

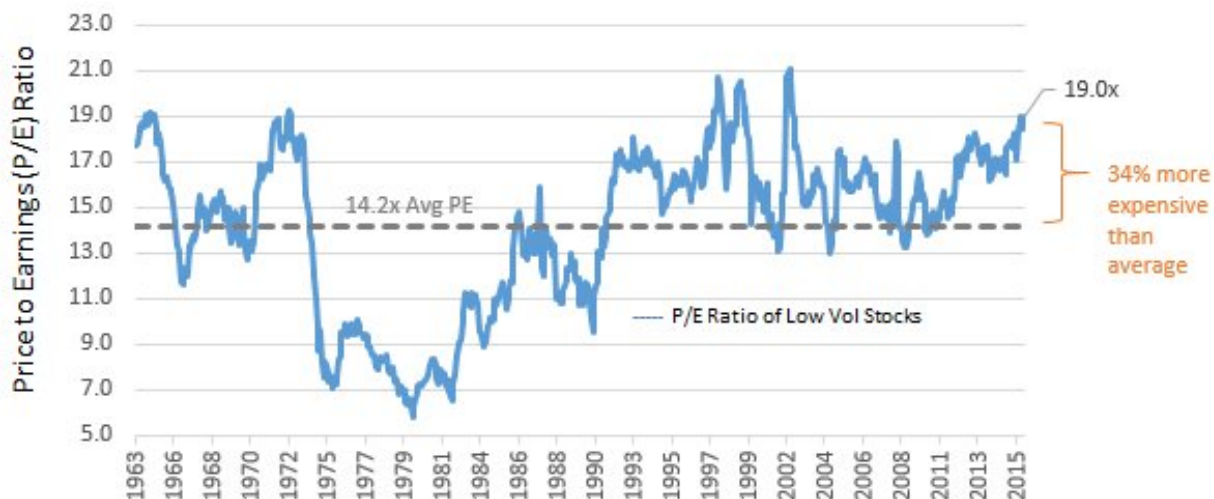
A Drawback of Low Volatility Strategies

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Jeremy Schwartz, CFA

Global Chief Investment Officer

One of the most exciting characteristics of exchange-traded funds (ETFs) is how trends of inflows and outflows paint a picture of investor behavior. Investors have a reputation for performance chasing, and what has been hot of late is minimum-volatility or [low-volatility strategies](#). The inflows have followed very strong performance, and expectations are widely held that 2016 will be marked by continued volatility. Below we review a potential drawback of many low-volatility strategies and propose an alternative solution that may be more attractive today. **How Do Most Low-Volatility Strategies Work?** Broadly speaking, there are two common approaches to achieving low or minimum volatility: • **Method One:** Select stocks from a given universe that have exhibited relatively lower volatility of their returns when measured against the full universe. Putting the greatest weight in the least volatile qualifying stock and the smallest weight in the most volatile qualifying stock could emphasize the tilt toward lower volatility even further. • **Method Two:** Utilize a portfolio-optimization function to examine the variances and covariances of returns across all potential pairings of stocks within a particular universe such that, in totality, securities are selected and weighted with the sole goal of creating the portfolio with the lowest possible expected volatility. **Key Factor:** However the aim is achieved, an important fact about these strategies is that they are insensitive to the behavior of underlying corporate fundamentals—the story here is about looking at price behavior and relationships between movements of different stock prices rather than anything about the underlying fundamentals of the firms. **The Pitfall of Low Volatility Today: Valuations Low-Volatility Decile Average Price-to-Earnings (P/E) Ratio**



Source: O'Shaughnessy Asset Management, for period from 12/31/1963 to 12/31/2015. Universe refers to U.S.-listed stocks with appropriate 12-month price history for volatility calculation. Cited with permission. Past performance is not indicative of future results.

The Factor Investor blog published a nice piece on the historical valuations of the lowest-volatility stocks.

