

3 MYTHS OF UNCONSTRAINED INVESTING

Rick Harper — Chief Investment Officer, Fixed Income and Model Portfolios

08/10/2015

Unconstrained bond strategies have experienced rapid growth in recent years.¹ However, as with any popular concept, success often begets cynicism and criticism. While adoption has increased rapidly, unconstrained bond investing is still often misunderstood by many investors. Unconstrained strategies very simply untether the investment manager from the constraints of a benchmark, such as the [market capitalization-weighted Barclays U.S. Aggregate Index](#). In our view, investor skepticism often arises due to the lack of [transparency](#) of the strategy and the diversity of approaches marketed under the “unconstrained” umbrella. By combining an investment process focused on risk management and daily transparency, the [WisdomTree Western Asset Unconstrained Bond Fund \(UBND\)](#) could help investors cut through the clutter. In our approach to unconstrained, Western Asset Management Company² (Western Asset) targets bond-like [volatility](#) (3% to 5%) and adheres to certain guardrails for exposures in the Fund. Given that the strategy is delivered in an exchange-traded fund (ETF), the holdings are published each day on [wisdomtree.com](#). As a result, investors are able to understand the portfolio manager’s thoughts on the markets every day. Additionally, investors are able to accurately assess the risk of their total portfolios in real time. In the remainder of this discussion, we seek to highlight some of the most common misconceptions about unconstrained strategies.

Myth No. 1: Unconstrained strategies simply substitute [interest rate risk](#) for speculative plays in [credit](#) and structured products. While UBND does invest in [non-investment grade](#) securities, it employs strict guardrails to preserve the overall portfolio [credit quality](#) and resulting risk profile of the Fund. In most scenarios, the Fund will invest at least 50% of its assets in [investment-grade](#) securities, employ no financial [leverage](#) and cap [unhedged](#) non-U.S. currency exposure at 25%.³ UBND also strives for a broad diversity of exposures, given the broad-based opportunities presented by the global fixed income market. It is important to remember that global markets are much more diverse than the Barclays U.S. Aggregate Index (Agg), the most commonly followed benchmark for the industry. In fact, the Agg represents only 35% of global fixed income opportunities.⁴ By limiting a portfolio to such a narrow subset of the market, it may be difficult to generate positive returns should U.S. [interest rates](#) rise.

Myth No. 2: Unconstrained strategies combine complexity and a lack of transparency. Departing from the benchmark does not necessitate complexity. To be fair, some strategies employ sophisticated [derivative](#) strategies and utilize financial leverage as a principal strategy. But others follow very straightforward strategies with [strong risk disciplines focused on delivering bond-like volatility](#). Since many investors in unconstrained bond strategies get only monthly or quarterly holdings on a lagged basis, investors are often forced to make investment decisions based solely on performance. In volatile markets, timely access to holdings is essential for investors to monitor and manage risk. Since UBND is an ETF, investors can see the holdings of the strategy every day. When the portfolio manager makes a change, the impact on the portfolio’s exposure is updated in the next day’s holdings. In our view, daily transparency enables investors to assess and monitor risk with greater precision. Should an investor’s views differ from those of the portfolio management team, the investor has access to all available holdings and can then make an informed decision about whether to continue to hold the position. Additionally, daily transparency can serve as a powerful signaling tool that investors can use in other segments of their portfolios.

Myth No. 3: The benchmark is an all-weather foundation for a bond portfolio. Why should investors deviate from the market? As we have mentioned previously, [market capitalization-weighted benchmarks reflect issuance, not value](#). In our view, the current composition of many core benchmarks could make it difficult to generate positive total returns should interest rates rise by even a small amount. Differing objectives for fixed income issuers (lower [yields](#), longer [maturities](#)) and investors (more income potential, less interest rate risk) often create a disconnect in the composition of broad-based indexes. In recent years, yields have fallen to very low levels, while interest rate risk has continued to rise.⁵ As a result, the current market represents one of the most disadvantageous trade-offs for income potential per unit of interest rate risk in the history of the Agg. Allowing a portfolio management team the flexibility to look for value outside the constraints of a

benchmark enables the unconstrained portfolio manager to harvest the desirable characteristics of fixed income while reducing exposure to less desirable ones—namely interest rate risk. While strategies marketed under the unconstrained bond fund banner will continue to evolve, we believe that delivering Western Asset’s approach in an ETF is an interesting innovation for the industry. In our view, UBNB has the ability to serve as a potential replacement for or a complement to an investor’s core bond position. As a result of daily transparency, investors have the potential to better manage risk in their portfolios compared to other less transparent approaches. ¹Source: Morningstar, as of 6/30/15. ²Western Asset Management Company serves as the sub-advisor for UBNB. ³Investment guidelines targeted by the sub-advisor. Please view the [Fund’s prospectus](#) for statutory limits. ⁴Source: Barclays, as of 6/30/15. ⁵As represented by the Barclays U.S. Aggregate Index, the most commonly followed benchmark for the industry. As of 6/30/15.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Unlike typical exchange-traded funds, there is no index that the Fund attempts to track or replicate. Thus, the ability of the Fund to achieve its objective will depend on the effectiveness of the portfolio manager. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer’s ability to make such payments will cause the price of that bond to decline. High yield, or “junk,” bonds have lower credit ratings and involve a greater risk to principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. 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. The Fund may engage in “short sale” transactions where losses may be exaggerated, potentially losing more money than the actual cost of the investment, and the third party to the short sale may fail to honor its contract terms, causing a loss to the Fund. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund’s prospectus for specific details regarding the Fund’s risk profile.

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

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

Transparency : The extent to which investors have ready access to any required financial information about a company, such as price levels, market depth and audited financial reports.

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