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FROM TAPERING TO TIGHTENING: PREPARING PORTFOLIOS FOR CHANGES IN FED POLICY

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Over the last nine months, the Federal Reserve (Fed) has gradually reduced the pace of its asset purchases in conjunction with improving strength in the U.S. economy. With "tapering[1]" on pace to conclude October 29, we believe that investors should now look beyond 2014 and start to focus on when, not if, the Federal Reserve will begin to tighten monetary policy.[2] In our view, the way that investors have prepared their portfolios for tapering could be inadequate for the likely market reaction to increases in short-term rates. In the remainder of this discussion, we intend to focus on the following topics:

+ **Preparing your portfolio for tightening[3] is different than tapering**
+ **Traditional approaches to rising rates may not adequately insulate portfolios from losses going forward**
+ **Duration[4]-hedged[5] and negative duration exchange traded funds (ETFs) may provide investors with more comprehensive and intuitive tools to mitigate interest rate risk**

So far in 2014, our base case has been that interest rates in the U.S. would rise as the economy strengthened. While inclement weather, geopolitical instability and economic weakness abroad have challenged this view so far, we still believe in our underlying thesis. The U.S. economy is growing at a faster pace than it was 12 months ago.[6] Labor market data is showing an ongoing trend of improvement. Housing appears to be on a more stable footing. For these reasons, we believe that the U.S. economy is creeping ever closer to escape velocity. Yet fixed income markets appear complacent. Forward guidance[7] from the Fed points to much higher rates than implied by current market pricing.[8] The term premium investors require to invest in the 10-year Treasury note compared to shorter maturities, is now at levels not seen since May 2013, pre-taper tantrum.[9] And this is precisely why some investors, ourselves included, are concerned.

PREPARING FOR TIGHTENING IS DIFFERENT THAN TAPERING

The most common refrain we have heard from financial advisors is that by shifting in to shorter-maturity fixed income securities last year, their clients have in effect "made their trade" for changes in Fed policy. This anecdotal evidence of investor positioning is also corroborated by fixed income ETF flows data. In our earlier white paper on the topic of rising rates, we noted when market pundits spoke about the "great rotation" out of fixed income

[1] Taper: a gradual reduction in the pace of asset purchases by the Federal Reserve.
[2] Monetary policy: actions undertaken by a central bank in order to stimulate or moderate an economy.
[3] Tightening: a reduction in the amount of monetary policy accommodation, often through interest rate hikes.
[4] Duration: A measure of a bond's sensitivity to changes in interest rates.
[5] Hedge: Apply strategies meant to mitigate the impact of duration movements; taking an offsetting position in a related security.
[6] Source: Bloomberg, as of 8/31/14.
[7] Forward guidance: A central bank policy tool intended to guide market expectations regarding the future of policy rates.
[8] As measured by Fed Fund Futures and Eurodollars. Source: Bloomberg, as of 8/31/14.
[9] Source: Federal Reserve, as of 8/31/14.

in 2013, they only got the story partially correct. Although outflows from long-maturity fixed income totaled $24.5 billion in 2013, net inflows into short-maturity fixed income totaled more than $34 billion.[10] With continued flows into this part of the yield curve[11] continuing in 2014, investors rationalize this trade as a response to Fed tapering: the Fed is reducing the pace of asset purchases in the long end; the short-end would largely be driven by the outlook of short-term rates (which wasn't expected to change until tapering was complete). However, with tapering set to end in short order, the market's focus could inevitably shift to the timing of the first rate hike.

Should the Federal Reserve hike interest rates in 2015, we believe that 2-year Treasury yields will rise well in advance of any action. Financial markets are anticipatory, meaning that the resulting move could lead to losses for short-term fixed income investors. In our view, the upcoming tightening path by the Fed is likely to have characteristics that are unique compared to previous tightening cycles. However, a comparison of current 2-year Treasury yields against the Fed funds target rate[12] is currently much different than previous cycles. In our view, the market is significantly underestimating a potential change in Fed policy.

