

# How to Profit When Rates Rise: Negative Duration Bond Strategies

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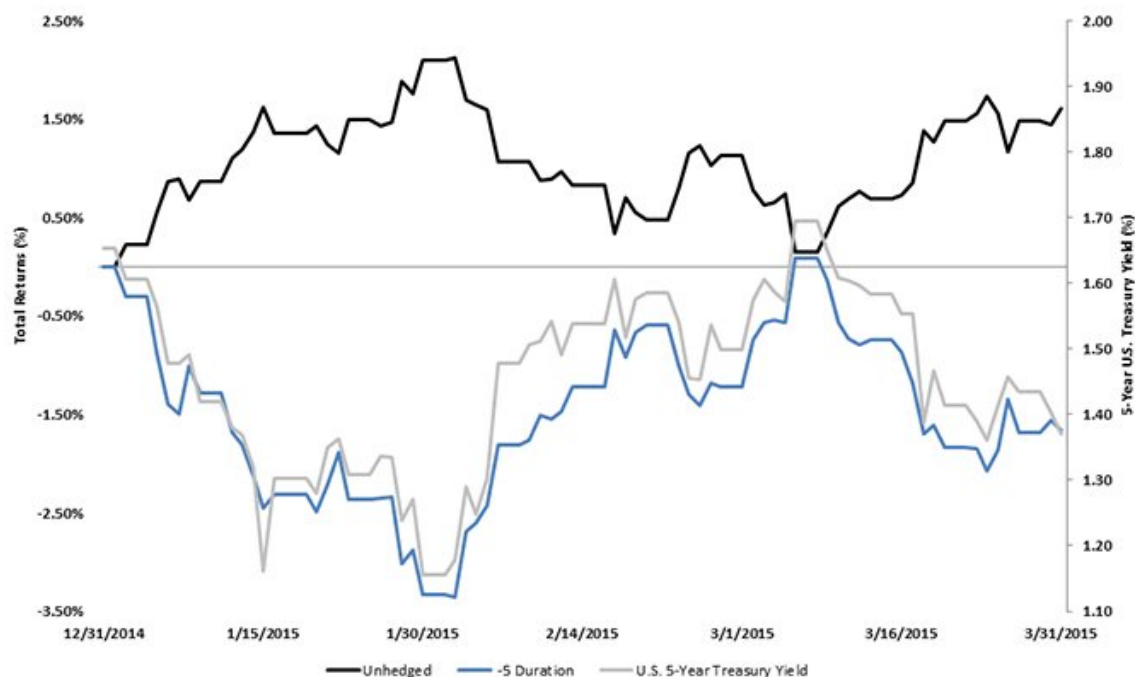
As the debate rages surrounding the timing of the first Federal Reserve (Fed) rate hike, we continue to discuss the potential tradeoffs surrounding this inevitable shift in policy. While some investors may be content to ride out the waning bull market in bonds, others may seek to position more tactically. We continue to believe that asymmetric risks remain in the bond market. As a result, investors should consider hedging interest rate risk. Historically, investors have quantified the amount of interest rate risk in their portfolios via duration. For every 1% move higher in interest rates, a five-year duration bond's price is expected to fall by approximately 5%. For those interested in expressing a view on rising U.S. rates, a negative duration bond strategy could provide investors a way to profit from rising rates (and lower bond prices). As in most markets, there is no free lunch. One of the hurdles associated with a "short" bond position is the costs of maintaining that position. What we mean by costs is that if a long position in a bond pays the holder interest, then a short position in that same security will require the short to pay the interest. A long bond position is akin to lending; a short position is akin to borrowing. For investors that believe higher interest rates are coming, timing is a crucial factor: time is literally money due to the cost of being short. Unless interest rates rise (and bond prices fall), the short position will experience negative total returns due to the impact of negative carry. One option to help defray the costs of the short position is to invest in a portfolio of bonds (positive carry) and then "overhedge" the portfolio by selling longer maturity securities to achieve a negative duration target. Through our collaboration with Barclays and Bank of America Merrill Lynch, WisdomTree has established strategies that are constructed on this simple premise. **Negative Duration Mechanics**

