NO FOMO FOR CORE INVESTORS

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As previously discussed in our earlier blog posts, the prevailing trend in the fixed income market this year has been the resurgence of income within fixed income. Our discussions have encompassed various sectors, including U.S. investment-grade (IG) and high-yield (HY), as well as local currency emerging markets (EM) bonds. These asset classes have exhibited robust performance, delivering year-to-date returns of 3.28%, 4.96% and 8.13%, as of June 21, 2023.

Despite experiencing an impressive rally in their spreads, these asset classes continue to offer attractive yield levels to long-term investors. This is primarily attributable to elevated risk-free interest rates. Depending on one's perspective on the future trajectory of Federal Reserve policy tightening, which may involve a pause or a few additional rate hikes, it can be said that investors may still be in the early stages of benefiting from above-average returns within the fixed income space.

However, it is important to recognize that not all investors possess the flexibility to venture into riskier segments of the market, such as HY or EM. Some investors and advisors are required to maintain a closer proximity to traditional asset classes within fixed income (core sectors). In this article, we will explore WisdomTree Yield Enhanced U.S. Aggregate Bond Fund (AGGY) and outline the reasons why it may serve as a favorable alternative to other conventional Agg products.

AGGY: An Attractive Alternative

AGGY tracks an index that uses a rules-based approach to reallocate across subcomponents of the Bloomberg U.S. Aggregate Index (Agg), seeking to enhance yield while maintaining a similar risk profile. Yield can typically be increased by shifting exposure along any of a number of risk dimensions, including sector exposure (Treasury, agency, credit, securitized), interest rate risk (duration) and credit risk. The three main steps of the Fund's index construction include:

- Divide the Agg into 20 subcomponents: The index is decomposed into 20 buckets across sector, maturity and credit quality.

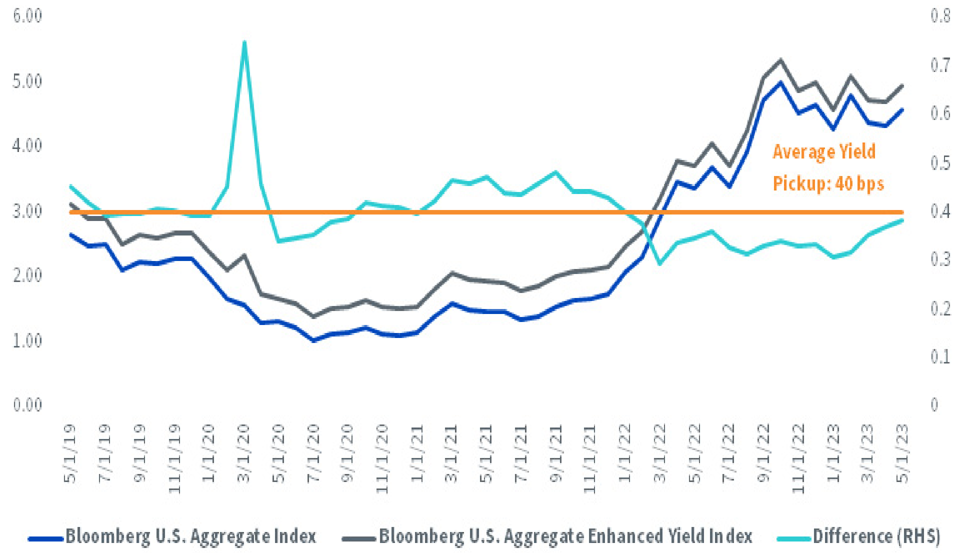
		Years to Maturity		
		1-5 Years	5-10 Years	10+ Years
Sector	Govt	Treasury 1-5, Agency 1-5	Treasury 5-10, Agency 5-10	Treasury 10+, Agency 10+
Sector	Credit	Credit 1-5 Aaa-Aa, Credit 1-5 A, Credit 1-5 Baa	Credit 5-10 Aaa-Aa, Credit 5-10 A, Credit 5-10 Baa	Credit 10+ Aaa-Aa, Credit 10+ A, Credit 10+ Baa
Sector	Securitized	Commercial Mortgage-Backed Securities (CMBS)	Asset-Backed Securities (ABS)	Government National Mortgage Association (GNMA) 30s
Sector	Securitized	Conventional Mortgage-Backed 30s	Conventional Mortgage-Backed 15s	

- Develop and apply constraints: Four major constraints will be applied after the first step in order to construct the new index—tracking error, duration, sector and subcomponent, and turnover constraints.

