SECTOR SENSITIVITY TO RISING RATES

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Longer-term interest rates in the U.S. have risen considerably since May on speculation the Federal Reserve may begin tapering its quantitative easing (QE) program. Even though, as of September 2013, tapering has yet to begin, in our most recent Market Insight, I evaluated how the recent rise in interest rates has impacted various income-oriented investment strategies. Among other things, I discussed the general effects that the recent interest rate hikes had on the different sectors of the S&P 500 Index. Ned Davis Research recently published a similar analysis on the 10 S&P 500 Index sectors and their sensitivity to the 10-year Treasury yield over the past 36 months, displayed as 10-year yield beta, below. Higher 10-year yield beta numbers signal a positive performance relationship (compared to the S&P 500 Index) when 10-Year Treasury yields were rising; negative numbers imply a negative performance relationship. In other words, a positive 10-year yield beta showed a sector outperforming, while a negative 10-year yield beta showed a sector underperforming the S&P 500.

SECTOR RELATIVE STRENGTH BETA TO CHANGES IN 10-YEAR TREASURY YIELD

Sector Relative to S&P 500	10-Year Yield Beta	% of Time Historically Significant	Currently Significant?
S&P 500 Financials	7.19	27.7	YES
S&P 500 Energy	5.65	15.0	YES
S&P 500 Materials	2.67	8.4	NO
S&P 500 Industrials	2.53	7.5	NO
S&P 500 Consumer Discretionary	**0.09**	**6.4**	**NO**
S&P 500 Information Technology	-0.37	4.9	NO
S&P 500 Health Care	-4.60	8.6	YES
S&P 500 Consumer Staples	-7.74	14.6	YES
S&P 500 Telecommunication Services	-10.47	8.4	YES
S&P 500 Utilities	-11.14	12.6	YES

Betas from 36-month regression of monthly changes, as of 7/31/2013; sector/market returns are price only. % of Time Historically Significant based on date range of 12/31/1975-7/31/2013. Sources: S&P Index Alert, Federal Reserve Board.

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Source: Ned Davis Research (07/31/13). Past performance is not indicative of future results. You cannot invest directly in an index.
Historically Significant: Looks at the 36-month periods from 12/31/1975 to 7/31/2013 and specifically includes the percentage of those time periods when the relationship between the change in the U.S. 10-Year Treasury yield and the respective S&P 500 Sector Index's performance is strong enough to be different from 0, meaning the complete absence of any relationship between these two variables.
Currently Significant: Looks only at the 36-month period ending 7/31/2013 to see if the relationship between the change in the U.S. 10-Year Treasury yield and the respective S&P 500 Sector Index's performance is strong enough to be different from 0, meaning the complete absence of any relationship between these two variables.

- **Defensive Sectors Show Negative Relationship to Rising Yields** – All of the defensive sectors displayed a negative relationship to rising yields, as shown through the 10-year yield beta metric. The Utilities and Telecommunication Services sectors showed the highest negative sensitivity over the period. Now, past performance does not guarantee future results, but if this relationship holds, you might expect these sectors to underperform the S&P 500 Index during a rising rate environment. • **Cyclical Sectors Show Positive Sensitivity to Rising Yields** – Most of the cyclical sectors displayed a positive relationship to rising yields, as shown through the 10-year yield beta metric. The Financials and Energy sectors showed the highest positive sensitivity over the period. If this relationship were to hold, you might expect these sectors to outperform the S&P 500 Index during a rising rate environment. **S&P 500 Sector Performance** In the same market insight, I looked at the performance of the S&P 500 sectors over the most recent period of rising Treasury yields, from April 30 to August 20, 2013. This period was chosen because it exhibited a steady rise in the 10-Year Treasury yield, from 1.63% to 2.81%. Although the above research from Ned Davis looked at the relative sector performance over the past 36 months, we found similar results. • The three sectors with the highest negative yield beta (Consumer Staples, Utilities and Telecommunications) were the three worst-performing sectors over the period. These sectors also exhibited the highest dividend yields over the period. • Sectors with higher earnings growth expectations (and lower dividend yields) were in the upper part of the performance spectrum. Typically, these sectors fall into the cyclically sensitive category and perform well when the economy is expanding. **Conclusion and WisdomTree Solutions** The recent spike in Treasury yields has caused a reevaluation of many equity strategies and an underperformance for the sectors with the highest dividend yields—typically Utilities and Telecommunication sectors. Investors should potentially look to the higher-growing and lower-yielding sectors in order to lower their portfolios' sensitivity to potential further increases in Treasury yields. WisdomTree has launched a family of dividend growth-oriented ETFs that include a Fund each for U.S. large caps and U.S. small caps, and we believe they are particularly well suited for a rising interest rate environment, as they tend to be more cyclically exposed and less exposed to Telecommunication and Utilities (which typically are higher-yield sectors and less dividend growth oriented). For more information on these new ETFs, please see: 1) Large Caps: WisdomTree U.S. Dividend Growth ETF (DGRW) 2) Small Caps: WisdomTree U.S. SmallCap Dividend Growth ETF (DGRS)

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Defensive sectors : Consumer Staples, Health Care, Telecommunication Services and Utilities.

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.