BOND INVESTORS: MANAGE VOLATILITY IF YOU'RE CONCERNED ABOUT LIQUIDITY

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As the political crisis between Greece and greater Europe continues to evolve, markets around the world are exhibiting ever greater levels of volatility. As Mario Draghi commented, "We should get used to periods of higher volatility."[1] We agree, and given fixed income's typical role in a portfolio as the low volatility component, it will be extra challenging for investors if volatility in the bond market picks up. For U.S. bond investors, the concern over the last several weeks[2] has been the potential for gaps in liquidity in the bond market. So far, no one has been able to provide a satisfactory answer to this industry-wide question. In response, we believe investors should focus on the likely result of potential gaps in liquidity, which is a rise in volatility in their bond portfolio. In today's bond market, the greatest source of volatility is interest rate risk. In our view, investors should consider hedging interest rate risk to manage potential gaps in liquidity.

Why Are Bond Markets So Volatile? When talking about the current market environment, it is important to think about the role fixed income plays in many investors' portfolios. Historically, bonds in traditional asset allocation have often served as ballast for the more volatile equity portion of the portfolio. However, as we discussed previously, this concept relies on two principles that may no longer be true: 1) reasonable income potential, and 2) modest correlation to riskier assets such as U.S. equities. As we inch ever closer to a change in Federal Reserve (Fed) policy, the early days of trend reversals in markets can be particularly volatile as investors try to exit before the crowd. This desire, combined with back-to-back years of record bond issuance and a decreased willingness by certain market participants to provide liquidity, will likely result in greater price gaps as markets attempt to react to news. Also, as we mentioned earlier, with coupon rates across a majority of fixed income benchmarks at their lowest levels in history, interest income provides very little cushion for changes in bond markets. As a result, it may appear painfully obvious that investors concerned about volatility in the bond market should hedge interest rate risk.

Risk vs. Return in Unhedged, Zero Duration & Negative Duration Strategies In our view, we are currently approaching an extremely uncertain market environment: questions about public finances in Europe, an imminent restructuring in Puerto Rico and, last but not least, the first change in U.S. monetary policy in nearly nine years. With all of this in mind, we continue to advocate that investors hedge interest rate risk in their bond portfolios. Below, we illustrate the impact of hedging or altering the interest rate risk profile of core investment-grade strategies[3] and U.S. high-yield strategies over the period from January 31 to June 30 of this year.

Core and High-Yield Bond Returns: 1/31/15–6/30/15

Strategy	Return (%)	Std Dev (%)	Correlation to U.S. Core
Barclays U.S. Aggregate Index	-2.15	1.39	1
Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration	0.06	0.66	-0.31
Barclays Rate Hedged U.S. Aggregate Bond Index, Negative Five Duration	4.2	2.17	-0.87
BofA Merrill Lynch 0-5 Year US High Yield Constrained Index	2.2	2.5	-0.21
BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index	2.47	2.92	-0.36
BofA Merrill Lynch 0-5 Year US High Yield Constrained, Negative Seven Duration Index	7.68	4.86	-0.71

Sources: Barclays, BofA Merrill Lynch, as of 6/30/15.
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. This table clearly shows the value of these strategies during a period of rising rates. In 2015, U.S. rates bottomed on January 30. Since that time, interest rate risk resulted in a drag on performance, with the benchmark aggregate bond index down over 2% over the period.[4] A zero duration approach to the Barclays U.S. Aggregate Index significantly reduced volatility while preserving returns; a negative duration strategy would have actually increased in value by over 4 percentage points over the period. Among U.S. high-yield strategies, investors were able to preserve a greater portion of bond returns compared with an unhedged strategy as nominal rates increased. Over that period, the primary driver of high-yield returns was credit risk. Since increases in nominal interest rates at the short end of the yield curve were more muted, the zero duration approach was marginally more volatile. In our view, should rates rise at the short end as a result of Fed rate hikes, we believe volatility could be lower than with the unhedged approach with greater total returns. As is the case with any investment, investors can be compensated by the market for taking a risk. Over the last 30 years, investors have continually been rewarded for assuming ever greater amounts of interest rate risk. Due to the current uncertainty in global fixed income markets, we continue to believe that investors should reduce interest rate risk via hedged strategies. For investors with a broader portfolio of interest rate-sensitive investments, negative duration strategies could serve as a broader portfolio hedge. [1]Mario Draghi, ECB press conference, 6/3/15. [2]As of July 10, 2015 [3]As proxied by the Barclays U.S. Aggregate Index. [4]As represented by the Barclays U.S. Aggregate Index, as of 6/30/15.

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

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

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

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

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.

Coupon : The annual interest rate stated on a bond when it's issued. The coupon is typically paid semiannually. This is also referred to as the "coupon rate" or "coupon percent rate.&rdquo.

Zero duration strategies : Refer to WisdomTree's Interest Rate Strategies that target an overall portfolio duration of zero; namely, the WisdomTree Barclays U.S. Aggregate Bond Zero Duration Fund and the WisdomTree BofA Merrill Lynch High Yield Bond Zero Duration Fund.

Negative duration strategies : Refer to WisdomTree's Interest Rate Strategies that target a negative overall duration; namely, the WisdomTree Barclays U.S. Aggregate Bond Negative Duration Fund and the WisdomTree BofA Merrill Lynch High Yield Bond Negative Duration Fund. .

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.

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

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

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.

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.