U.S. CORE FIXED INCOME PERFORMANCE AT A CROSSROAD

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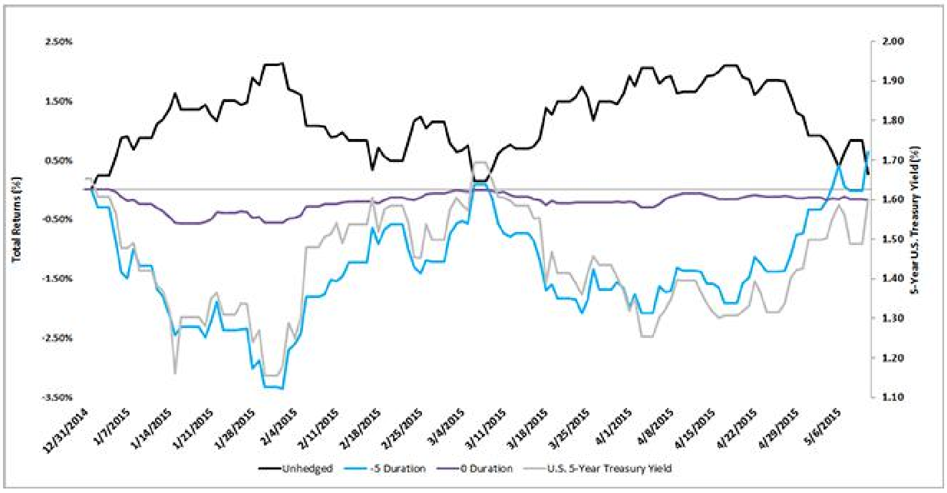
Year-to-date total returns for core U.S. fixed income[1] peaked at 2.1% in early February despite yielding only 2.25% to start the year.[2] The primary driver of total returns over this period was not income, but rather a rapid decline in U.S. interest rates. In recent weeks, longer-term borrowing costs around the world have started to rise rapidly. As a result, long only investors are now sitting on losses in their bond portfolios for the first time in 2015. This can be psychologically significant. While the losses remain modest, we believe that many investors are beginning to reassess their fixed income holdings for the first time this year. In response, we refresh the variety of approaches investors can take to maintain exposure to the Barclays U.S. Aggregate Index (Agg), but manage their exposure to interest rate risk. **Year to Date Performance Impact from Changes in Interest Rates Barclays U.S. Aggregate Index Total Returns: Unhedge vs. Zero Duration vs. -5 Duration**



Source: Barclays, as of 5/11/15. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the chart, visit our glossary. **#No.1 Do Nothing** For investors who currently own an Agg-based strategy, this seems like the path of least resistance. However, with Federal Reserve (Fed) chairman Janet Yellen voicing concern about complacency[3] in the bond market, we remain concerned that the Agg does not offer enough income potential relative to the level of interest rate risk investors are being forced to assume. Should rates rise, investors may be faced with negative total returns in their core bond portfolio for only the 4th time since 1994.[4] **#No. 2 Maintain Exposure, but Hedge Duration to Zero** In this approach[5], investors still own bonds that represent the Agg, but a second step occurs to alter the final exposure. The Index separates its portfolio into several duration "buckets" across the yield curve. Next, the strategy shorts Treasury futures contracts in order to help immunize the portfolio from changes in interest rates. If rates rise, the short positions help offset losses in the traditional bond portfolio. This approach is based on a concept similar to currency-hedging foreign equity strategies. The value of taking a "hedged" approach to fixed income is that investors still receive the income from their bond portfolios, while reducing their exposure to changes in interest rates. While there is no free lunch to this approach, the cost of hedging the portfolio will breakeven should interest rates rise by only a modest amount. **#No.3 Maintain Exposure, but "Over-hedge" the Portfolio to a Negative Duration** This final approach[6] to the Agg is also the most aggressive. However, it is constructed in a nearly identical way to strategy No. 2.

The key difference is that this portfolio doesn't just seek to offset interest rate risk; it actually goes short longer --maturity futures contracts to target a duration of negative five years. In this approach, if interest rates rise by 100 basis points (bp), the negative duration portfolio would, in theory, rise by 5 %. Of course, if interest rates fell by 100bp, the portfolio would decline by 5%. However, this strategy could be an attractive option given that the long-bond portfolio helps to finance the cost of the short position. In fact, as of May 11, 2015, the negative five duration strategy actually had a net positive yield. This means that an investor's total return would be driven largely by changes in interest rates. Since rates are not causing a drag on total returns, investors could combine these strategies with other interest rate sensitive investments to reduce their overall portfolio risk. At the end of the day, investors will need to make their own decisions about the future path of interest rates. However, we believe zero and negative duration approaches provide powerful tools to investors who want to manage the interest rate risk in their portfolios. In our view, the options presented underscore a nearly limitless array of combinations that can be implemented to fine-tune your interest rate risk exposure with greater precision. While the total returns of a negative duration bond strategy will ultimately be determined by changes in interest rates, the same argument could be made about long-only fixed income strategies that are tied to the Barclays U.S. Aggregate. Learn more about WisdomTree interest rate strategies. [1]As represented by the Barclays U.S. Aggregate Index. [2]Source: Barclays, as of 5/13/15. [3]Source: Institute for New Economic Thinking, 5/6/15. [4]Source: Barclays. Negative total returns previously occurred in 1994, 1999 and 2013. [5]As represented by the Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration. [6]As represented by the Barclays Rate hedged U.S. Aggregate Bond Index, 5 Duration.

Important Risks Related to this Article

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.

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DEFINITIONS

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.

Bloomberg Barclays U.S. Aggregate Index OAS : the amount of compensation in excess of Treasuries that investors demand for lending to borrowers in the Bloomberg Barclays U.S. Aggregate Index.

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.

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.

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

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Rate-Hedged : A bond portfolio that has offsetting positions in Treasury securities to reduce interest rate risk.

Maturity : The amount of time until a loan is repai.

Basis point : 1/100th of 1 percent.

Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration : Combines long positions in the Barclays U.S. Aggregate Bond Index with short positions in U.S. Treasury Bonds to provide a duration exposure of 0 years. Market values of long and short positions are rebalanced at month-end.

Barclays Rate Hedged U.S. Aggregate Bond Index, Negative Five Duration : Combines long positions in the Barclays U.S. Aggregate Bond Index with short positions in U.S. Treasury Bonds to provide a duration exposure of -5 years. Market values of long and short positions are rebalanced at month-end.