

Markets Continue to Test the Fed's "Patience": Why We Think It's Time to Hedge

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Bradley Krom

U.S. Head of Research

On March 18, 2015, the Federal Open Market Committee (FOMC) completed one of its final prerequisites for making its first upward change in monetary policy in almost nine years. While economists generally agreed that the word "patience" would be dropped from the statement, interest rate futures markets have continued to be unimpressed. While many economists have stuck to their calls for a mid-June liftoff, markets are currently pricing in the first rate hike in September.¹ With market prices and analyst views diverging, we believe investors should consider hedging their bets until the Federal Reserve (Fed) makes its first move.

Lessons from the Currency Market

In our view, the most relevant explanation for why an investor should hedge in front of a shift in central bank policy can be taken from lessons learned in the currency market since the announcement of European quantitative easing (QE). Making the wrong call on the euro has resulted in a loss of nearly 8%.² While European equities have actually rallied by over 9% in local terms, U.S.-based investors who did not hedge currency risk are up less than 2%.

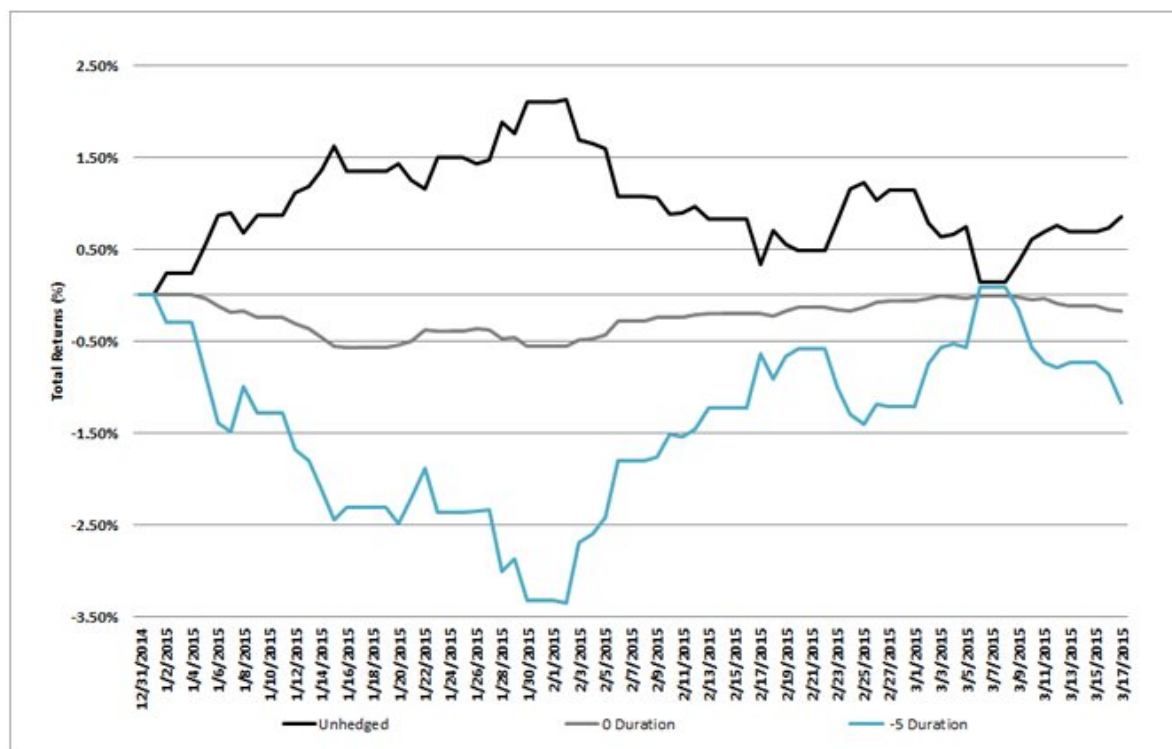
In the bond market, risks remain significantly skewed against lower yields. In our view, the case for lower yields amounts to a bet on deflation and Fed policy makers stuck in neutral. In the current market environment, U.S. Treasury bonds are trading more like growth stocks: Total returns are almost exclusively being driven by price returns. In our view, there will come a point when consensus shifts and bond prices correct lower. In fact, markets are already beginning to move in front of a shift in Fed action at the short end of the yield curve. The primary factor that makes the coming period of rising interest rates so problematic, and drastically different than in the past, is that coupon rates are so low. When rates begin to rise, there typically is very little cushion (via coupon payments) to help dampen losses.

