

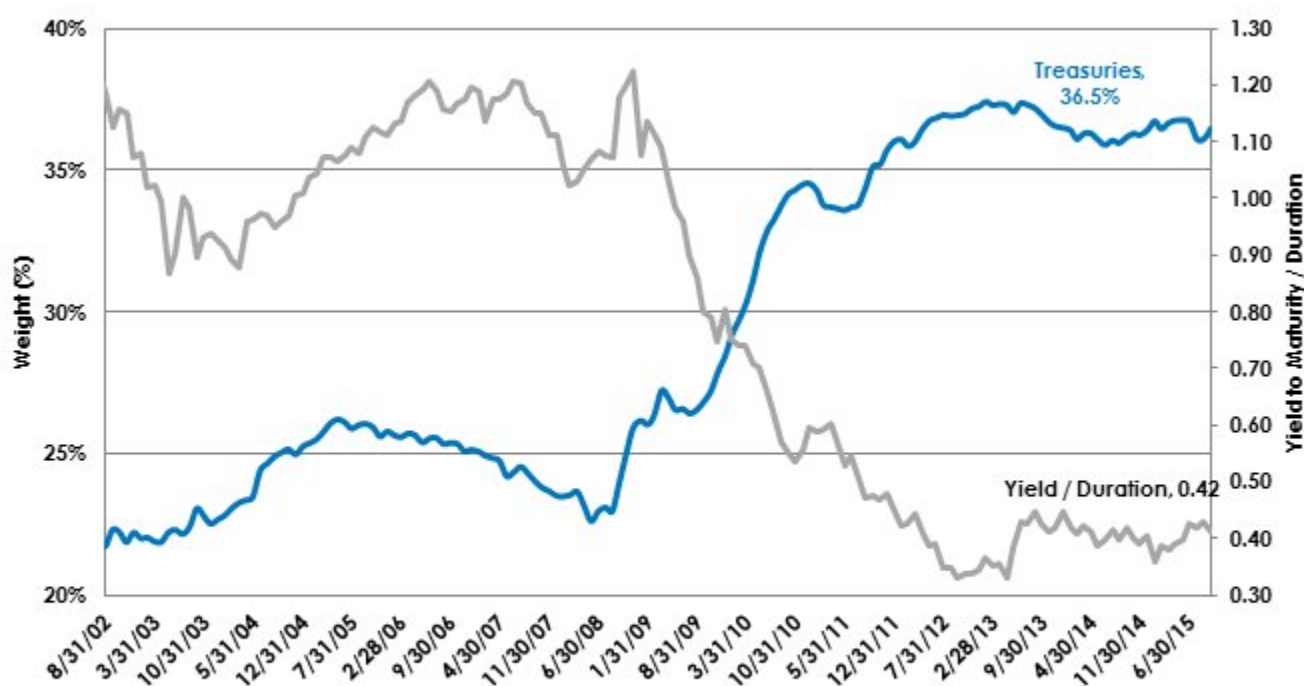
How to Find Opportunities in U.S. Core Fixed Income

Published November 3, 2015

Christopher Gannatti, CFA

Global Head of Research

In a portfolio context, lower volatility and potentially more predictable income streams can make fixed income investments attractive complements to equities. Additionally, the general downward trend that we've seen in interest rates has helped make fixed income attractive from a total return perspective. One of the most recognized benchmarks for fixed income is the Barclays U.S. Aggregate Bond Index (Agg); however, investors have been looking outside the Agg in search of higher return potential. **Agg Does Not Rebalance Back to Constant Weights** Over time, the composition of the Agg has not been held constant, and as the patterns of issuance and eligibility in its different underlying sectors have changed, so have their weights within the Index. Today's Agg looks much different than it did when it was created in 1986.1 Agg's Sector Exposures as of September 30, 2015:2 • Treasuries: 36.5% • Government-related securities: 8.6% • Corporate: 24.0% • Securitized: 30.9% What this tells us at a high level is that the Index may be very well positioned for any "risk-off" environment with such a large weight in Treasuries. On the other hand, it is important to note that more than 22% of that 36.5% is in U.S. Treasuries maturing in five years or less, so if the U.S. Federal Reserve (Fed) does in fact raise interest rates at some point in the near future, this part of the Treasury curve may have a greater potential to feel the impact than the longer-maturity components. **What about a "Low & Slow" Fed and Improving Economic Conditions in the United States?** However, if the baseline view to be expressed is not one of an imminent risk-off change in sentiment, but rather a continued gradual improvement in U.S. economic conditions, is positioning with nearly 40% exposure to Treasuries the best option? We don't think so, especially with the changing risk profile of the Treasuries themselves. **What Is the Risk in U.S. Treasuries in the Current Environment?** Risk, in this context, is not meant as an outright default, as we don't see the safe-haven status of U.S. Treasuries changing anytime soon. However, the experience of investing in bonds can be quantified by two important concepts: • Yield to maturity: At the time of purchase, this statistic encapsulates a measure of the returns to expect, assuming that all future coupon and principal obligations are met. • Duration: This statistic encapsulates how responsive the price of a bond might be, given a change in interest rates, with higher numbers indicating the potential for greater responsiveness. **The Bottom Line:** When looking at the yield-to-maturity/duration ratio over time, an upward-sloping line indicates more potential compensation per unit of interest rate risk, while a downward-sloping line indicates less potential compensation per unit of interest rate risk. **Agg: More Exposure to U.S. Treasuries as Their Risk Profile Worsens**



