

Use Cases for the WisdomTree 90/60 U.S. Balanced Fund

Published September 14, 2018

Jeremy Schwartz, CFA

Global Chief Investment Officer

In rural Maine at Camp Kotok, I sat with Barry Ritholtz, CIO of Ritholtz Wealth Management, on the deck of Leen's Lodge discussing the launch of the [WisdomTree 90/60 U.S. Balanced Fund \(NTSX\)](#) and how investors should think about using this new 90/60 strategy in a portfolio context.

My starting point was very technical and specific for how a 90/60 portfolio combination could be useful: a two-thirds allocation to a 90/60 strategy represents a common 60/40 portfolio of stocks/bonds and this "capital-efficient" access vehicle would free the remaining one-third of additional capital to be deployed in other diversifying strategies or simply just additional exposure.

Ritholtz stopped me halfway through my explanation and suggested I was positioning this 90/60 strategy all wrong. He asked (or perhaps suggested): "Wouldn't you be better off positioning this 90/60 strategy as a 'hedged equities' strategy, with the bond exposure acting as a 'hedge,' or diversifier, to U.S. equity exposure?"

Do Bond Futures Act as a Hedge to Equities?

While there are of course no guarantees in life—in particular, that future returns in either stocks or bonds, or the relationship between stocks and bonds, will hold in the future as they have in the past—evaluating the last 30 years of bond futures index data can give us an idea for how bond futures may perform during declining equity markets.

We evaluated the last 10 big market drawdowns over the last three decades—the limit of historical lookback being bond futures index data.

Context	Starting Peak	Ending Trough	Day Count	S&P Drawdown	Bond Futures Composite
Global financial crisis	10/9/2007	3/9/2009	517	-55.3%	16.4%
Dot-com bubble burst	9/1/2000	10/9/2002	768	-47.4%	19.2%
1998 Russian crisis & LTCM	7/17/1998	8/31/1998	45	-19.2%	2.7%
Negative global rates, falling crude, pain in banking sector	7/20/2015	2/11/2016	206	-13.0%	7.0%
Producer inflation surprise upside/hawkish greenspan	7/16/1999	10/15/1999	91	-11.8%	-2.2%
Dot-Com bubble early innings	3/24/2000	4/14/2000	21	-11.1%	1.7%
Asian contagion/Tom Yum Goong	10/7/1997	10/27/1997	20	-10.8%	0.1%
Inflation fears	1/26/2018	2/8/2018	13	-10.1%	-1.5%
Ugly job report, record low 10-year yields	4/2/2012	6/1/2012	60	-9.6%	5.3%
Signs of future inflation and potential hike in May '97	2/18/1997	4/11/1997	52	-9.4%	-3.7%

Sources: WisdomTree, S&P, Bloomberg, Zephyr StyleADVISOR, for the period 8/31/1990–7/31/2018. Bond Futures Composite is constructed using an equal weight of four indexes: the ICE BofA Merrill Lynch 2-, 5-, 10- and 30-Year U.S. Treasury Futures Excess Return Indexes. S&P Drawdown represents the peak-to-trough decline in performance for the S&P 500 Index. Past performance is not indicative of future results. You cannot invest directly in an index.

The two biggest equity declines—the global financial crisis and the bursting of the dot-com bubble that saw approximately 50% drawdowns in equities—coincided with positive returns to bond futures indexes, as investors flocked out of risky assets to bonds, sending bond yields down and bond futures index returns up. The gains in bond futures indexes were over 15% in each period—meaning that the gains in bonds would have cushioned some of the declines (a modest amount), lending to a partial hedge to equity exposure with the bond futures.

Of course, bond futures didn't act as a hedge in every market decline, but the probability of it being in your favor was in your favor. The gains in bond futures provided you the most cushioning during the two aforementioned drawdowns. In seven of these 10 declining equity markets, the bond futures indexes provided a positive return, and in three of 10 equity declines coincided with negative bond futures returns.

One period in which bonds declined alongside equities was from July 1999 to October 1999, when the [S&P 500](#) Index had an 11.8% drawdown that coincided with positive inflation surprises, rising interest rates and investors believing then Federal Reserve Chairman Alan Greenspan was becoming more hawkish.

More recently, in January/February 2018, inflation data started giving fears of rising interest rates and a more aggressive Federal Reserve, as the 10-Year rates picked up and the S&P 500 had about a 10% correction—with bond futures declining approximately 1.5% over a two-week stretch when the S&P 500 lost 10.1%.

90/60 Strategy to Lower Equity Beta:

If one compares a 90/60 strategy with a 100% equities position, the lower exposure to equities (10% lower exposure by only investing 90 cents of every dollar invested into equities) is one way this 90/60 strategy acts as a lower beta/lower volatility approach—that is, by being “less invested.”

The key question is: can the 10% cash exposure plus the 60% bond futures exposure help achieve similar returns as the 100% equities but with lower volatility?

To determine if the strategy will have lower volatility, one important relationship to examine will be the correlation between stocks and bond futures. If stocks and bonds decline at the same time (i.e., a rising interest rate environment causes stocks to decline), there could be compounding risk. But the lower equity exposure (being only 90% invested in equities for every dollar investor) could ultimately dampen volatility enough to keep volatility lower with a 90/60 strategy.

Our research does lead us to believe the combined volatility in a 90/60 strategy should be lower than 100% equities, and, if anything, recent evidence shows increasing diversification of the stock and bond pieces.

Using trailing 3-/5-/10-year correlation windows shows a trend toward consistently negative correlations of stocks and bond futures. There was a time over last 30 years during the early 1990s where there was a more positive correlation, but that hasn't been the case recently. Bonds have increasingly acted as a "negative beta" asset to equities and have shown negative correlation and diversification potential.

Rolling Correlations of S&P 500 and Bond Futures Composite



Sources: WisdomTree, S&P, Bloomberg, Zephyr StyleADVISOR, for the period 8/31/1990–7/31/2018. Bond Futures Composite is constructed using an equal weight of four indexes: the ICE BofA Merrill Lynch 2-, 5-, 10-, and 30-Year U.S. Treasury Futures Excess Return Indexes. Past performance is not indicative of future results.

- Our expectation is that less than 20% of rolling three-year periods will wind up with the 90/60 strategy having a beta greater than 1 to equities, while more than 66% of rolling three-year periods should exhibit an equity beta lower than .9.

While certainly one use case for the 90/60 strategy is to supplement a traditional stock and bond portfolio, I think Ritholtz made a very good point in Maine—perhaps this 90/60 strategy will also find some additional

use cases in helping investors lower their equity market risk while trying to achieve similar long-term returns as a 100% equities position.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. While the Fund is actively managed, the Fund's investment process is 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 Fund invests 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 Fund's 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 Fund 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. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

Diversification does not eliminate the risk of experiencing investment losses.