

Buying Wine for the “Duration Party” in our Model Portfolios

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This article is relevant to financial professionals who are considering offering model portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

Extending Duration; Remaining Cautiously Short

Throughout 2022, we have maintained a short duration profile within the fixed income allocations of our Model Portfolios.

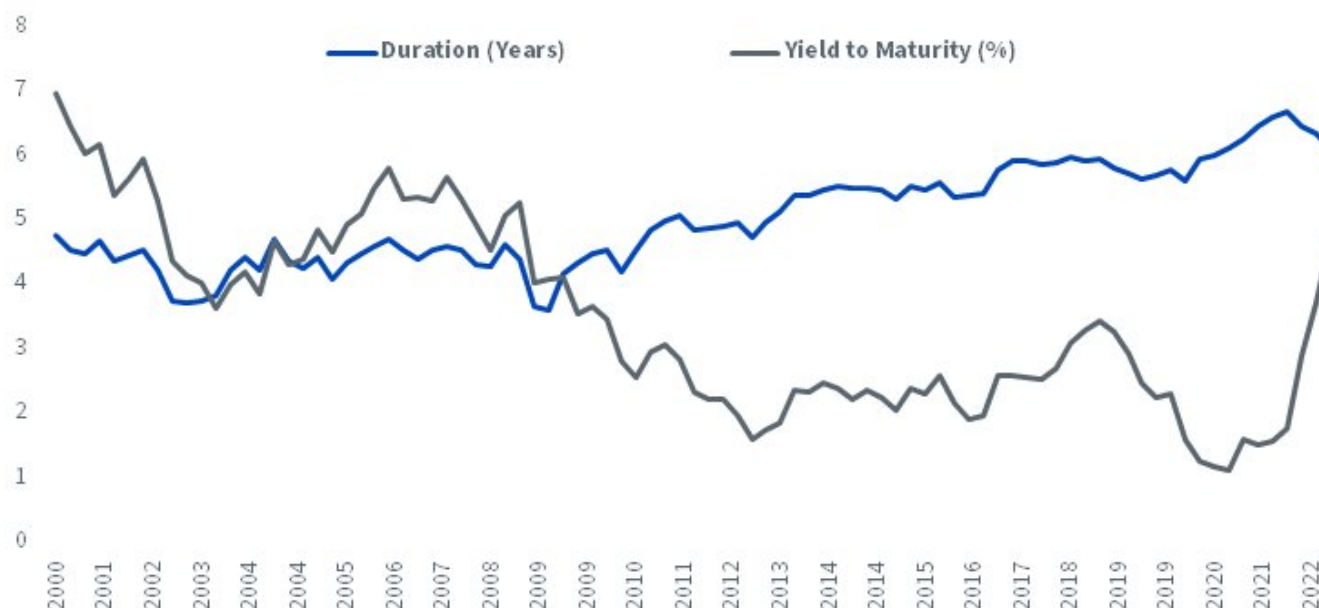
This is based on our view that, given persistent inflationary pressures, increasingly hawkish rhetoric from the Fed and heightened interest rate volatility, it is better to be late than early to the “duration party.”

Furthermore, the risk/return trade-off in core fixed income portfolios has been challenged since the global financial crisis, as potential returns (yields) have cratered while interest rate risk (duration) has marched higher.

That environment may be changing—since the start of the year, the yield on the Bloomberg U.S. Aggregate Bond Index has increased from 1.75% to over 4.6%! Bond investors are now being compensated with a greater yield for taking on a similar level of duration risk.

While volatility in both interest rates and credit spreads remains elevated, the [income is back in fixed income](#) markets.

Duration, Yield of Bloomberg U.S. Aggregate Bond Index



Sources: WisdomTree, Bloomberg, as of 10/29/21 and 9/30/22. Past performance is not indicative of future returns. You cannot invest directly in an index.

Another way to look at the risk profile of fixed income is to consider the extent to which current yields can offset the price impact of a rise in interest rates.

Going back almost one year to October 2021, when our Model Portfolio Investment Committee made the decision to shorten duration, yields in fixed income were lower and durations higher than today. Put another way, investors had a slimmer yield cushion to offset what was a greater price sensitivity to a move in rates.

Fast forward to today and the combination of higher yields and lower durations has dramatically changed that picture. With the cushion offered by today's yield levels, fixed income can still deliver positive total returns in a rising rate environment.

Interest Rate Risk Buffer in Fixed Income Yields

	October 2021			September 2022		
	Yield	Duration	Projected total return from a 1% rise in interest rates	Yield	Duration	Projected total return from a 1% rise in interest rates
2-Year Treasury	0.49	1.91	-1.4%	4.11	1.85	2.3%
10-Year Treasury	1.56	9.23	-7.7%	3.70	8.40	-4.7%
IG Credit	2.22	8.71	-6.5%	5.38	7.25	-1.9%
High-Yield Credit	4.23	3.98	0.2%	9.00	4.10	4.9%

Low-yield cushion
Higher durations

More attractive yields
Retracement in duration
Better risk/return trade-off

Sources: WisdomTree, Bloomberg, as of 10/29/21 and 9/30/22. Past performance is not indicative of future returns. You cannot invest directly in an index. IG Credit represented by the Bloomberg U.S. Corporate Bond Index. High Yield Credit represented by the Bloomberg U.S. Corporate High Yield Bond Index.