YIELDS AND TOTAL RETURNS OF 2-YEAR TREASURY NOTES DURING PAST TIGHTENING PERIODS

Yield And Rate Levels				
Six Months Before The First Hike	8/4/1993	12/29/1998	12/29/2003	Current, 8/31/2014
2-Year Treasury Yield	4.16%	4.66%	1.78%	0.49%
Fed Funds Target	3.00%	4.75%	1.00%	~ 0 - 25%
Difference	1.16%	-0.09%	0.78%	0.24% - 0.49%

Day Before The First Hike	2/3/1994	6/29/1999	6/29/2004
2-Year Treasury Yield	4.28%	5.68%	2.81%
Fed Funds Target	3.00%	4.75%	1.00%
Difference	1.28%	0.87%	1.81%

Cumulative Returns For BAML Current 2-Year Treasury Index			
Six Months Before The First Hike To The Last Hike	8/4/1993 – 2/1/1995	12/29/1998 – 5/16/2000	12/29/2003 – 6/29/2006
Price Return	-4.62%	-4.48%	-4.99%
Income Return	7.96%	7.63%	8.02%
Total Return	3.34%	3.15%	3.03%

Source: BofA Merrill Lynch, Bloomberg. Past performance is not indicative of future results.

[10] Source: Bloomberg, WisdomTree, as of 8/31/14.
[11] Yield curve: a 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.
[12] Fed funds target rate: The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another.

In past periods, much higher yields provided a sizable cushion to offset price deterioration and keep total returns over the tightening period remarkably similar. Current yield levels offer no such safety net if the extent and magnitude of tightening proves similar. This could have the impact of generating negative total returns for investments in 2-year Treasury securities.

In recent research released by the Federal Reserve Bank of San Francisco and echoed in statements by several Fed regional bank presidents, Fed officials have voiced concerns that the market is currently underestimating the probability and timing of a change in monetary policy.[13] If previous market cycles are any indication, heavy positioning and an earlier than anticipated tightening cycle by the Fed could leave many investors vulnerable to a shift in policy.

In today's market, 2-year Treasury yields are currently anchored below 0.50%. We believe it is possible that yields could breach 1% for the first time in nearly 5 years in anticipation of the first rate hike. Absent other factors, this could result in a loss in price terms of approximately 1%. From a timing perspective, Morgan Stanley has determined that during the most recent tightening cycle of 2003/2004, markets begin to price in a change in Fed policy approximately 6 months before the actual change.[14] With current economist forecasts calling for the first hike in mid-2015, we believe that now may be a prudent time to reduce interest rate risk.

PERFORMANCE REVIEW OF TRADITIONAL APPROACHES TO RISING RATES

When then Fed Chairman Bernanke introduced the prospect of tapering in May 2013, market pundits began to debate the meaning of tapering vs. tightening. More than one year later, we can look back with the benefit of hindsight and conclude that tapering was in fact not tightening. However, as the market grappled with this question, we observed a meaningful test run for rising rate strategies that could prove useful when fears of tightening resurface. In the initial months following Bernanke's comments, rates rose rapidly, catching many investors off-guard. Unfortunately, while most traditional approaches for trying to reduce interest rate risk were able to generate positive returns, the magnitude of those returns paled in comparison to losses experienced in other parts of their bond portfolios.[15]

By examining this period as 2 distinct parts, we are better able to interpret the impact of initial tapering/tightening fears from the reality of the actual reduction in purchases. As shown in the table below, traditional approaches to rising rates during the "taper tantrum" managed to avoid losses, but failed to provide a significant offset to the losses experienced in the rest of their fixed income portfolios.

[13] http://www.frbsf.org/economic-research/publications/economic-letter/2014/september/assessing-expectations-monetary-policy/.
[14] Morgan Stanley, 6/9/14.
[15] Source: Bloomberg, as of 8/31/14.

