

# 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 \(DYLS\)](#), 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.

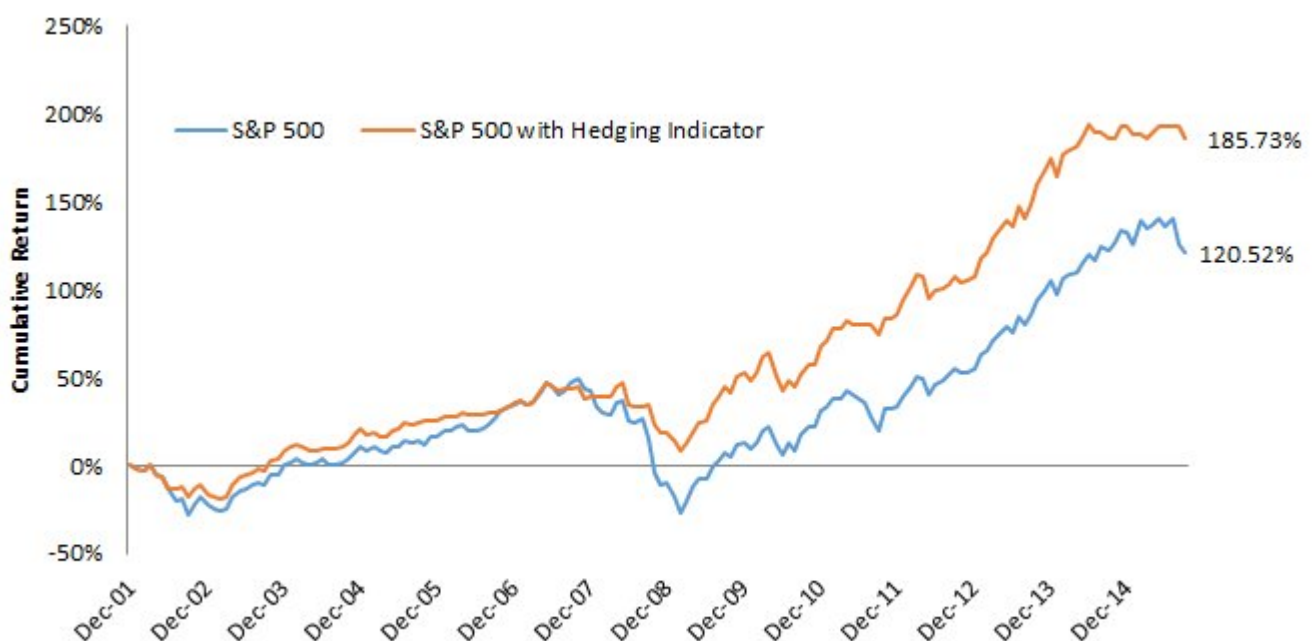
**Index Component Exposure** The Index contains both long and short components. The net short exposure will change monthly based on an evaluation of the market environment. Based on the growth and value indicators of the market, the component weights will be one of the following: **Dynamic Hedge Component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

| Value/Growth Indicators | Long Portfolio       | Dynamic Hedge Ratio<br>(% Portfolio Short) | Signal Reading<br>(% 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.