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

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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

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## DEFINITIONS

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

**Investment grade** : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

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

**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.