SHOULD INVESTORS ENHANCE THEIR AGG POSITION IN THE FACE OF RISING RATES?

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In July 2015, we launched the WisdomTree Barclays U.S. Aggregate Bond Enhanced Yield Fund (AGGY), an exchange-traded fund (ETF) that seeks to track the yield and performance of the Bloomberg Barclays U.S. Aggregate Enhanced Yield Index. The primary rationale that led us toward this approach was that we believed the Bloomberg Barclays U.S. Aggregate Index (Agg) no longer satisfied the income requirements of today's investors. For passive investors, allowing the yield of the most widely tracked performance benchmark in U.S. fixed income to be diluted by issuance patterns of the U.S. government seemed out of step. In doing so, we believe we have helped create a more intuitive, all-weather strategy for core fixed income. Below, we examine the performance drivers of this approach both since inception and during the most recent period of rising rates.

How Can Investors Boost Yield?

The simplest answer is that they have to assume more risk. Through our enhanced yield approach, we draw from the same investable universe as the Agg but seek to maximize yield while applying a series of qualitative and quantitative constraints. The output of this approach means that since inception, our portfolio has been over-weight in credit risk and the duration (or interest rate risk) of our portfolio has been increased by one year. Since July 2015, credit spreads have tightened while nominal interest rates have declined. In effect, our approach has outperformed on both accounts. As we show below, the strategy has handily outperformed the Agg as well as a significant percentage of higher-fee, actively managed fixed income strategies. However, in discussing this approach with financial advisors, a common question we received was "What happens when rates go up?"

Enhanced Yield vs. the Agg

Enhanced Yield vs the Agg

While we will also discuss the drivers of return below, the only period of rising rates that we can use as a live test case began on July 8. In the chart above, we also compare the performance of the enhanced yield strategy vs. the Agg after rates bottomed on July 8, 2016. Since then, the U.S. 10-Year rose by 78 basis points (bps) to 2.14%.[1] Bond math 101 tells us that as interest rates rise, we can approximate the decline in bond prices by this formula: rise in rates X duration

Interestingly, even though our portfolio has a higher duration than the Agg, our strategy performed in line with the lower-risk strategy. Below, we outline how this is possible.

Drivers of Performance

Since our portfolio is in higher-yielding investment-grade (IG) bonds, the additional income we earn on these investments partially offsets the losses we incurred from assuming more interest rate risk. In fact, as of November 10, 2016, by assuming more credit and interest rate risk at the margin, the enhanced yield strategy had an income advantage over the Agg of 58 bps.[2] All else being equal, the Agg would need to outperform by 55 bps per year to narrow this performance gap. This would mean that credit spreads would need to widen or interest rates would need to rise more rapidly than our portfolio could earn its way back to even. The key question is, should investors be willing to assume incrementally more risk over a market cycle?

Currently, we would be comfortable making that bet. This is primarily driven by our view that any change in monetary policy by the Federal Reserve reflects its confidence in the health of the U.S. economy. With economic growth still expanding, we believe that investors should continue to be over-weight in credit in their bond portfolios. While credit is less "cheap" than it was to start the year, we don't currently see many catalysts for why we should see a rapid deterioration in the markets' pricing of risk. Absent increased fears of recession, a marked deterioration in the health of

IG corporations or an unknowable exogenous shock, we believe that an enhanced Agg strategy is worth the additional .20% uptick in volatility compared with the Agg.[3]

In sum, we believe that investors should prudently increase the risk they are assuming in their aggregate bond portfolios. While no strategy will always outperform, we believe our approach strikes a more appropriate balance between risk and income in today's market environment.

[1]Source: Bloomberg, as of 11/10/16.

[2]Source: Bloomberg, as of 11/10/16.

[3]Source: Zephyr StyleADVISOR, WisdomTree, as of 10/31/16.

IMPORTANT INFORMATION

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DEFINITIONS

Bloomberg Barclays U.S. Aggregate Enhanced Yield Index : a constrained, rules-based approach that reweights the sector, maturity, and credit quality of the Barclays U.S. Aggregate Index across various sub-components in order to enhance yield.

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.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

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.

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

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Basis point : 1/100th of 1 percent.

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

Widen : an increase in the amount of compensation bond holders require to lend to risky borrowers. When spreads widen, the market is implying that borrowers pose greater risk to lenders.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.