

How to Invest in a Rising Rates Environment

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One of the big takeaways since Donald Trump won the U.S. presidential election on November 8 has been the direction of interest rates in the U.S. This is likely the result of market participants factoring in, right away, the potential impact of new fiscal, regulatory and tax policies on U.S. gross domestic product growth, inflation and federal deficits—in late 2017, 2018 and the years that follow.

Yields on 10-Year U.S. Treasuries have backed up about 100 basis points (bps) since yields bottomed at 1.36% on July 8, 2016. This has affected various asset classes since the summer, and the sudden acceleration of rates since Trump's surprise election victory has created a chain reaction across asset classes since November 8.

While some debate whether interest rates and the dollar have risen too far, too fast, investors ought to be open-minded to the possibility that rates may well continue to rise as the U.S. labor markets tighten and wage pressures begin to take hold inside the economy. WisdomTree has several simple solutions to help investors navigate a rising interest rate environment, using WisdomTree exchange-traded funds (ETFs). This blog post is the first of a series that will highlight some of our best ideas, spanning U.S. equity, international equity, currency, fixed income and alternative strategies.

For U.S. equity investors, I believe that U.S. mid- and small-cap stocks may continue to lead the market for the next 12 to 18 months. Companies that derive most of their revenue and profit from within the 50 states are more likely to benefit from faster economic growth and the easing of regulations within the U.S., and from higher take-home pay for U.S. workers that should occur if individual tax rates are lowered. They are also less vulnerable to a strengthening U.S. dollar, which could become a headwind for U.S. multinationals. Finally, mid- and small-cap companies may get a larger benefit from any reduction in corporate tax rates, as a good portion of large-cap profits are generated overseas. Not surprisingly, U.S. mid- and small-cap indexes have led the rally higher since the election, and it would not surprise me to see this relative outperformance continue in 2017, assuming the lion's share of President-elect Trump's domestic economic agenda passes the Republican-controlled Congress.

Although past performance does not guarantee future results, the past performance of two WisdomTree ETFs during previous rising interest rate environments is notable.

The table below shows how the [WisdomTree SmallCap Earnings Fund \(EES\)](#) and the [WisdomTree MidCap Earnings Fund \(EZM\)](#) have performed during previous periods over the past 10 years when interest rates rose in the U.S. (Please click each Fund for standardized performance.)

Start Date	End Date	Increase/Chg In 10-Year Yield	Total Return for Period		EES Excess Return vs. S&P 500	Total Return for Period		EZM Excess Return vs. S&P 500
			WisdomTree SmallCap Earnings Fund	S&P 500		WisdomTree MidCap Earnings Fund	S&P 500	
3/7/2007	6/12/2007	0.81	5.0%	7.7%	-2.7%	8.0%	7.7%	0.3%
9/10/2007	9/30/2007	0.37	5.3%	4.7%	0.6%	4.3%	4.7%	-0.4%
12/3/2007	12/14/2007	0.39	-1.0%	-0.2%	-0.8%	-0.7%	-0.2%	-0.5%
1/22/2008	2/25/2008	0.46	8.5%	4.9%	3.5%	9.8%	4.9%	4.9%
8/17/2008	6/16/2008	0.96	8.6%	7.1%	1.6%	13.1%	7.1%	6.0%
9/15/2008	10/14/2008	0.69	-19.1%	-16.2%	-2.9%	-19.9%	-16.2%	-3.7%
12/30/2008	6/10/2009	1.89	25.0%	6.8%	18.2%	23.4%	6.8%	16.6%
10/1/2009	4/5/2010	0.81	18.3%	16.5%	1.8%	23.9%	16.5%	7.5%
10/7/2010	2/8/2011	1.35	17.8%	15.1%	2.7%	19.3%	15.1%	4.3%
9/22/2011	10/27/2011	0.68	20.5%	13.9%	6.6%	17.5%	13.9%	3.5%
1/31/2012	3/19/2012	0.58	4.9%	7.8%	-2.9%	7.1%	7.8%	-0.7%
7/24/2012	12/31/2013	1.64	62.8%	42.6%	20.2%	62.6%	42.6%	20.0%
1/30/2015	3/6/2015	0.60	4.9%	4.1%	0.8%	5.2%	4.1%	1.0%
4/17/2015	6/10/2015	0.62	0.6%	1.5%	-0.9%	0.9%	1.5%	-0.6%
10/14/2015	11/9/2015	0.37	4.1%	4.4%	-0.3%	2.6%	4.4%	-1.8%
2/11/2016	3/11/2016	0.32	16.5%	10.8%	5.7%	14.9%	10.8%	4.1%
7/8/2016	10/14/2016	0.44	4.0%	0.7%	3.3%	1.7%	0.7%	1.0%
			Average When Interest Rates Rose					
Average			11.0%	7.8%	3.2%	11.4%	7.8%	3.6%
Compound Cumulative			398.6%	226.9%	171.7%	428.4%	226.9%	201.5%
			Average When Interest Rates Declined					
Average			-0.93	-5.2%	-3.2%	-4.8%	-3.2%	-1.7%
Compound Cumulative			-62.3%	-44.6%	-17.7%	-59.6%	-44.6%	-15.0%
			All Periods					
Average Annual Return			6.7%	6.3%	0.4%	8.1%	6.3%	1.8%
Compound Cumulative			87.7%	80.9%	6.8%	113.3%	80.9%	32.4%