FIXED INCOME PERFORMANCE PRE AND POST "TAPERING"

	Taper Tantrum	Actual Tapering	Cumulative Period		
	5/22/13 – 12/18/13 (211 days)	12/18/13 – 8/31/14 (256 days)	5/22/13 – 8/31/14 (467 days)		
Traditional Fixed Income	Total Return (%)	Total Return (%)	Yield Change (bp)	Total Return (%)	Current Yield to Maturity (%)
U.S. 2 Year Treasury	0.29%	0.49%	+25.4	0.78%	0.49%
U.S. 5 Year Treasury	-1.58%	1.35%	+80.6	-0.25%	1.63%
U.S. 10 Year Treasury	-6.35%	6.94%	+41.7	0.15%	2.34%
Barclays U.S. Aggregate Index	-1.84%	4.55%	+32.0	2.62%	2.22%
Rising Rate Alternatives	Total Return (%)	Total Return (%)	Yield Change (bp)	Total Return (%)	Current Yield to Maturity (%)
Cash (Barclays 1-3m T-Bill Index)	0.02%	0.02%	-1.0	0.04%	0.02%
Barclays U.S. Aggregate Index, 1-3 Year	0.42%	0.61%	+24.0	1.04%	0.73%
Barclays U.S. Dollar Floating Rate Note (FRN) Index	0.49%	0.74%	-12.0	1.23%	0.52%
Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration	N/A	1.51%	N/A	N/A	0.46%

Source: Bloomberg, Barclays, 8/31/2014. Real-time data limited for Barclays Rate Hedged U.S. Aggregate Index, Zero Duration. Past performance is not indicative of future results. You cannot invest directly in an index.

Shifting the focus of the analysis to the period of actual Fed tapering that began December 18, 2013, we see that traditional fixed income performed well as longer-term rates fell in 2014. Curiously, rising-rate strategies provided very similar returns to those experienced during the "taper tantrum." This can largely be explained by the fairly muted rise in interest rates at the short end of the yield curve. During both periods, income potential and roll down were the primary driver of returns. As a result, total returns remained constrained, but positive. With short-end rates marginally above zero, investments in Treasury bills continue to represent a significant sacrifice in purchasing power due to the effects of inflation.

As an alternative, we also illustrate how a duration-hedged approach performed since the Fed began tapering. In this strategy, the Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration is the same as the traditional Barclays U.S. Aggregate Index, but a second-step adjustment seeks to hedge interest rate risk to zero. As a result, the strategy is able to maintain traditional bond exposures while mitigating interest rate risk. In hindsight, we know that hedging interest rate risk detracted from returns as rates fell over the period. However, when compared to traditional rising rate alternatives, this approach generated significantly better performance.

BUNDLING RISING RATE STRATEGIES VIA ETFS

In our view, ETFs provide a powerful tool for fixed income investors. Historically, even the most sophisticated investment managers have sought to use ETFs in order to gain broad-based exposure to certain sectors of the fixed income market. This is perhaps most applicable in high-yield[16] and emerging market debt. From the investor's perspective, ETFs allow them a way to efficiently access a basket of bonds as opposed to attempting to buy or sell each security on their own. With this same approach in mind, WisdomTree is attempting to bundle institutional caliber strategies to mitigate interest rate risk in an easy to access ETF wrapper. As we highlight below, the mechanics of these approaches seek to address the risk of rising rates head on.

One common concern about traditional rising rate strategies is that the underlying investment characteristics of the portfolios change in the name of reducing risk. By altering the coupon[17] type or shifting to the very front of the yield curve, investors must fundamentally change the DNA of their portfolio. In our approach to rising rates, we have sought to maintain traditional bond exposures while modifying the portfolio's exposure to interest rate risk. In doing so, we sought to create portfolios that investors are familiar with that provide them with the risk management tools they are seeking.

