

As investors continue to assess their options for reducing interest rate risk, the United States Treasury is seeking to tap this growing demand by issuing floating rate notes (FRNs)<sup>1</sup> for the first time in its history. For investors, the option to invest in floating rate debt issued by the U.S. government may prove to be an attractive option for those who prefer to limit their exposure to credit risk<sup>2</sup>, but still want to participate in the potential for higher yields should interest rates rise from present levels. In our view, U.S. floating rate debt helps bridge an important gap between short-maturity Treasury bills<sup>3</sup> and longer-maturity, fixed rate Treasury bonds.<sup>4</sup>

The U.S. Treasury completed its first floating rate auction on January 29, 2014, issuing \$15 billion of a note with a two-year stated maturity.<sup>5</sup> This was the first new class of issuance by Treasury since it issued Treasury Inflation-Protected Securities (TIPS)<sup>6</sup> in 1997. The Treasury currently intends to auction a new two-year note of similar size every quarter, with re-openings of the new issue in the two months that follow. As another means for the Treasury to fulfill growing investor demand and diversify its sources of funding, we believe that issuance and increasing investor adoption of floating rate Treasuries are poised to grow over the next several years. By comparison, the last new product issued by the Treasury has grown to become a market of over a trillion since 1997.<sup>7</sup>

## **BOND BASICS: WHAT IS A FLOATING RATE TREASURY NOTE?**

For many investors, exposure to bonds generally starts and stops with fixed income securities, which customarily pay a fixed rate of interest and refunds the principal balance at maturity. However, floating rate notes are slightly different. Although floating rate Treasuries make payments to holders each quarter, the size of these payments is based on a rate that is reset daily in reference to a rate that is determined weekly. This reference rate is based on the high yield determined at the weekly 13-week Treasury bill auction, which is generally held every Monday.

Therefore, if yields on the Treasury bill auction rise week to week, investors could receive greater compensation than with a fixed coupon payment from a traditional fixed income investment. This reset frequency should also mitigate price fluctuations in floating rate notes compared to fixed income bonds of similar maturities. Given that these securities are issued by the U.S. government, they could serve as reference benchmarks for a variety of floating rate issuers in the same way that U.S. Treasury bonds serve as interest rate benchmarks for all other U.S. dollar-denominated fixed income issuance.

But there is never a free lunch in financial markets. At today's levels, investors will likely receive lower coupon payments relative to fixed coupon bonds of a similar maturity. However, in the current market environment, we believe that the opportunity cost of protecting against higher rates is low and the margin for error in navigating a rising rate environment is continuing to narrow.

<sup>1</sup> Floating rate notes: A debt instrument whose coupon payments are tied to a short-term borrowing rate such as a US Treasury Bill Rate or the London Interbank Offered Rate (LIBOR).

<sup>2</sup> Credit risk: The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

<sup>3</sup> Treasury bill: A short-term debt obligation backed by the U.S. government with a maturity of less than one year.

<sup>4</sup> Treasury bonds: A debt obligation backed by the U.S. government with a maturity of more than ten years.

<sup>5</sup> Source: U.S. Department of the Treasury, 1/29/14.

<sup>6</sup> Treasury Inflation-Protected Securities (TIPS): bonds issued by the U.S. government whose coupon and principal payments are linked to the Consumer Price Index (CPI).

<sup>7</sup> Barclays, as of 12/31/15.

## WHAT ROLE CAN FLOATING RATE TREASURIES PLAY IN INVESTOR PORTFOLIOS?

With interest rate risk<sup>8</sup> on the minds of many investors, 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. Whereas other investments may also pay a rate of interest that resets each month or quarter, such securities are exposed to credit risk or the risk that the borrower will not be able to meet its financial obligations.

Although funds that hold these new Treasury securities should not be viewed as “money market funds,” in our view, floating rate Treasuries could function as a core alternative for short-term bond exposure with reduced interest rate and credit risk. With many issuers (including the U.S. government) focusing on issuing longer-term debt, short-term bill issuance has continued to decline as a percentage of overall issuance over the last three years.<sup>9</sup> Given that U.S. government securities are assumed to be default risk free, the value of the security will be determined by the interest rate at each weekly auction.

The Treasury decided to offer this floating rate option as an alternative to investors rolling three-month Treasury bills every quarter. This can help by reducing transaction costs and extends the holding period of their investments, but not their interest rate sensitivity, which will hinge on the frequency of the reset (effective maturity of one week). As the market matures, floating rate note issuance is expected to be expanded to include notes with different terms to maturity.<sup>10</sup> From an operational perspective, floating rate Treasuries can be an important addition to the investment opportunity set available to today’s investor.

## INTRODUCING USFR—FLOATING RATE NOTES WITHOUT CREDIT RISK

The WisdomTree Bloomberg Floating Rate Treasury Fund (USFR) seeks to track the price and yield performance of the Bloomberg U.S. Treasury Floating Rate Bond Index.

### FUND QUICK FACTS

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**Ticker:** USFR

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**Exchange:** NYSE

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**Expense Ratio:** Net Expense Ratio, amount charged to shareholder: 0.15%

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**Structure:** Open-end ETF. Registered under the Investment Company Act of 1940.

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**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.

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**Primary Exposures:** Floating rate Treasury notes.

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**Duration Target:** Determined by the reset frequency of the underlying securities in the index, currently 1 week.

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<sup>8</sup> Interest rate risk: the risk that an investment’s value will decline due to an increase in interest rates.

<sup>9</sup> Sources: U.S. Department of the Treasury, WisdomTree.

<sup>10</sup> Source: J.P. Morgan.

WisdomTree ETFs **BLOOMBERG FLOATING RATE TREASURY FUND**

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**For more information or to invest in USFR, contact your WisdomTree representative or call 866.909.WISE (9473).**

You cannot invest directly in an Index.

**Investors should carefully consider the investment objectives, risks, charges and expenses of the Fund before investing. To obtain a prospectus containing this and other important information, call 866.909.WISE (9473) or visit [wisdomtree.com](http://wisdomtree.com). Read the prospectus carefully before you invest.**

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 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.

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 bonds.

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WTGM-0900

