

IS NOW THE TIME TO CONSIDER LONG/SHORT ALTERNATIVES?

Jeremy Schwartz — Global Chief Investment Officer

08/30/2016

Forbes recently published an article, “Scary Results at Long-Short Equity Funds,” in its August 23, 2016, issue. The author doesn’t pull any punches in describing the dismal results, writing:¹

Important question: Do you really want [hedge-fund-like returns](#)? Take a look at them before signing up. Morningstar counts 133 publicly offered funds in its “long-short equity” category, holding a combined \$34 billion. Results: awful. The average return for the bunch has been 2% a year over the 36 months to June 30. You could have had 11.7% a year from a stock index fund.

One obstacle these [long /short funds](#) face is fees. Again, quoting the author:

Those 133 strivers ... have “proprietary” models, “high conviction investments” and “patent pending” strategies—and charge accordingly. The average expense ratio runs to 1.9% a year. That’s 38 times as high as for a stock index fund.

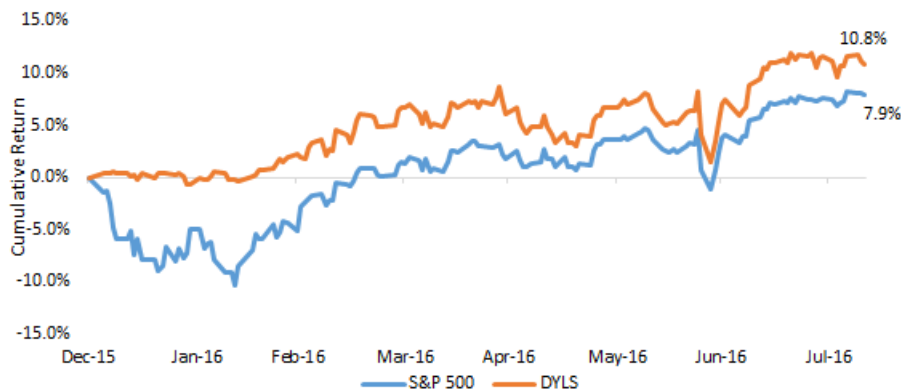
Extending on this analysis, below we show the category returns in 2016 and over longer-term periods. The average long/short equity fund had a negative return in 2016 through July, while the [S&P 500](#) had a return of 7.7%. Going back 10 years, the average fund underperformed the S&P 500 by over 200 [basis points \(bps\)](#) per year.

Performance as of 7/30/2016					
	YTD	1-Year	3-Year	5-Year	10-Year
S&P 500 Index	7.66%	5.61%	11.16%	13.38%	7.75%
Morningstar Long/Short Equity	-0.09%	-3.96%	2.19%	4.17%	5.61%

Sources: WisdomTree, Morningstar as of 7/30/16. Morningstar Long/Short Equity includes exchange-traded funds as well as mutual funds in the Morningstar Long/Short Equity Category. Past performance is not indicative of future results. You cannot invest directly in an index.

Morningstar, Inc., 2016. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance, rankings and ratings are no guarantee of future results.

The disappointing returns for the category cited above do not refute the role or stated goal for these strategies. With stock markets and bond markets at all-time highs, investors are perhaps appropriately looking for solutions that can help lower portfolio [volatility](#) and navigate adverse moves in the market. But does one need to rely on an [active](#) approach, which typically carries higher fees and therefore higher hurdle rates? **A Systematic, Exchange-Traded Fund (ETF) Approach to Long/Short Investing** Late last year, WisdomTree launched a long/short equity Fund in the ETF structure. Our thought process: we saw the high fees in traditional active long/short strategies and wanted to build a rules-based systematic ETF that attempts to deliver value through both stock selection and a [dynamic hedging](#) of market risk at a low cost² for this category, with the expense ratio of 0.48%. We believe the [WisdomTree Dynamic Long/Short Equity Fund \(DYLS\)](#) could currently be one of the lowest-cost funds in the long/short equity category. In what has been a difficult environment for the traditional long/short equity funds this year—with performance of the average long/short fund showing negative returns in 2016—DYLS has had returns over 10% through August 10, 2016, while the S&P 500 was up approximately 8%. For standardized performance of DYLS, visit the [WisdomTree Dynamic Long/Short Equity Fund](#) page. **DYLS vs. S&P**



Sources: WisdomTree, Bloomberg, 12/31/15–8/10/16. Double-digit returns were achieved primarily during favorable market conditions. Investors should not expect that such favorable returns can be consistently achieved. A fund's performance, especially for very short time periods, should not be the sole factor in making your investment decision.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

500 YTD

Quality and Value

Selection, with No Inherent Sector Bets DYLS implements a stock selection strategy that incorporates a value and quality discipline to forming the portfolio. One of the features of its underlying Index methodology, though, is a sector-neutral starting point and sector-driven stock selection strategy. Despite employing a strategy that selects stocks selling at relatively lower price multiples with higher-quality characteristics, the incorporation of a sector-neutral weighting scheme leaves no inherent sector bets being made in DYLS. This sector neutrality mitigates the risk from value stocks or quality stocks falling out of favor in a given market cycle and really focuses on the value-added side of the value/quality factors for picking stocks. We also believe that employing unique models for every sector helps differentiate this strategy from other "smart beta" funds, which typically look at quality or value stocks using a single framework across all stocks. Further, within each sector, there is a low-volatility weighting emphasis.

How Dynamic Hedging Could Have Helped Protect a Portfolio in Early 2016 In the chart above on performance in 2016, one can see DYLS had a relatively flat performance in January and February, while the market swooned 10% and then rallied back in March. DYLS uses a [dynamic hedging indicator](#) that was fully hedged for January and February, and the [hedge](#) came off on March 2. The full market hedge in DYLS that was incorporated in January and February has been a key differentiator for its performance. The indicators we use have remained unhedged since March, so DYLS has participated in the market's gains since March 2. The dynamic hedging process employed by DYLS looks at trends in underlying [profit margins](#) and quality of profits, combined with overall market valuations. The model for hedging is completely rules-based. When our fundamental indicators show more risk building up in the market, a hedge will be put back in place. Given the indicator is based on trends in profits and valuations, it is certainly possible for a hedge to come back in place. This should help lower overall volatility compared to "vanilla" long-equity strategies but probably has a slightly higher overall equity market exposure than the typical long/short fund in the active space, in our view. While the period is quite limited, with less than one year of real-time performance results, our hedging indicator has coincided quite accurately with market performance in 2016, giving a nice start to DYLS. In a year marked by disappointing performance for many long/short active strategies, investors may consider a relatively low-cost ETF option like DYLS.

¹William Baldwin, "Scary Results At Long-Short Equity Funds," Forbes, 8/23/16. ²Ordinary brokerage commissions apply.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. The Fund invests 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 increase the Fund's vulnerability 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.

Past performance is not indicative of future results.

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

Hedge fund like returns : exhibiting returns sharing characteristics of many actively managed hedge fund strategies.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Short (or Short Position) : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

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.

Basis point : 1/100th of 1 percent.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Dynamic Hedge : Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of time.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Profit margins : Net income divided by total sales. Higher values indicate a greater fraction of each dollar of sales being left to the firm and its owners after expenses are accounted for.