

Your Toolkit for Rising Rates

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2015 could be the year we finally see rising interest rates in the U.S. This creates an opportunity to reassess portfolios and asset classes and evaluate how they performed during historical periods of rising interest rates. While the past can never guarantee the future, historical context is important for understanding a phenomenon that we really haven't seen in a longer-term trend for approximately 30 years.

Bonds vs. Stocks

The critical question here—as in many environments—is stocks versus bonds. By design, the fixed nature of bond interest payments creates a bit of a headwind as rates rise. On the other hand, rising interest rates usually occur in tandem with rising inflation, and stocks have historically grown their dividends at a level above that of inflation over long periods.[1]

Big Picture: To the extent that rising interest rates reflect rising growth expectations and rising inflation expectations, we believe that equities can see a tailwind and perform quite well over the medium to long term, even if U.S. Federal Reserve (Fed) activity (or inactivity) can cause some short-term volatility.

Further Distinctions to Be Made

Also here - as in many environments - it's not just stocks versus bonds, but types of stocks versus types of bonds.

Within equities, we wanted to look at three categories: large caps (the S&P 500 Index), small caps (the Russell 2000 Index) and high-yielding dividend payers (the Dow Jones U.S. Select Dividend Index). While this certainly doesn't exhaust all equity possibilities, it does provide an interesting cross-section of a few major categories—indicating how they reacted in different periods of rising interest rates.

Within fixed income, we examined the difference between a pure government bond exposure (interest rate risk, but not credit risk), a high-quality bond index and a high-yield bond index (less interest rate risk, more credit risk). Within equities, we looked at dividend-paying stocks.

We'd expect higher-yielding dividend payers to face a headwind, while more growth-oriented companies could be better positioned to grow their dividends with rising interest rates and rising inflation.

We looked at times when the U.S. 10-Year Treasury note rose 100 basis points (bps) or more and saw the following:

- **High-Quality and U.S. Government Fixed Income Faced a Headwind:** Both the U.S. 10-Year Treasury note and the Barclays U.S. Aggregate Index experienced negative average returns during our rising rate periods.

- **High-Yield Fixed Income Performed Better:** While the BofA Merrill Lynch High Yield Index delivered differentiated performance with respect to the other two fixed income options, it was still able to generate a positive average return during the rising rate periods. It actually outperformed an index of high-yielding dividend payers on an average annual basis over these periods.
- **Equities Strong to Quite Strong:** Both the S&P 500 Index and the Russell 2000 Index tended to perform better during the rising rate periods than over the entire period. This fits with what we mentioned earlier—that equities can perform well when rising rates signal improvements in growth and generally rising inflation.
- **Small Caps Were Especially Strong in Rising Rates:** With the exception of the first rising rate period, from October 15, 1993, to November 7, 1994, the Russell 2000 Index delivered a double-digit return in every period. Its average annual return during the rising rate periods was 15.1%, versus its average annual return during the full period at 8.6%.

[1] Source: Professor Robert Shiller, with data measured from 31/12/1957 to 30/06/2015 for the S&P 500 Index universe

*Average Return Rising Rates: Average cumulative total return during periods of rising rates shown in the chart. ** Full Period Average Annual Return: Average annual total return for each index from 10/15/1993 to 9/5/2013. Source: Bloomberg. Data measured from 10/15/1993 to 6/30/2015. Periods of rising rates determined by an increase of at least 100 bps in the 10-Year US Treasury note interest. Past performance is not indicative of future results. You cannot directly invest in an index.

Rising Rate Solutions for Your Toolkit:

- The WisdomTree U.S. SmallCap Dividend Fund (DESE): DESE tracks the performance of the WisdomTree U.S. SmallCap Dividend Index which includes small-cap, dividend-paying companies with relatively high growth and quality characteristics, historically placing very low weight within the Utilities and Telecommunication Services sectors.
- The Boost 3x and 5x short ETPs tracking 10Y US Treasuries: these ETPs provide a total return comprised of respectively three and five times the inverse daily performance of the US Treasury Note 10Y Rolling Future Index. The geared inverse exposure offers investors an opportunity to efficiently position bearishly on US fixed income.
- [WisdomTree U.S. SmallCap Dividend Fund \(DESE\)](#)
- [Boost US Treasuries 10Y 3x Short Daily ETP \(3TYS\)](#)
- [Boost US Treasuries 10Y 5x Short Daily ETP \(5TYS\)](#)

All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.

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