Sources: Bloomberg, Barclays, with data from 8/31/02 to 9/30/15. Past performance is not indicative of future results. You cannot invest directly in an index.

• The reality of the Agg, going back over a period of 13 years, is that today the Treasury component is close to its highest level over this period, while the yield-to-maturity/duration ratio is close to its lowest point. Additionally, it is clear that weight to Treasuries tended to increase at the same time the risk/reward trade-off for that exposure worsened. **Introducing the Barclays U.S. Aggregate Enhanced Yield Index** To address this issue of relatively higher exposure to U.S. Treasuries at a time when the risk/reward benefits of that exposure may not warrant it, WisdomTree collaborated with Barclays to introduce the Barclays U.S. Aggregate Enhanced Yield Index (Agg Enhanced Yield). The key idea is that the Agg can be broken into many subcomponents based on attributes such as sectors of the bond market, maturities, or credit qualities. The Agg Enhanced Yield in effect reweights the Agg into areas that may have better risk/return attributes, rather than simply holding more of components that have increased in issuance. Looking at the resulting exposures:³ • **Treasuries:** Instead of the nearly 40% that we saw in the Agg, the Agg Enhanced Yield was closer to 17%. It's worth noting that this is very close to the maximum allowable under-weight to Treasuries relative to the Agg, set at 20%. • **Corporates:** Instead of the corporate exposure being close to 24%, as seen in the Agg, the Agg Enhanced Yield's exposure to this segment was closer to 45%. • **Government-Related & Securitized Exposures:** Differences here between the Agg and the Agg Enhanced Yield were much less pronounced, in the 2% to 5% range. The main difference, therefore, involved taking the exposure to U.S. Treasuries—representative of a relatively poor risk/reward potential trade-off—and pushing it toward corporates. Doing this led to the yield to maturity of the Agg Enhanced Yield looking about 80 basis points (bps) higher than that of the Agg⁴. As a firm, given that we believe that the U.S. economic picture is on an improving trend that we expect to continue, we see more opportunity

today in corporate credit than we do in U.S. Treasuries. **Preparing for a “Low & Slow” U.S. Federal Reserve** For those who find the concept of reweighting the Agg of interest, see our recent blog post *“Looking within the Barclays U.S. Aggregate Index to Enhance Income.”*. 1Source: Barclays U.S. Aggregate Index Factsheet, 5/5/14. 2Sources: Bloomberg, Barclays, with data as of 9/30/15. 3Sources: Bloomberg, Barclays, WisdomTree, with data as of 9/30/15. 4Source: Bloomberg, as of 9/30/15.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. 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.

Barclays Capital Inc. and its affiliates (“Barclays”) are not the issuer or producer of the Funds, and Barclays has no responsibilities, obligations or duties to investors in the Funds. These Barclays Indexes are a trademark owned by Barclays Bank PLC and licensed for use by WisdomTree with respect to the WisdomTree Trust as the issuer of the Funds. Barclays’ only relationship with WisdomTree is the licensing of these Barclays Indexes, which are determined, composed and calculated by Barclays without regard to WisdomTree or the Funds. While WisdomTree may for itself execute transaction(s) with Barclays in or relating to these Barclays Indexes in connection with the Funds that investors acquire from WisdomTree, investors in the Funds neither acquire any interest in these Barclays Indexes nor enter into any relationship of any kind whatsoever with Barclays upon making an investment in the Funds. The Funds are not sponsored, endorsed, sold or promoted by Barclays, and Barclays makes no representation or warranty (express or implied) to the owners of the Funds, the Issuer or members of the public regarding the advisability, legality or suitability of the Funds or use of these Barclays Indexes or any data included therein. Barclays shall not be liable in any way to the issuer, investors or other third parties in respect to the use or accuracy of these Barclays Indexes or any data included therein or in connection with the administration, marketing, purchasing or performance of the Funds.