

No FOMO for Core Investors

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As previously discussed in our earlier blog posts, the prevailing trend in the fixed income market this year has been the resurgence of [income within fixed income](#). Our discussions have encompassed various sectors, including U.S. investment-grade (IG) and high-yield (HY), as well as local currency emerging markets (EM) bonds. These asset classes have exhibited robust performance, delivering year-to-date returns of 3.28%, 4.96% and 8.13%, as of June 21, 2023.

Despite experiencing an impressive rally in their spreads, these asset classes continue to offer attractive yield levels to long-term investors. This is primarily attributable to elevated risk-free interest rates. Depending on one's perspective on the future trajectory of Federal Reserve policy tightening, which may involve a pause or a few additional rate hikes, it can be said that investors may still be in the early stages of benefiting from above-average returns within the fixed income space.

However, it is important to recognize that not all investors possess the flexibility to venture into riskier segments of the market, such as HY or EM. Some investors and advisors are required to maintain a closer proximity to traditional asset classes within fixed income (core sectors). In this article, we will explore [WisdomTree Yield Enhanced U.S. Aggregate Bond Fund \(AGGY\)](#) and outline the reasons why it may serve as a favorable alternative to other conventional Agg products.

AGGY: An Attractive Alternative

[AGGY](#) tracks an index that uses a rules-based approach to reallocate across subcomponents of the Bloomberg U.S. Aggregate Index (Agg), seeking to enhance yield while maintaining a similar risk profile. Yield can typically be increased by shifting exposure along any of a number of risk dimensions, including sector exposure (Treasury, agency, credit, securitized), interest rate risk (duration) and credit risk. The three main steps of the Fund's index construction include:

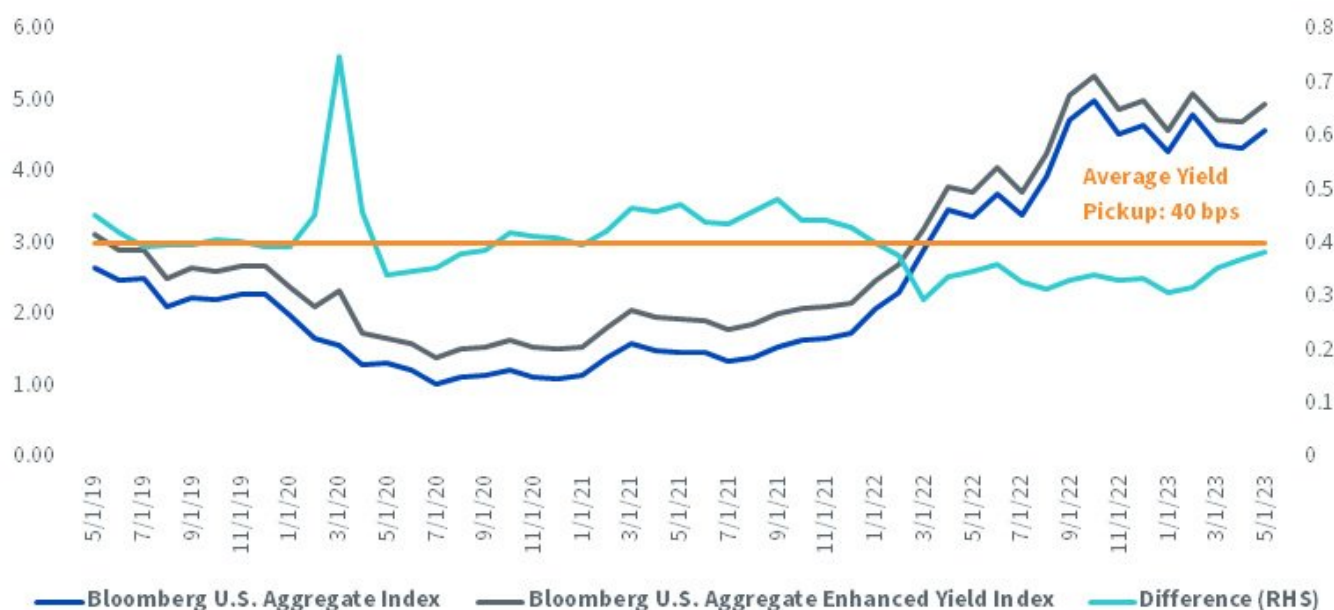
- Divide the Agg into 20 subcomponents: The index is decomposed into 20 buckets across sector, maturity and credit quality.