- Determine Index weights: On a monthly basis, weights of the Index are reallocated across the 20 subcomponents to maximize yield while adhering to the four constraints.

The resulting index will exhibit comparable risk characteristics to the Agg while on average providing around 40 basis points (bps) more yield (carry) since May 2019.

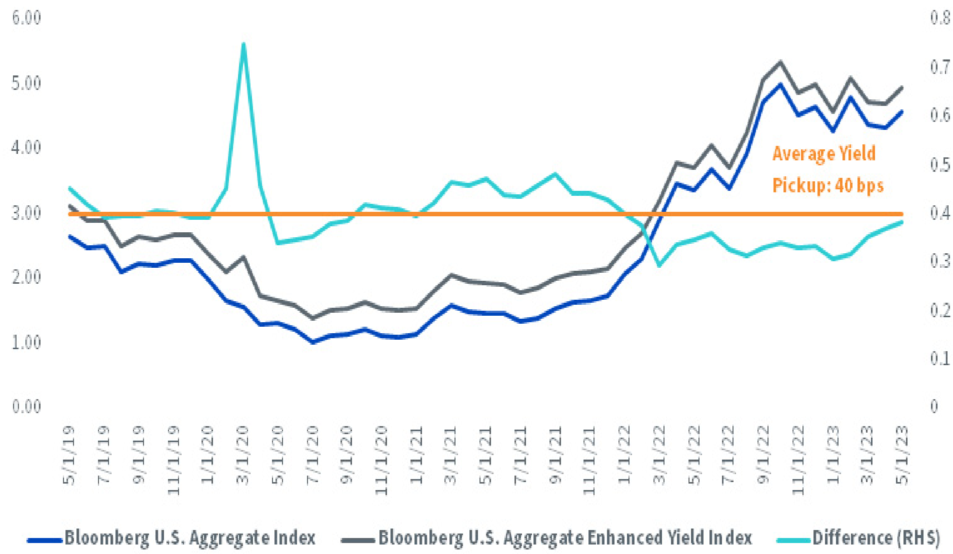
Yield to Worst (%)



Source: Bloomberg, as of 05/31/23. Performance is historical and does not guarantee future results.

In the past, achieving this yield pickup typically involved maintaining a higher duration and greater sensitivity to changes in interest rates. However, as a result of the Federal Reserve's quantitative tightening and the subsequent shift in the risk attributes of the aforementioned 20 subcomponents, the current landscape enables the index to attain this increased yield without extending the duration relative to the Agg.

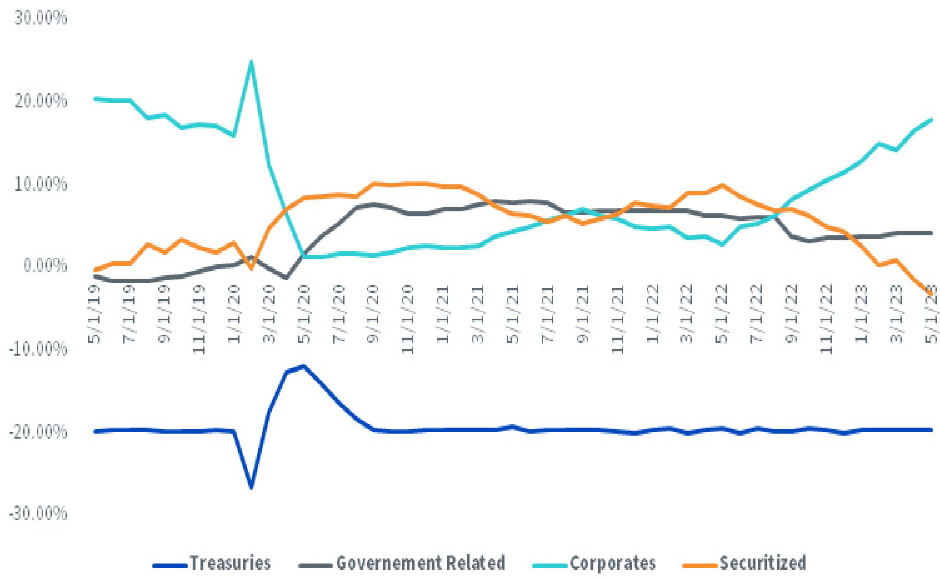
Duration (Years)



Source: Bloomberg, as of 05/31/23.

