

# RISING RATES IMPLEMENTATION PLAN: "CORE PLUS" & RISK MANAGEMENT

Rick Harper — Head of Fixed Income & Currency  
10/21/2014

Over the last several weeks, we have spent a great deal of time discussing what might be next for U.S. fixed income markets. While our view on [rising rates](#) has yet to meaningfully materialize this year, our underlying thesis has not changed. In our view, it may be time for investors to think about how a bond portfolio may perform as a result of changes in Federal Reserve (Fed) policy. From our discussions, we understand that some advisors believe that they already "made their trade" for rising rates last year. In our view, a great deal has changed since that time. As a result, we believe that investors should reexamine their current positioning and consider additional options to help manage [interest rate risk](#). In recent years, many investors have extended beyond [investment-grade](#) fixed income to incorporate satellite positions in [high-yield corporate bonds](#). Money managers have employed these so-called "core plus" strategies as a way to potentially add value to investors' portfolios. Ultimately, these strategies seek to balance income and [credit risk](#) in order to increase total returns. When devising new alternatives, WisdomTree's approach to rising rates has sought to avoid forcing advisors to fundamentally alter the way they run portfolios. Our goal was to maintain the exposures investors were familiar with while managing the risks. We believe that exchange-traded funds (ETFs) can provide a powerful tool for investors seeking to manage their exposure to credit. Through our suite of [rising rate strategies](#), we believe that investors can mitigate interest rate risk in the same way. While some investors may use our rising rate suite piecemeal, in our opinion, the real strength of the strategies is how they can be combined as part of an existing portfolio. By constructing portfolios using [zero duration](#) and [negative duration](#) tools, as shown in the tables, advisors can further refine their specific exposure not only to credit risk but also to a specific level of interest rate risk. **Impact of Incorporating Rising Rate Strategies in "Core Plus" Portfolios**

Core Plus Strategy		Duration	Yield
Traditional Core Plus Portfolio (80% Agg, 20% High Yield)		4.96	3.09%
Zero Core Plus Portfolio (80% Agg Zero, 20% HY Zero)		0.05	1.72%
Negative Core Plus Portfolio (80% Agg Neg, 20% HY Neg)		-5.32	0.68%

  

Zero Duration Core Plus Strategy		Duration	Yield
Traditional Core Plus Portfolio (80% Agg, 20% High Yield)		4.96	3.09%
Zero Core Plus Portfolio (80% Agg Zero, 20% HY Zero)		0.05	1.72%
80% Core Plus/ 20% Zero Core Plus		3.98	2.82%
70% Core Plus/ 30% Zero Core Plus		3.49	2.68%
60% Core Plus/ 40% Zero Core Plus		3.00	2.55%
50% Core Plus/ 50% Zero Core Plus		2.51	2.41%

  

Negative Duration Core Plus Strategy		Duration	Yield
Traditional Core Plus Portfolio (80% Agg, 20% High Yield)		4.96	3.09%
Negative Core Plus Portfolio (80% Agg Neg, 20% HY Neg)		-5.32	0.68%
80% Core Plus/ 20% Negative Core Plus		2.91	2.61%
70% Core Plus/ 30% Negative Core Plus		1.88	2.37%
60% Core Plus/ 40% Negative Core Plus		0.85	2.13%
50% Core Plus/ 50% Negative Core Plus		-0.18	1.89%

Traditional Core Plus portfolio proxied by an 80% allocation to the Barclays U.S. Aggregate Index and a 20% allocation to the BofA Merrill Lynch 0-5 Year US High Yield Constrained Index. Zero Core Plus portfolio proxied by an 80% allocation to the Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration and a 20% allocation to the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index. Negative Core Plus portfolio proxied by an 80% allocation to the Barclays Rate Hedged U.S. Aggregate Bond Index, Negative Five Duration and a 20% allocation to the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Negative Seven Duration Index. Sources: Barclays, BofA Merrill Lynch, WisdomTree, as of 9/30/14. Hypothetical illustration only. Past performance is not indicative of future results.

*For definitions of indexes in the chart please visit our [glossary](#).* The left-hand table shows a variety of hypothetical zero duration core plus blends. Compared to a traditional approach, investors are able to reduce their portfolio [duration](#) to zero at a cost of 1.37% per year. While this portfolio sacrifices approximately 44% of its income potential, interest rates would only need to rise by approximately 27 [basis points \(bp\)](#) over the course of a year to break even. If investors believe that rates could rise by more than this amount, [hedging](#) could potentially add value. Turning our attention to the table on the right, we see that investors can have a greater impact on the duration of their portfolio when they blend exposure with a negative duration core plus strategy. However, this approach may be more sensitive to distortions in the shape of the [yield curve](#). Since this strategy is constructed through selling longer-duration securities, a rise in interest rates might be possible, and investors' hedges may not immunize their portfolio from losses resulting from these higher interest rates. However, for investors with a stronger conviction about rising long-term interest rates, a negative core plus strategy can provide positive

income potential with a negative duration position of more than five and a half years. This approach could allow investors to essentially finance their negative interest rate bet, compared with the negative carry associated with shorting bonds outright. Ultimately, investing is largely about tradeoffs. As we highlighted earlier, we believe that our suite of rising rate strategies can provide powerful tools for investors seeking to manage risk in their portfolio. By striking the appropriate balance between credit and interest rate risk, we believe that these approaches may help add value to investor portfolios as the Fed begins to normalize its [monetary policy](#).

#### Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Non-investment-grade debt securities (also known as high-yield or “junk” bonds) have lower credit ratings and involve a greater risk to principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. The duration Funds seek to mitigate interest rate risk by taking short positions in U.S. Treasuries, but there is no guarantee this will be achieved. Derivative investments can be volatile, and these investments may be less liquid than other securities and more sensitive to the effects of varied economic conditions. 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. The duration Funds may engage in “short sale” transactions of U.S. Treasuries, where losses may be exaggerated, potentially losing more money than the actual cost of the investment, and the third party to the short sale may fail to honor its contract terms, causing a loss to the duration Funds. While the duration Funds attempt to limit credit and counterparty exposure, the value of an investment in the duration Funds may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of each Fund’s portfolio investments. Investors should anticipate that due to the negative duration target, those Funds will be highly sensitive to interest rate changes. The higher (whether positive or negative) a bond fund’s duration, the greater its sensitivity to interest rates changes, and fluctuations in value, whether positive or negative, will be more pronounced. Investing in mortgage- and asset-backed securities involves interest rate, credit, valuation, extension and liquidity risks and the risk that payments on the underlying assets are delayed, prepaid, subordinated or defaulted on. Due to the investment strategy of certain funds, they may make higher capital gain distributions than other ETFs. 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 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. Please read each Fund’s prospectus for specific details regarding each Fund’s risk profile.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

## **IMPORTANT INFORMATION**

**U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.**

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ([www.msci.com](http://www.msci.com))

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

## DEFINITIONS

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

**Investment Grade** : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

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

**Corporate Bonds** : a debt security issued by a corporation.

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

**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. .

**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.

**Basis point** : 1/100th of 1 percent.

**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.

**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.

**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.