		Years to Maturity		
		1-5 Years	5-10 Years	10+ Years
Sector	Govt	Treasury 1-5, Agency 1-5	Treasury 5-10, Agency 5-10	Treasury 10+, Agency 10+
	Credit	Credit 1-5 Aaa-Aa, Credit 1-5 A, Credit 1-5 Baa	Credit 5-10 Aaa-Aa, Credit 5-10 A, Credit 5-10 Baa	Credit 10+ Aaa-Aa, Credit 10+ A, Credit 10+ Baa
	Securitized	Commercial Mortgage-Backed Securities (CMBS) Conventional Mortgage-Backed 30s	Asset-Backed Securities (ABS) Conventional Mortgage-Backed 15s	Government National Mortgage Association (GNMA) 30s

- Develop and apply constraints: Four major constraints will be applied after the first step in order to construct the new index—tracking error, duration, sector and subcomponent, and turnover constraints.
- Determine Index weights: On a monthly basis, weights of the Index are reallocated across the 20 subcomponents to maximize yield while adhering to the four constraints.

The resulting index will exhibit comparable risk characteristics to the Agg while on average providing around 40 basis points (bps) more yield (carry) since May 2019.

Yield to Worst (%)

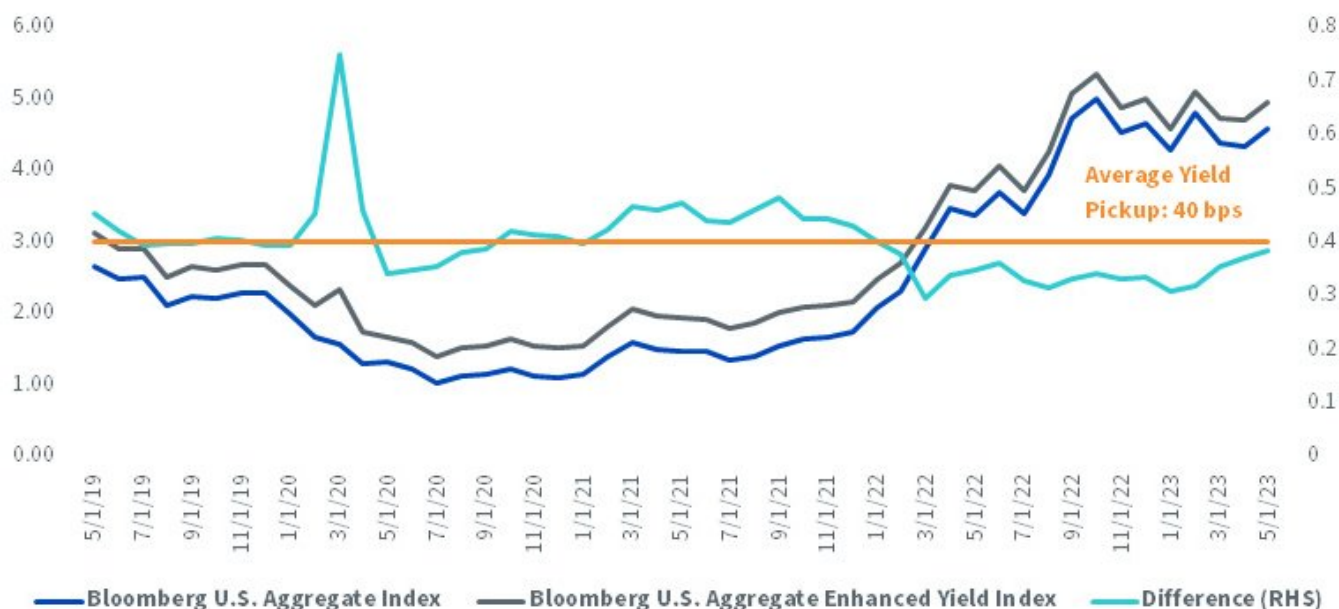


Source: Bloomberg, as of 05/31/23. Performance is historical and does not guarantee future results.