As investors have become more comfortable with currency-hedged equity strategies that isolate equity risk from currency risk, interest-rate-hedged bond strategies operate on a similar principle. In creating our suite of rising-rate strategies, we sought to focus on traditional bond indexes that investors already have exposure to today. The only difference in our approach is that a second adjustment factor is applied via the interest rate overlay. As figure 1 shows, the negative duration variant of the Barclays U.S. Aggregate Bond Index (Agg)1 can be thought of as a combination of two portfolios: a portfolio of bonds and a portfolio of short Treasury positions. The bond portfolio provides income that helps defray the cost of the short positions. In a rising-rate environment, the profits from the short positions help offset losses from the long bond position, thus generating positive total returns. **Figure 1: Under the Hood of Negative Duration**



Sources: Barclays, WisdomTree, as of 12/31/15.  
Past performance is not indicative of future results. You cannot invest directly in an index.

In our view, the best way to understand these strategies is to examine the net effect of a rise in rates. On January 30, interest rates across the U.S. yield curve made fresh year-to-date lows. Over the next several weeks, interest rates rose, resulting in losses for unhedged positions in the Agg. As figure 2 shows, an unhedged portfolio fell by approximately 1.45%, whereas the negative duration strategy rose by 2.86%.<sup>2</sup> Over the same period, the five-year U.S. Treasury bond yield rose by nearly 54 basis points, implying a price loss of approximately 2.58%.<sup>3</sup> As we have mentioned [previously](#), U.S. Treasury bonds continue to trade like growth stocks: total returns are almost exclusively being driven by price returns. **Figure 2: Unhedged vs. Negative Duration Returns as Yields Rise & Fall Barclays U.S. Aggregate Index Total Returns: Unhedged vs. -5 Duration**



Sources: Barclays, Bloomberg, as of 3/31/15.

Past performance is not indicative of future results. You cannot invest directly in an index. Performance, especially for very short time periods, should not be the sole factor in making your investment decision.

While investors should view a negative duration strategy as an implicit bet against U.S. interest rates, they must also understand that total returns from plain-vanilla fixed income are primarily being driven by changes in bond prices, as opposed to income. As a result of potential changes in Fed policy coming this year, we believe that interest rates may be poised to rise in the coming months. In today's market environment, investors should consider tactical positions in negative duration fixed income strategies to benefit from rising U.S. interest rates. 1Barclays Rate Hedged U.S. Aggregate Bond Index, Negative Five Duration. 2Source: Barclays, as of 3/9/15. 3Calculated: 54 basis points x 4.78 years = -2.58% price change.

## Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. The Fund seeks to mitigate interest rate risk by taking short positions in U.S. Treasuries, but there is no guarantee this will be achieved. Derivative investments can be volatile, and these investments may be less liquid than other securities and more sensitive to the effects of varied economic conditions. 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. The Fund may engage in “short sale” transactions of U.S. Treasuries, where losses may be exaggerated, potentially losing more money than the actual cost of the investment, and the third party to the short sale may fail to honor its contract terms, causing a loss to the Fund. While the Fund attempts to limit credit and counterparty exposure, 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. 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. Due to the investment strategy of certain Funds, they may make higher capital gain distributions than other ETFs. Please read the Funds’ prospectus for specific details regarding the Funds’ risk profile. Barclays Capital Inc. and its affiliates (“Barclays”) is 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 to WisdomTree is the licensing of these Barclays Indexes, which is 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 to other third parties in respect of 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. Merrill Lynch, Pierce, Fenner & Smith Incorporated and its affiliates (“BofA Merrill Lynch”) indexes and related information, the name “BofA Merrill Lynch” and related trademarks are intellectual property licensed from BofA Merrill Lynch and may not be copied, used or distributed without BofA Merrill Lynch’s prior written approval. The licensee’s products have not been passed on as to their legality or suitability and are not regulated, issued, endorsed, sold, guaranteed or promoted by BofA Merrill Lynch. BOFA MERRILL LYNCH MAKES NO WARRANTIES AND BEARS NO LIABILITY WITH RESPECT TO THE INDEXES,

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