The Barclays U.S. Aggregate Index is the most recognized fixed income index in the world with over $4 trillion in assets[18]. In partnering with BofA Merrill Lynch, we were able to access a commonly followed investment strategy of high yield bonds maturing within 5 years. However, in a rising rate environment, both strategies are likely to underperform. In response, we sought to create two different risk profiles for each strategy:

+ **Zero duration indices which seek to offset the interest rate exposure in the long bond portfolio and**
+ **Negative duration indices whereby the overlay strategy is constructed to target a duration below zero, creating an index that could potentially benefit from a rising rate environment**

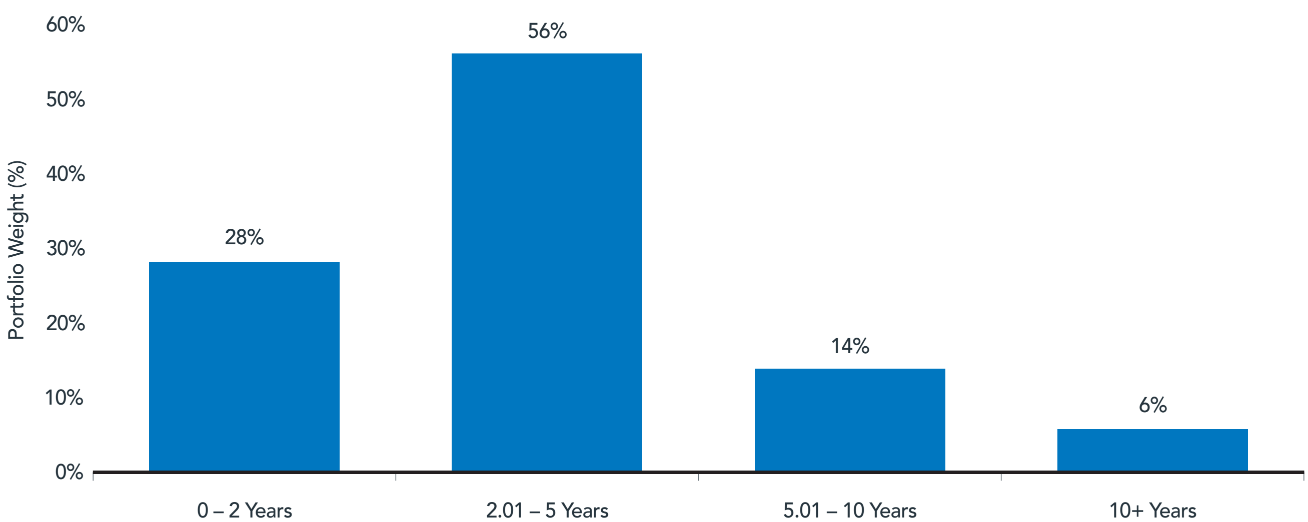
In both approaches, investors are given the flexibility to mitigate interest rate risk in the same way that they currently mitigate credit risk via ETFs. On the day the Fed began tapering its asset purchase program, WisdomTree launched the Barclays Aggregate Bond Zero Duration Fund (AGZD), the Barclays Aggregate Bond Negative Duration Fund (AGND), the BofA Merrill Lynch High Yield Bond Zero Duration Fund (HYZD), and the BofA Merrill Lynch High Yield Bond Negative Duration Fund (HYND) in order to help investors maintain bond exposure while mitigating risk.

[16] High-yield: Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securities.
[17] Coupon: the rate of interest paid by a bond as a percentage of face value.
[18] Barclays, as of 12/31/13.

INTEREST RATE RISK IS MORE THAN A NUMBER

While some investors seek to quantify interest rate risk via a single duration number, it is important to note that interest rates seldom move in parallel shifts across the yield curve. As we alluded to above, we believe that the short-end of the yield curve remains vulnerable to an eventual Fed rate hike. As illustrated below, traditional fixed income strategies have a large percentage of their exposure to securities at the short end of the yield curve. In the case of the Barclays U.S. Aggregate Index, over 80% of the portfolio falls within the 0-5 year duration bucket.[19]

BARCLAYS U.S. AGGREGATE INDEX



Source: Barclays, as of 8/31/14. You cannot invest directly in an index. Subject to change.

In constructing our rising rate strategies, the index first identifies the sensitivities of the long portfolio to interest rate risk. As part of this process, the sensitivities are quantified then a mirror image of interest rate exposures is constructed within the hedge in order to help immunize the bond positions from fluctuations in rates.