In the past, achieving this yield pickup typically involved maintaining a higher duration and greater sensitivity to changes in interest rates. However, as a result of the Federal Reserve's quantitative tightening and the subsequent shift in the risk attributes of the aforementioned 20 subcomponents, the current

landscape enables the index to attain this increased yield without extending the duration relative to the Agg.

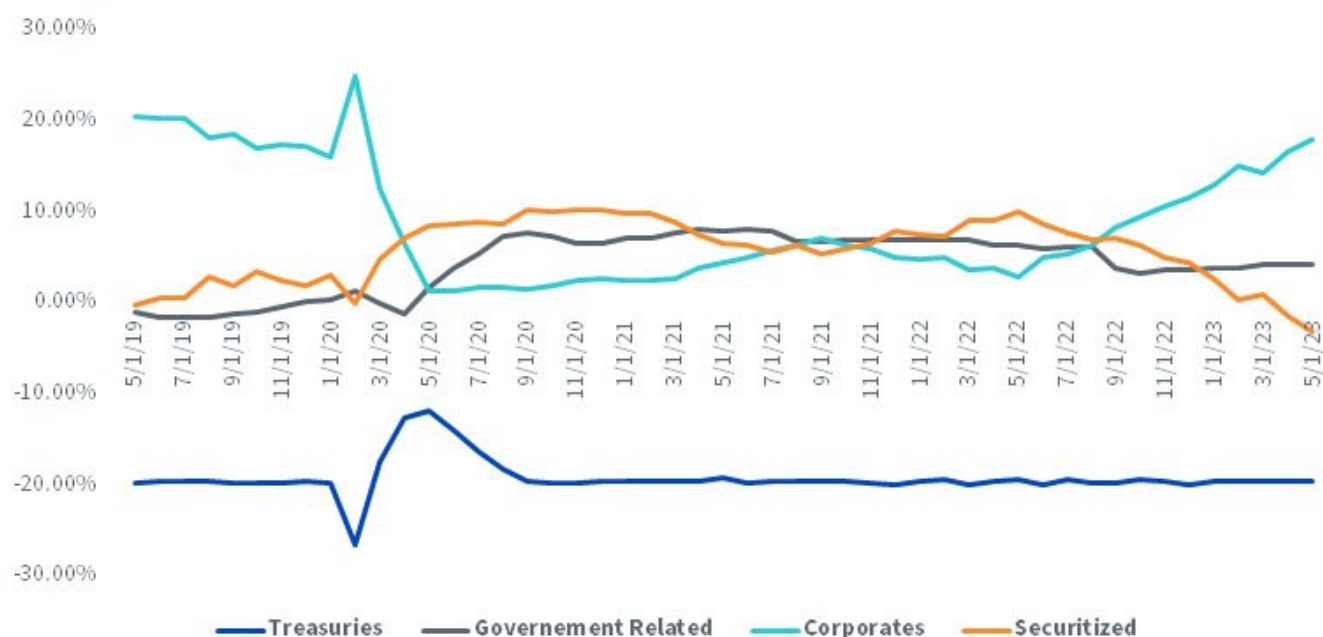
Duration (Years)



Source: Bloomberg, as of 05/31/23.

This fundamental shift can be attributed to the notable increase in the allocation of corporates within the portfolio relative to the Agg, which has risen from an over-weight allocation of approximately 3% one year ago to above 18% as of the end of May. In contrast, the relative market value of the securitized asset class has gone from a 10% over-weight allocation to a 3% under-weight allocation during the same period.

