

Enhance Your Agg Position for the Current Market Environment

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As we've highlighted over the last several weeks, [investors should be taking a closer look at their bond portfolios](#) and determining if allocations to the Barclays U.S. Aggregate Index (Agg) are consistent with their investment objectives. In our view, while the Agg provides a time-tested barometer for fixed income performance, as an investment strategy, the approach is suboptimal. We believe investors should consider looking inside the Agg at its components as one way to position going forward. **Return Prospects from Short-Dated Treasuries Are Not Compelling** When considering a change in investment strategy, it may make sense for investors to rethink the reason they own bonds in the first place: simply put, bonds help to generate steady returns when equity markets slide. Next, why do investors own Treasuries? Most likely to manage volatility in their bond portfolio and potentially benefit if the economy starts to slip. Shifting our focus to the Agg, why should an investor hold 22% of a fixed income portfolio in 1- to 5-Year¹ Treasuries that yield 0.85%² Regardless of investors' views of changes in policy at the Federal Reserve (Fed), this paltry level of income could be costing them performance. Over the last six years since the financial crisis, the exposure to U.S. Treasuries of the Agg has swelled to nearly 40%.³ This shift in exposure was not driven by any particular investment rationale, but rather a simple increase in issuance patterns over the last several years. In our view, exposure to certain segments of the Agg may only make sense in some of the least-favorable, lowest-probability economic environments. **Credit Appears Compelling, Particularly in the Long Run** Year-to-date, securitized debt has outperformed Treasuries, which have outperformed credit.⁴ Even so, in the medium term, we believe we would need to see a meaningful deterioration in the global economy to have credit underperform Treasuries. As a result of widening in credit spreads year-to-date, we view valuations today as compelling. Interestingly, Baa credit spreads would need to widen by an additional 60 basis points (bps)⁵ in the next year in order to underperform the total return of U.S. Treasuries. Should this occur, spreads would be at their widest levels since the global financial crisis of 2008. While concerns about credit have cropped up, most notably in high-yield Materials and Energy credits, we believe that fundamentals are strong in the investment-grade space. Additionally, with Baa credit spreads currently higher than the all-in yield of a 10-Year Treasury bond, this signals to us that the market is attractively priced. In fact, this has occurred only two times in history: briefly during the euro crisis of 2011 and the global financial crisis of 2008.⁶ **Implementation Considerations** In response, we believe investors should consider looking within the Agg as one way to enhance the income of their portfolios. As a result, we have shown the net impact on yield, duration and sector positioning by swapping a hypothetical allocation between the Agg and the Barclays U.S. Aggregate Enhanced Yield Index. While many investors have historically increased their exposure to bonds outside the Barclays Aggregate as a way to enhance

income, we believe our approach could deliver better risk-adjusted returns than allocating solely to market capitalization-weighted credit indexes. **Yield and Duration for Blends of Agg and Agg Enhanced Yield, 9/30/2015**

	100% Agg	75% Agg / 25% Agg Enhanced Yield	50% Agg / 50% Agg Enhanced Yield	25% Agg / 75% Agg Enhanced Yield	100% Agg Enhanced Yield
Yield	2.31%	2.52%	2.73%	2.93%	3.14%
Duration	5.65	5.90	6.15	6.40	6.65

Sector Breakdown for Blends of Agg and Agg Enhanced Yield, 9/30/2015

	100% Agg	75% Agg / 25% Agg Enhanced Yield	50% Agg / 50% Agg Enhanced Yield	25% Agg / 75% Agg Enhanced Yield	100% Agg Enhanced Yield
Credit	34%	38%	41%	45%	49%
Securitized	30%	31%	32%	33%	34%
U.S. Government	37%	32%	27%	22%	17%

Sources: Barclays, WisdomTree, as of 9/30/15. Past performance is not indicative of future results. You cannot invest directly in an index.

As we show above, for a modest uptick in duration, investors can also meaningfully enhance the income component of their portfolios while retaining the familiar risk versus return profile of the Agg. This is primarily achieved by reducing exposure to shorter-maturity Treasuries and over-weighting corporate bonds, which we believe offer the potential for greater total returns. Ultimately, our timing could prove to be early, and it may be possible that this approach will underperform. However, in the medium term, we believe our updated approach to the Barclays Agg could ultimately add to higher total returns over the market cycle. 1As measured by duration. 2Source: Barclays, as of 9/30/15. 3Source: Barclays, as of 9/30/15. 4Source: Barclays, as of 9/30/15. 5Source: Barclays, as of 9/30/15. 6Sources: Barclays, WisdomTree, as of 9/30/15.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. Investing in mortgage- and asset-backed securities involves interest rate, credit, valuation, extension and liquidity risks and the risk that payments on the underlying assets are delayed, prepaid, subordinated or defaulted on.