What's the Cost to Hedge My Bond Portfolio?

One of the primary struggles for most fixed income investors has been the issue of timing. Given that time is money (at least outside of Europe), hedging too early can cost investors performance relative to an unhedged position. However, on an annualized basis, the cost of hedging the interest rate risk of the Barclays U.S. Aggregate Index (Agg) is approximately 139 basis points (bp).³ Therefore, interest rates must rise by approximately 25 bp in order to break even on this position.⁴ While rates are basically flat compared to the start of the year, rates have already risen by almost 30 bp from their lows in January. This

has resulted in total returns of approximately -1.22% for the Agg.5 Over this same period, a zero duration approach to the Agg returned +0.39%⁶. Again, with the margin of error so low, we continue to believe hedging is the most prudent course of action.

Bond Total Returns Driven by Interest Rate Risk



Sources: Bloomberg, Barclays, as of 3/17/15. Unhedged: Barclays U.S. Aggregate Index. 0 Duration: Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration. -5 Duration: Barclays Rate Hedged U.S. Aggregate Bond Index, -5 Duration.

Past performance is not indicative of future results. You cannot invest directly in an index.

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

Hedging a New Position vs. Hedging a Portfolio

In the above example, we described the trade-off between an unhedged position in the Barclays Agg and a zero duration approach of the same Index. However, many investors have shown an unwillingness to sell out of legacy bond positions due to potential tax considerations, despite their view on rates. For these investors, another option would be to combine [negative duration bond strategies](#) to dial down the overall portfolio sensitivity to changes in rates. As we highlighted in the chart above, a negative duration approach⁷ combined with legacy positions could have helped offset losses experienced by the most recent move higher in rates.

New Tools

As a result of numerous discussions with advisors, WisdomTree created an asset allocation tool to help

investors manage risk in their bond portfolios. Using this tool, financial advisors can combine existing positions with rising rate strategies in order to target a specific risk (duration) and return (yield) profile. The tool is available for financial professionals only and can be accessed at wisdomtree.com.

As we have mentioned [previously](#), rising rate strategies can help investors further refine their interest rate risk profile while maintaining their current balance of credit risk.

While interest rate-hedged strategies have yet to have their “hedge the euro” moment, we believe the case for prudent risk management continues to build. In our view, it is highly likely that interest rates will continue to rise in 2015 due to a shift in Fed policy. As a result, investors should consider hedging interest rate risk via rising rate strategies.

1Source: Bloomberg, as of 3/17/15.

2Source: Bloomberg, 1/22/15–3/17/15.

3Source: Barclays, as of 3/17/15.

4131 bp ÷ 5.5-year duration = 25 bp.

5As proxied by the Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration.

6Source: Bloomberg, as of 3/17/15.

7As proxied by the Barclays Rate Hedged U.S. Aggregate Bond Index, -5 Duration.

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. 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 Fund's prospectus for specific details regarding the Fund's risk profile. Foreside Fund Services, LLC, is not affiliated with Barclays. Barclays Capital Inc. and its affiliates ("Barclays") are not the issuers or producers of the Fund, and Barclays has no responsibilities, obligations or duties to investors in the Fund. This Barclays Index is a trademark owned by Barclays Bank PLC and licensed for use by WisdomTree with respect to the WisdomTree trust as the issuer of the Fund. 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 (expressed 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 with 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.