Currently, the lowest-volatility decile of stocks has a P/E ratio that is 34% more expensive than its

52-year historical average.¹ **An Alternative Approach to Lower Volatility and Focus on Valuations**

In late 2015, WisdomTree launched an alternative strategy, the [WisdomTree Dynamic Long/Short U.S. Equity Fund \(DYLS\)](#),

that incorporates a multifactor, sector-neutral portfolio that focuses on valuations and quality characteristics of individual stocks, while weighting the constituents by their low-volatility characteristics. DYLS, together with the Index it is designed to track before fees and expenses, adds a dynamic market hedge that we believe has the potential to lower the volatility of the Fund by adjusting its market hedge ratio based on trends in underlying fundamentals. The description above has a lot to it, so let's zone in on the details of how DYLS works: 1) **Sector-Neutral Approach:** A number of low-volatility strategies have sector weights that materially drift from the market. The strategy targets sector exposure of the 500 largest stocks by market capitalization and selects stocks from every sector to achieve that sector-neutral exposure. 2) **Grading Stocks Based on Valuation and Quality Characteristics:** Unlike most volatility-reduction strategies that focus on historical volatility only, this strategy grades stocks in every sector with a unique, sector-specific model that looks at valuation criteria such as dividend yield, price-to-earnings ratio, price-to-book ratio, as well as quality measures like return on equity, return on assets and operating profit margins. A result of this stock selection strategy is that the portfolio exposure does not represent strictly a value or a quality strategy; it equally balances characteristics of both valuation and quality criteria to determine the most attractive stocks. The fundamental comparison of the stocks in DYLS to the [S&P 500 Index](#) shows how there is a blend of lower valuations, higher historical earnings growth, higher return on equity, higher return on assets and higher margins. **DYLS vs. the S&P 500 Index from a Fundamental Perspective**

Equity Fundamental Statistic	DYLS	S&P 500 Index
Dividend Yield	2.47%	2.16%
Trailing 12-Month P/E Ratio	15.40x	19.18x
Return on Equity (based on Forward 12-month Earnings Estimates)	17.33%	16.37%
Net Income Growth over Trailing 12 Months	14.30%	-0.38%
Operating Income Growth over Trailing 12 Months	11.29%	1.06%
Average Annual Dividend Growth for Past 5 Years	16.98%	12.40%
3-Year Average Return on Equity	32.25%	19.89%
3-Year Average Return on Assets	8.92%	6.47%
Return on Invested Capital	14.97%	11.91%

Source: Bloomberg, with data as of 4/26/16. Past performance is not indicative of future results. You cannot invest directly in an index.

Click here for standardized performance of [DYLS](#). 3) Within each sector, once the most attractive stocks are selected, they are weighted not by market capitalization but rather in a manner that gives higher weights to lower-volatility stocks. 4) The fourth element of the strategy incorporates a dynamic hedge on the market that leaves the net equity exposure of the portfolio ranging from being fully invested to half hedged or fully hedged. [The strategy was fully hedged in January and February](#), and during the market volatility experienced during that period, DYLS performance remained relatively flat. The market hedge came off in March as the strategy participated in the gains of the market in March. It is our expectation that the stock selection and weighting system that favors lower-priced, higher-quality and lower-volatility companies could help lower the volatility compared to the market by 10% to 15%. Adding a dynamic market hedge that aims to reduce the net market exposure approximately one-quarter to one-third of the time may result in lowering the overall portfolio volatility.² We expect the net beta, or market exposure of DYLS compared to the S&P 500, to be about 0.7 or less over longer periods.³ We encourage those investors looking for a lower-volatility approach but worried about the extended valuations in some of the popular minimum-volatility strategies to consider DYLS. Moreover, DYLS, with a long short approach, was launched with an expense ratio of 0.48%, what we consider to be a low-cost⁴ leader in these market-hedged or long/short approaches. ¹Source: O'Shaughnessy Asset Management, for period from 12/31/1963 to 12/31/2015. Cited with permission. ²Sources: WisdomTree, Alpha Vee, with data from 12/31/01 to 3/31/16. ³Subject to change. ⁴Ordinary brokerage commissions apply.

Important Risks Related to this Article

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