Sources: WisdomTree, Bloomberg, as of 10/14/16. Data calculated at net asset value.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

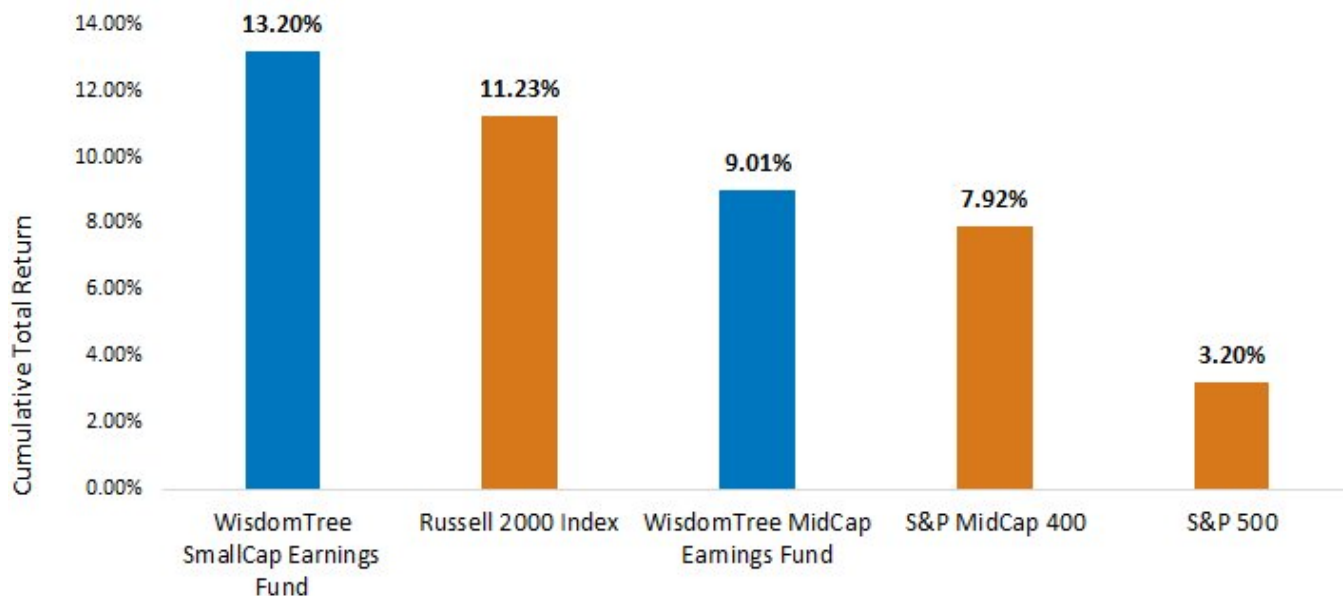
For definitions of terms in the chart, visit our [glossary](#).

The table shows that when rates rose, EES generated returns that on average surpassed the [S&P 500 Index](#) by 320 bps. EZM generated average excess returns of 360 bps over those same 17 periods. In two of the periods with the greatest increase in rates—spanning 2009 and 2013—EES beat the S&P 500 by 18.2 and 20.2 percentage points, respectively. Similarly, EZM beat that large-cap barometer by more than 16 percentage points in the 2009 period and by 20 percentage points from mid-2012 through the end of 2013.

Since Trump's election victory, we have seen a similar setup developing. As the chart below shows, EES has outperformed the Russell 2000 Index, as small-cap stocks have beaten large caps. And EZM has beaten the [S&P MidCap 400 Index](#), as mid-caps have also trumped large caps.

Cumulative Total Return Since Presidential Election

11/8/16 to 11/29/16



Sources: WisdomTree, Bloomberg as of 11/29/16. Data calculated at net asset value. Past performance is not indicative of future results. You cannot invest directly in an index. Double-digit returns were achieved primarily during favorable market conditions. Investors should not expect that such favorable returns can be consistently achieved. A fund's performance, especially for very short time periods, should not be the sole factor in making your investment decision.

EES and EZM have been able to establish a compelling performance history over nearly 10 years against comparable cap-weighted indexes and against actively managed funds because they do something fairly unique. First, the indexes they track only include profitable companies at the time of their annual rebalance in December; second, component weights are based on the profits companies earn, not on their market values. The earnings-weighted indexes they track, in effect, make an active bet against the market once a year. This results in different sector exposures. And for the past decade, this investment process has resulted in portfolios that typically exhibited lower aggregate price-to-earnings (P/E) ratios and higher return-on-equity (ROE) ratios compared to their benchmark peers at the annual rebalance, which occurs each December. Presently, both Funds are overweight financial, industrial and consumer discretionary stocks relative to their cap-weighted peers, and underweight the interest rate- sensitive real estate sector.

Conclusion

For investors looking to gain exposure to small- and mid-company stocks, consider EES and EZM for the small- and mid-cap sleeves of your portfolio. They have proven themselves over nearly a decade, and may be uniquely aligned to benefit from the new macro environment being ushered in by the new administration coming to power in Washington.

Unless otherwise noted, data source is Bloomberg, as of 11/30/2016.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read each Fund's prospectus for specific details regarding each Fund's risk profile.