While we are not ready to fully close out our short duration position and make our entrance at the duration party, we have begun to move in that direction.

As part of the quarter-end rebalance on September 30, 2022, we extended the maturity profile of our bond allocations, partially closing the existing short duration position in our Model Portfolios.

A straightforward way to evaluate potential changes to the duration profile of a fixed income portfolio is through our “barbell” tool, which allows investors to toggle between short and intermediate/longer duration exposures.

Within our Strategic Model Portfolios, our approach to the barbell strategy consists of the [WisdomTree Yield Enhanced U.S. Aggregate Bond Fund \(AGGY\)](#) for intermediate/longer duration exposure and the [WisdomTree Floating Rate Treasury Fund \(USFR\)](#) for shorter duration exposure.

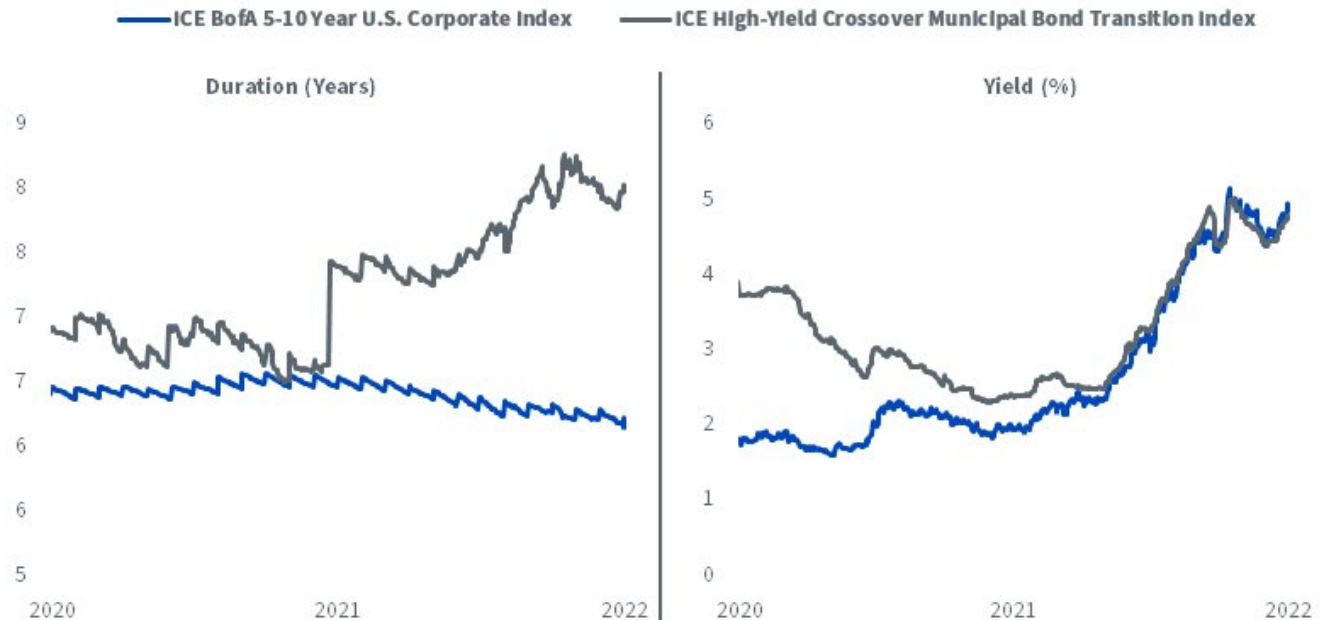
Rotating Out of High-Yield Municipal Bonds

Another change we implemented in September was removing our existing allocation to high-yield municipal bonds in our Multi-Asset Income Model Portfolios. These strategies live within our Outcome-Focused Model Portfolio suite, where we maintain portfolios that are designed to achieve very specific investment objectives including enhanced yield and income generation, disruptive growth, volatility management and risk factor diversification.

This high-yield municipal bond position was added several years ago when the sector offered a considerable yield advantage to investment-grade corporate credit, in addition to valuable diversification benefits to a traditional core fixed income portfolio.

In recent months, that yield advantage has disappeared while the interest rate risk (duration) of high-yield municipal bonds has steadily increased.

Duration Yield of Intermediate U.S. Corporates, High Yield Municipal Bonds



Sources: WisdomTree, ICE BofA Indexes, as of 8/31/22. Past performance is not indicative of future returns. You cannot invest directly in an index.

With these market dynamics in mind, our Model Portfolio Investment Committee made the decision to reallocate from high-yield municipal bonds to investment-grade corporate credit in these Models.

Conclusion

As interest rate volatility remains elevated, we continue to monitor fixed income markets and the trade-offs between risk and potential returns across sectors.

While we maintain our preference for shorter duration exposure, intermediate and longer-term yields may now be less vulnerable to rising rates than they were a year ago.

With this in mind, our Model Portfolio Investment Committee moved to extend the maturity profile of our fixed income portfolios, partially closing the existing short duration position. We still would rather be late than early to the duration party and liken this first step to buying a bottle of wine before arriving.

Lastly, as the relative yield premium of high-yield municipal bonds has diminished, we reallocated from this sector into investment-grade corporate bonds within our [Multi-Asset Income Model Portfolios](#).

Important Risks Related to this Article

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USFR: There are risks associated with investing, including the 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.