In the case of the negative duration strategies, these portfolios "overhedge" their long exposure through selling longer duration securities to target the desired exposure without leverage. As shown in the table below, the primary difference between zero and negative duration strategies is the concentration of short positions in the longer end of the yield curve.

[19] Barclays, as of 8/31/14.

DURATION STATISTICS AND BREAKOUTS FOR "RISING RATE" INDEXES [As of 8/31/14]

	Duration (years)	0 – 2 Years	2.01 – 5 Years	5.01 – 10 Years	10+ Years
Barclays U.S Aggregate Index (LBUSTRUU)	5.61	27.65%	55.97%	13.78%	5.70%
Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration (BAZDTRUU)	0.00	-27.65%	-55.97%	-13.78%	-5.70%
Barclays Rate Hedged U.S. Aggregate Bond Index, -5 Duration (BUAFTRUU)	-5.00	–	-15.17%	-64.83%	-20.00%

	Duration (years)	0 – 6 Months	6 Months – 2 Years	2.01 – 5 Years	5+ Years
BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained Index (HUCD)	2.16	21.69%	51.95%	26.21%	––
BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, Zero Duration Index (HZCD)	0.00	-21.69%	-51.95%	-26.21%	–
BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, -7 Duration Index (H7CD)	-7.00	–	–	-18.32%	-72.31%

Source: Barclays, BofA Merrill Lynch, as of 8/31/14. Subject to change. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index.

RISING RATE STRATEGIES IN A FALLING RATE ENVIRONMENT

After a difficult market environment for bond investors in 2013, the prevailing market consensus to start the year was that long-term bond yields would continue to rise in 2014. This view has clearly not come to pass so far this year. However, the market reprieve for assuming interest rate risk has still provided us with valuable information about the performance of various bond strategies. As shown in the table below, we highlight how hedged and negative duration variants of traditional fixed income indexes have performed in a falling interest rate environment since the beginning of Fed tapering.

YIELD, DURATION, AND RECENT PERFORMANCE FOR "RISING RATE" INDEXES [As of 8/31/14]

	Yield to Worst (YTW)				12/18/13 – 8/31/14
Aggregate Strategies	**Net**	**Long**	**Short**	**Duration**	**Total Return (%)**
Barclays U.S Aggregate Index (LBUSTRUU)	2.22%	2.22%	N/A	5.61	4.40%
Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration (BAZDTRUU)	0.60%	2.22%	-1.62%	0.00	1.50%
Barclays Rate Hedged U.S. Aggregate Bond Index, -5 Duration (BUAFTRUU)	-0.30%	2.22%	-2.52%	-5.00	-4.21%
High Yield Strategies	**Net**	**Long**	**Short**	**Duration**	**Total Return (%)**
BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained Index (HUCD)	4.96%	4.96%	N/A	2.16	3.74%
BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, Zero Duration Index (HZCD)	4.43%	4.96%	-0.53%	0.00	3.19%
BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained, -7 Duration Index (H7CD)	2.82%	4.96%	-2.14%	-7.00	-3.21%

Source: Barclays, BofA Merrill Lynch, Bloomberg, WisdomTree, as of 8/31/14. The Federal Reserve began tapering the pace of its asset purchases on 12/18/13. Yield to Worst (YTW): The rate of return generated assuming a bond is redeemed by the issuer on the least desirable date for the investor. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

In financial markets, there is no free lunch. Therefore, as rates have fallen, hedged and negative duration strategies have underperformed. This will clearly not always be the case. However, we can now definitively quantify this risk versus reward relationship in real-time. In the case of the Barclays Rate Hedged U.S. Aggregate Bond Index, returns were driven by assuming credit and prepayment risk, but did not benefit from the fall in nominal interest rates.

