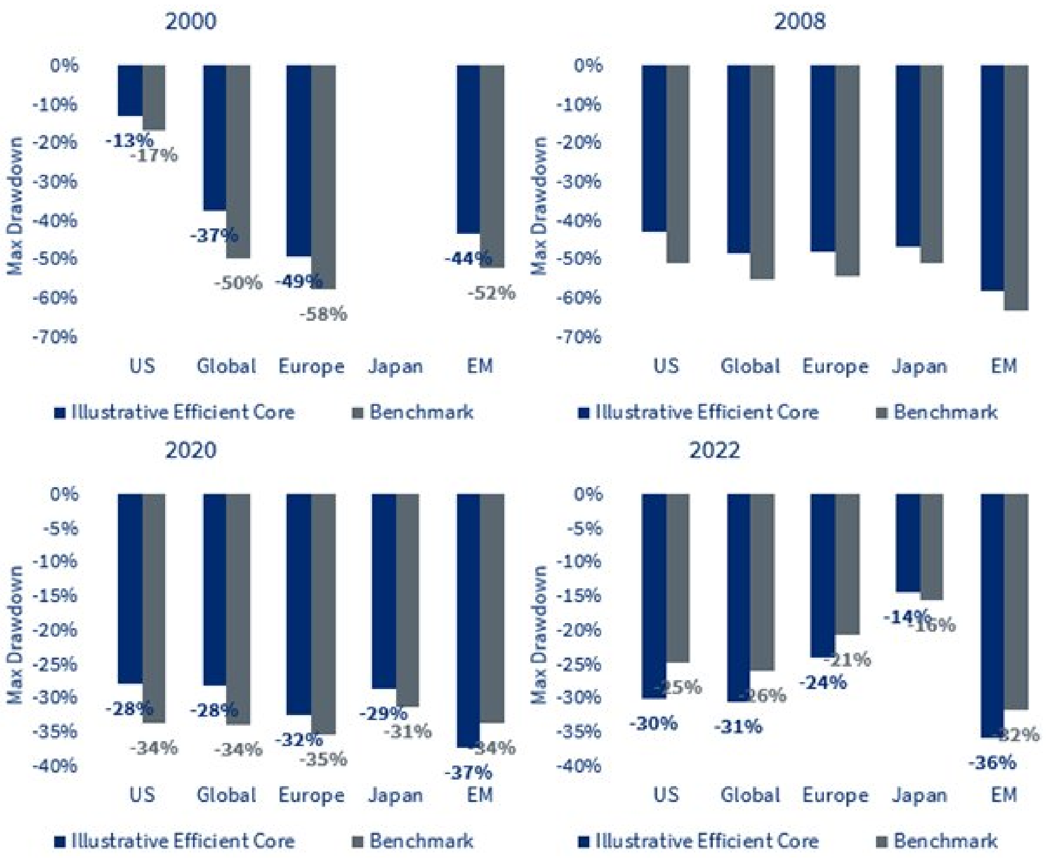
Figure 1: Higher returns and lower volatility across all regions

Sources: Bloomberg, WisdomTree. As of 17 October 2023. Daily data in the relevant currency (USD, EUR or JPY) is used. All analyses start on 31 December 1998 except for Japan, which starts in January 2002. Equity indices are net total returns. Backtested data used. Historical performance is not an indication of future performance and any investments may go down in value.

A lower risk approach

One of the interesting features of the Efficient Core strategies is their capacity to lower daily risk (that is, lower the volatility) but also to limit the overall risk (that is, lower the max drawdown and Value at Risk). Looking at the recent and less recent market drawdowns, in Figure 2, we observe that during the dot-com drawdown in 2000, the financial crisis in 2008 and the COVID-19 drawdown in 2020, all the Efficient Core strategies cushioned the equity loss, reducing the max drawdown by up to 13%. This is key for long-term investors, as large drawdowns take a long time to overcome.

Figure 2: Efficient Core drawdown vs the market over the last 20 years



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Of course, 2022 tells a different story. With the fastest rate hike cycle in history in most developed markets, 2022 yielded both an equity and bond bear market. While not a unique situation, this is only the sixth time since the 1920s. With such a market, Efficient Core delivered a deeper drawdown than equities in almost all regions.

How does Efficient Core compare to Min Volatility strategies?

Efficient Core strategies are, overall, defensive strategies and can, therefore, be compared to Minimum and Low Volatility strategies. Those strategies are designed to offer downside protection during market downturns but also often offer lower upside participation during bull markets. Figure 3 compares the upside and downside capture of both styles of strategies. We observe that both strategies are asymmetric; that is, they exhibit a higher upside capture ratio than downside capture, which explains why both strategies tend to outperform the market over the long term. The Min Volatility strategies are very defensive, with an upside capture of around 75%, while the Efficient Core strategies offer an upside capture of around 90%.

Figure 3: Upside and downside capture for Efficient Core and Min Volatility strategies

Sources: Bloomberg, WisdomTree. As of September 2023. Monthly data in the relevant currency is used (USD or EUR). All analyses start on 31 December 1998 except Europe, which starts in December 2001. Min Volatility strategies are proxied by the MSCI Min Vol TR net Index in the relevant geography. Backtested data used. Historical performance is not an indication of future performance and any investments may go down in value.

This different capture ratio results in a slightly different risk return profile:

- Min Volatility strategies have, historically, exhibited lower max drawdown than the market. They have also outperformed the market over the long term.

- Efficient Core strategies have, historically, exhibited lower max drawdown than the market but slightly higher than Min Volatility strategies. They have also outperformed the market as well as Min Volatility strategies over the long term.

Figure 4: Annualised returns and max drawdown for Efficient Core and Min Volatility strategies

Sources: Bloomberg, WisdomTree. As of September 2023. Monthly data in the relevant currency is used (USD or EUR). All analyses start on 31 December 1998 except Europe, which starts in December 2001. Min Volatility strategies are proxied by the MSCI Min Vol TR net Index in the relevant geography. Backtested data used. Historical performance is not an indication of future performance and any investments may go down in value.

Key Takeaways

- By adding bond exposure to physical equity exposure, Efficient Core offers investors a better risk-return profile than a pure equity exposure. Leveraging the diversification between the two asset classes, it is possible to outperform equities with less volatility.

- Efficient Core strategies can be very efficient replacements for passive or index equities exposure with higher returns and lower volatility, historically, across many world and regional exposures.

- Efficient Core strategies can be quite defensive, offering historically lower drawdown, lower volatility, and lower downside capture. But, at the same time, they also deliver above-market returns and interesting upside capture. Compared to the Min Volatility strategy, they offer the same asymmetry but with high upside capture and overall returns.

Read our full Efficient Core whitepaper here.

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