This fundamental shift can be attributed to the notable increase in the allocation of corporates within the portfolio relative to the Agg, which has risen from an over-weight allocation of approximately 3% one year ago to above 18% as of the end of May. In contrast, the relative market value of the securitized asset class has gone from a 10% over-weight allocation to a 3% under-weight allocation during the same period.

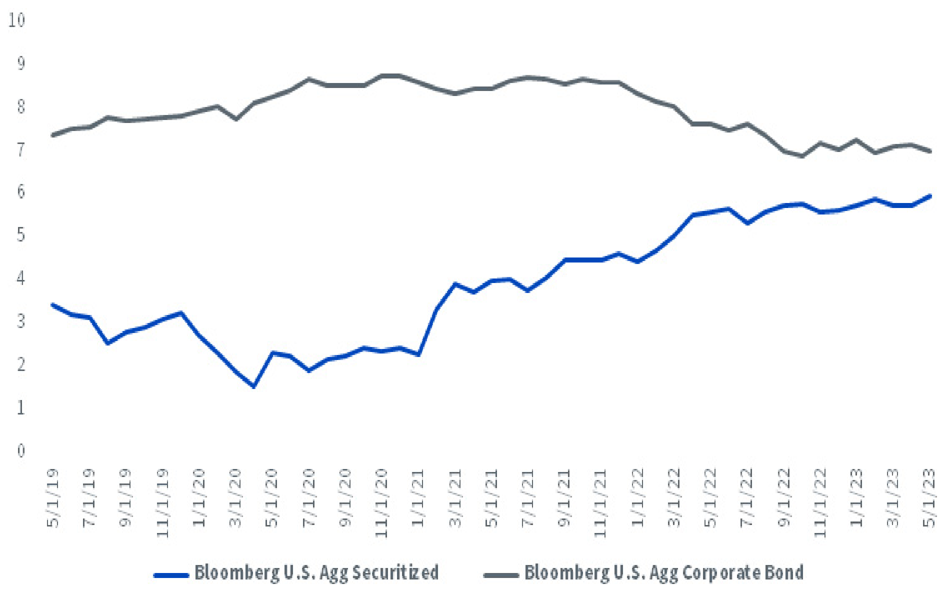
Relative Market Value % (Bloomberg U.S. Aggregate Enhanced Yield Index - Bloomberg U.S. Aggregate Index)



Source: Bloomberg, as of 05/31/23. Performance is historical and does not guarantee future results.

Upon deeper analysis, one can see why our Index construction process has made this happen. With the rise in risk-free rates, and consequently mortgage rates, borrowers have had less incentive to pursue refinancing or new home acquisitions, leading to extension in duration for the majority of mortgages. Corporate duration has fallen. As a result, A GGY has effectively managed to sustain an average yield advantage over Agg while maintaining a lower relative duration.

Duration (Years)



Source: Bloomberg, as of 05/31/23.

Conclusion

With the biggest policy tightening in recent Fed history almost in the books, the Fed has created different pockets of opportunities for investors. While riskier segments of fixed income ("plus" sectors) can offer an attractive risk-reward profile for long-term investors, core investors need not feel left out. Through a quantitative approach, AGGY presents these investors an opportunity to achieve higher carry compared to a typical Agg portfolio, while currently taking less interest rate risk and offering lower exposure to segments of the market that lack appealing risk-adjusted rewards.

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For the top 10 holdings of AGGY please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/fixed-income/aggy

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You cannot invest directly in an index.

DEFINITIONS

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Fed tightening : Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Credit quality : A measure of a borrowers potential risk of default.

Basis point : 1/100th of 1 percent.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Quantitative Tightening : Quantitative easing is a process whereby a central bank targets lowering longer-term interest rates by purchasing bonds and other securities to stimulate the economy. Quantitative tightening is the reverse process whereby securities are either sold or the proceeds of maturing securities are not reinvested with the goal of tightening economic conditions to prevent the economy from overheating.