Shifting the focus to the negative duration high yield strategy, this approach lost value as credit spreads widened and interest rates fell. However, returns from income were able to help offset a portion of these losses. In the case of both negative duration strategies, the risk versus return payoff is asymmetric. Total returns from the negative duration strategies didn't lose as much as the strategies gained from the move in rates. This can largely be attributed to the fact that the long bond portion helps to defray some of the costs associated with maintaining these positions. While examining these strategies independently can give some insight into the future drivers of total return, we believe the real value of these strategies is how they can be incorporated into a broader portfolio of interest rate risk sensitive assets.

IMPLEMENTATION STRATEGIES: "CORE PLUS" & RISK MANAGEMENT

While viewing each strategy independently provides valuable information, the power of these strategies, in our opinion, is how they can be combined as part of an existing portfolio. In recent years, many investors have extended beyond investment-grade[20] fixed income to incorporate satellite positions in high-yield corporate bonds. In recent years, so-called "core plus" strategies have been employed successfully by money managers as a way to potentially add value to investors' portfolios. Ultimately, these strategies seek to balance income and credit risk in order to generate total returns. By constructing these hypothetical portfolios using zero duration and negative duration tools as shown below, advisors can further refine their specific exposure not only to credit risk, but to a specific level of interest rate risk as well.

Core Plus Strategy	Duration	Yield
Traditional Portfolio (80% Agg, 20% HY)	4.92	2.82%
Zero Portfolio (80% Agg Zero, 20% HY Zero)	-0.03	1.40%

Core Plus Strategy	Duration	Yield
Traditional Portfolio (80% Agg, 20% HY)	4.92	2.82%
Negative Portfolio (80% Agg Neg, 20% HY Neg)	-5.51	0.27%

	Duration	Yield
Traditional Core Plus	4.92	2.82%
85% Core Plus / 15% Zero Core Plus	4.18	2.61%
75% Core Plus / 25% Zero Core Plus	3.68	2.46%
65% Core Plus / 35% Zero Core Plus	3.19	2.32%
50% Core Plus / 50% Zero Core Plus	2.44	2.11%
Zero Core Plus	-0.03	1.40%

	Duration	Yield
Traditional Core Plus	4.92	2.98%
85% Core Plus / 15% Negative Core Plus	3.36	2.57%
75% Core Plus / 25% Negative Core Plus	2.31	2.30%
65% Core Plus / 35% Negative Core Plus	1.27	2.03%
50% Core Plus / 50% Negative Core Plus	-0.29	1.62%
Negative Core Plus	-5.51	0.27%

Sources: Barclays, BofA Merrill Lynch, WisdomTree, as of 8/31/14. Hypothetical illustration only. Past performance is not indicative of future results.

On the left, we show 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 1.42% per year. While this portfolio sacrifices approximately 50% of its income potential, interest rates would only need to rise by approximately 28 basis points[21] (bp) over the course of a year to breakeven. If investors believe that rates may rise by more than this amount, hedging could potentially add value.

