MANAGING CREDIT RISK IN A FLOATING RATE BOND PORTFOLIO

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In 2013, one of the hottest trends in the exchange-traded fund (ETF) industry centered on investors' managing their exposure to interest rate risk. As part of this trend, investors reduced their positions in fixed-rate coupon bonds by buying floating rate notes and bank loans.[1] By way of review, a floating rate note is a debt security whose coupon payments are reset periodically and pay a predetermined spread over a short-term interest rate such as the London Interbank Offered Rate (LIBOR), the Federal Funds Rate or a U.S. Treasury Bill Rate. As a result, investors' compensation may rise or fall at each reset date as interest rates change. However, until today, ETF-minded investors' only option for purchasing floating rate debt was limited to that issued by corporations. Even though we do not believe that credit conditions are likely to deteriorate overnight, we believe that investors should seek to balance the risks in their floating rate portfolios the same way they manage their more traditional fixed income portfolios between risky and credit risk-free securities. **New Issuance from Treasury** As we mentioned in a previous blog post, the United States Treasury completed its first floating rate Treasury auction on January 29, 2014, issuing $15 billion of a note with a two-year stated maturity.[2] We believe this first issuance may represent an interesting new source of funding for the U.S. government going forward. As virtually all borrowers have sought to take advantage of interest rates near all-time lows, the overall maturity profile of their debt has tended to increase.[3] The U.S. government's issuance profile is no different. However, in order to diversify the sources of funding away from longer-dated debt and short-term Treasury bills, the Treasury sought to tap the growing demand from investors for floating rate debt as one more way to finance the government. With interest rate risk on the minds of many investors so far in 2014, we believe that floating rate Treasury securities represent an effective way for investors to help reduce their exposure to rising interest rates while generating income payments that are backed by the full faith and credit of the U.S. government. Although returns in many markets such as bank loans have been impressive thus far,[4] these markets may pose several risks that investors must thoroughly consider. **Replacing One Risk Factor with Another** In many investors' minds, interest rate risk represents the primary risk to the performance of their bond portfolio. However, this can be an oversimplification when lending to issuers that have non-investment-grade credit profiles. Although we do not believe that credit conditions in the U.S. are about to change course, we do believe that investors should take a prudent approach to the market. The simple fact is that as money has continued to flood into the bank loan market, several risks have come to light. Principally, with so many investors seeking out many of the same opportunities, there may be a risk that the market could be painted with too broad a brush. Not all borrowers are created equal, and with so much money flowing into the market, it is likely that many companies are enjoying more attractive borrowing rates than their fundamentals may warrant. As a way to mitigate credit risk, investors might consider diversifying their floating rate portfolio with a portion in U.S. government-issued floating rate debt. Although risks may have risen in many of these markets, we believe that bank loans and floating rate notes still have a place in many investor portfolios. However, striking the correct balance between income potential and credit risk may continue to be a challenge. By not taking on risk, investors miss out on the opportunity for higher levels of income. By taking on too much risk, investors may overextend themselves to risky borrowers. However, with the U.S. Treasury now entering the market, we believe that investors will have a new option for floating rate exposure with ample liquidity and transparent pricing that can serve as a risk-free benchmark for floating rate note issuance going forward. **WisdomTree Bloomberg Floating Rate Treasury Fund (USFR)** In order to provide yet another tool for investors to manage interest rate and credit risk, WisdomTree partnered with Bloomberg to create the WisdomTree Bloomberg Floating Rate Treasury Fund (USFR). As floating rate issuance from the Treasury continues to grow over time, the Fund will seek to track the price and yield performance of the Bloomberg U.S. Treasury Floating Rate Bond Index. **Fund Quick Facts Ticker:** USFR **Exchange:** NYSE **Expense Ratio[5]:** 0.20%, contractually waived to 0.15% **Structure:** Open-end ETF. Registered under the Investment Company Act of 1940. **Objective:** The Fund seeks to track the price and yield performance, before fees and expenses, of the Bloomberg U.S. Treasury Floating Rate Bond Index. **Primary Exposures:** Floating rate Treasury notes **Duration Target:** Determined by the reset frequency of the underlying securities in the index, currently one week. [1]Sources: Bloomberg, WisdomTree, as of 12/31/13. [2]Source: U.S. Department of the Treasury, 1/29/14. [3]Sources: WisdomTree, Bloomberg, as of 12/31/13. [4]Source: Bloomberg, as of 12/31/13. [5]The Fund's gross expense ratio of 0.20% and the net expense ratio of 0.15% reflect a contractual waiver of 0.05% through the Fund's first year of operations.

Important Risks Related to this Article

Diversification does not eliminate the risk of experiencing investment losses. There are risks associated with investing, including possible loss of principal. Securities with floating rates can be less sensitive to interest rate changes than securities with fixed interest rates, but they may decline in value. The issuance of floating rate notes by the U.S. Treasury is new and the amount of supply will be limited. Fixed income securities will normally decline in value as interest rates rise. The value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund's portfolio investments. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile. ALPS Distributors Inc. is not affiliated with Bloomberg.

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DEFINITIONS

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

Floating Rate Security : A debt instrument with a variable interest rate usually tied to a benchmark rate such as the US Treasury Bill Rate or the London Interbank Offered Rate.

Bank loan : A private debt arrangement issued by a financial institution which is senior to other creditors.

Credit conditions : The markets perception of the willingness of lenders to extend credit to risky borrowers.

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

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

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.

Bloomberg U.S. Treasury Floating Rate Bond Index : A rules-based, market-capitalization-weighted index engineered to measure the performance of floating rate U.S. Treasury notes.