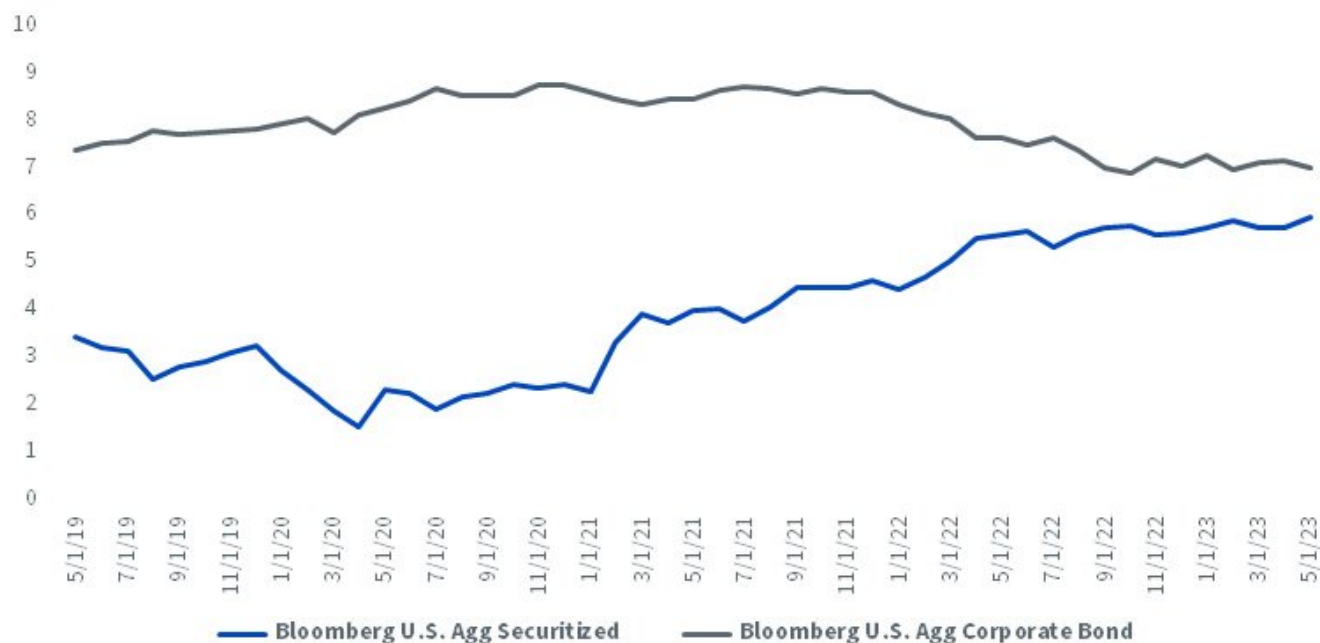
Relative Market Value % (Bloomberg U.S. Aggregate Enhanced Yield Index - Bloomberg U.S. Aggregate Index)



Source: Bloomberg, as of 05/31/23. Performance is historical and does not guarantee future results.

Upon deeper analysis, one can see why our Index construction process has made this happen. With the rise in risk-free rates, and consequently mortgage rates, borrowers have had less incentive to pursue refinancing or new home acquisitions, leading to extension in duration for the majority of mortgages. Corporate duration has fallen. As a result, [AGGY](#) has effectively managed to sustain an average yield advantage over Agg while maintaining a lower relative duration.

Duration (Years)



Source: Bloomberg, as of 05/31/23.

Conclusion

With the biggest policy tightening in recent Fed history almost in the books, the Fed has created different pockets of opportunities for investors. While riskier segments of fixed income (“plus” sectors) can offer an attractive risk-reward profile for long-term investors, core investors need not feel left out. Through a quantitative approach, [AGGY](#) presents these investors an opportunity to achieve higher carry compared to a typical Agg portfolio, while currently taking less interest rate risk and offering lower exposure to segments of the market that lack appealing risk-adjusted rewards.

Important Risks Related to this Article

There are risks associated with investing, including the 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. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.