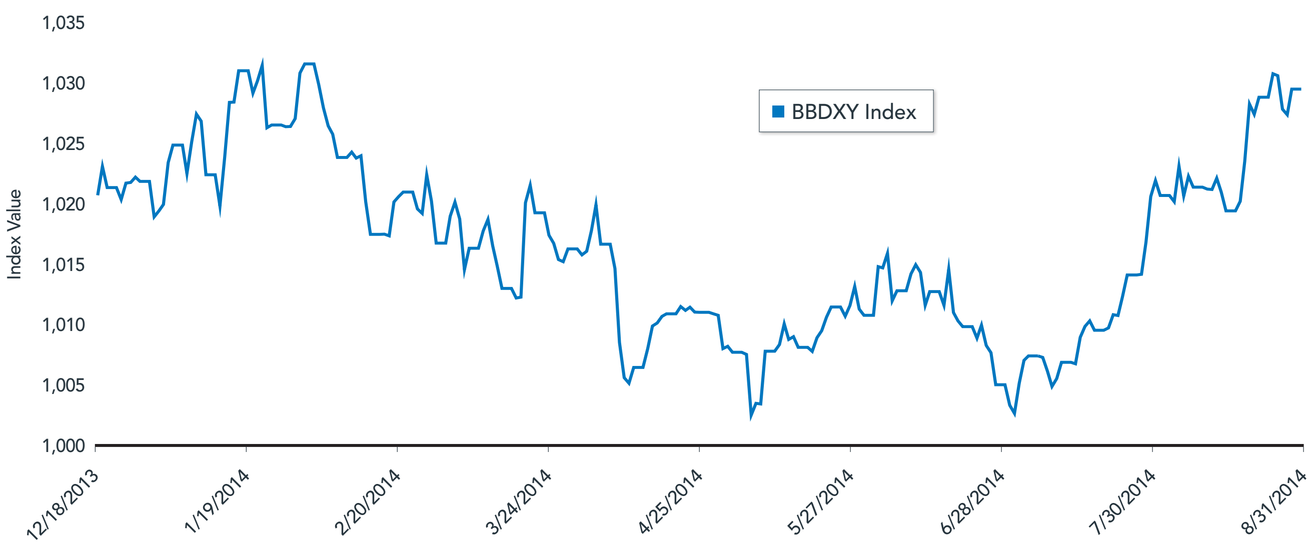
Turning our attention to the table at the right, investors can have a greater impact on the duration of their portfolio when blending exposure with a negative duration core plus strategy. However, this approach may be more sensitive to distortions in the shape of the yield curve. Since this strategy is constructed through selling longer duration securities, it may be possible that interest rates could rise, but the investor's hedge may not necessarily immunize their portfolio losses from higher interest rates. However, for investors with a higher conviction about rising long-term interest rates, a negative core plus strategy can provide positive income potential with a negative duration position of over 5.5 years.

[20] 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.
[21] Basis point: 1/100th of 1 percent.

DIRECTION & TIMING OF RISING RATES

A difficulty that many investors have experienced so far in positioning their portfolios for the prospect of rising rates is that this shift requires not only a positioning element, but a timing element as well. Given that hedging incurs costs, investors may prefer to delay moving in to more defensive strategies until they have greater conviction about a move in rates. While a good portion of our focus thus far has been on the impact of changes in Fed policy, we believe one indicator of a potential increase in rates is already beginning to move. Since bottoming on July 1st, the U.S. dollar[22] has started to advance against virtually every major developed market currency and many emerging market currencies as well. International finance teaches us that relative interest rates can have a significant impact on a currency's exchange rate. When interest rates rise, currencies tend to strengthen; when interest rates fall, currencies tend to depreciate. While a decent portion of the recent strength in the dollar has been caused by foreign rates falling, we believe that it is only a matter of time before short-term rates begin to price in impending changes in Fed policy. In our view, this most recent move in the value of the dollar could be a signal of changes in rates to come.

BLOOMBERG DOLLAR SPOT INDEX [12/18/2013 – 8/31/2014]



Source: Bloomberg, as of 8/31/14. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

[22] As measured by the Bloomberg Dollar Spot Index.

CONCLUSION

U.S. interest rates remain at historically low levels across the yield curve. The current combination of low coupons and extended durations make the bond market very sensitive to shifts in interest rates. At present, the market has a more benevolent view of the path for rates than the Fed's forward rate guidance. Should the path of rate hikes more closely match current Fed projections, investors may be caught off guard. While many investors have sought to protect their portfolios from Fed tapering, we believe that these traditional approaches remain vulnerable to tightening. Compared to previous tightening cycles, cushion from income potential remains significantly constrained. As a result, the prospect of negative returns from short-term fixed income strategies remains skewed to the upside. In our view, investors should consider taking an institutional approach to mitigating interest rate risk via overlay strategies. ETFs which package these strategies can provide investors the opportunity to preserve their existing fixed income strategies while mitigating their interest rate risk in a single trade.

While the timing of changes in Fed policy remains uncertain, we believe the market may be overly complacent compared to the potential risks of rising rates. For this reason, we believe these new tools could prove timely, as the countdown to the first Fed rate hike begins.

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