

Rising Rate Strategies: Core Plus Portfolio Performance During Tapering

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In an earlier discussion on preparing portfolios for [rising rates](#), we sought to illustrate the value of blending [rising rate strategies](#) to target a specific yield and duration profile in response to changes in Federal Reserve (Fed) policy. However, over the last 10 months, interest rates have actually fallen as the Fed has reduced the pace of its asset purchases. With "tapering" expected to be completed on October 29, we believe that this approach to risk management may be more relevant than ever as rates remain at depressed levels. In the remainder of this piece, we seek to highlight the total return profiles of these approaches since the start of the Fed's shift in policy. **Core Plus Performance During Tapering, 12/18/13–10/22/14**

Core Plus Strategy	Total Returns	Duration
Traditional Core Plus Portfolio (80% Agg, 20% High Yield)	4.85%	4.88
Zero Core Plus Portfolio (80% Agg Zero, 20% HY Zero)	1.18%	0.00
Negative Core Plus Portfolio (80% Agg Neg, 20% HY Neg)	-5.52%	-5.40

Zero Duration Core Plus Strategy	Total Returns	Duration
Traditional Core Plus Portfolio (80% Agg, 20% High Yield)	4.85%	4.88
Zero Core Plus Portfolio (80% Agg Zero, 20% HY Zero)	1.18%	0.00
80% Core Plus/ 20% Zero Core Plus	4.12%	3.91
70% Core Plus/ 30% Zero Core Plus	3.75%	3.42
60% Core Plus/ 40% Zero Core Plus	3.38%	2.93
50% Core Plus/ 50% Zero Core Plus	3.01%	2.44

Negative Duration Core Plus Strategy	Total Returns	Duration
Traditional Core Plus Portfolio (80% Agg, 20% High Yield)	4.85%	4.88
Negative Core Plus Portfolio (80% Agg Neg, 20% HY Neg)	-5.52%	-5.40
80% Core Plus/ 20% Negative Core Plus	2.78%	2.83
70% Core Plus/ 30% Negative Core Plus	1.74%	1.80
60% Core Plus/ 40% Negative Core Plus	0.70%	0.77
50% Core Plus/ 50% Negative Core Plus	-0.33%	-0.26

Traditional Core Plus portfolio proxied by an 80% allocation to the Barclays U.S. Aggregate Index and a 20% allocation to the BofA Merrill Lynch 0-5 Year US High Yield Constrained Index. Zero Core Plus portfolio proxied by an 80% allocation to the Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration and a 20% allocation to the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index. Negative Core Plus portfolio proxied by an 80% allocation to the Barclays Rate Hedged U.S. Aggregate Bond Index, -5 Duration and a 20% allocation to the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Negative Seven Duration Index. Duration values listed as of 12/18/13. Sources: Barclays, BofA Merrill Lynch, WisdomTree, as of 10/22/14. Hypothetical illustration only. 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](#). Over the last 10 months, nominal interest rates have fallen and credit spreads have generally widened. With hindsight, we know that hedging interest rate risk cost investors performance. Additionally, even though high-yield bonds generated positive returns, risky debt underperformed investment grade credit by nearly 2%. However, we believe we can learn a great deal about portfolio construction from this experience: 1) For most bond investors, the greatest determinant of a portfolio's total return is the starting yield level. As shown in the table, over this period, the primary driver of returns was the amount of interest rate risk investors had in their portfolios. Unless investors believe that the risk of deflation is poised to increase, we continue to believe that hedging interest rate risk is a prudent course of action. 2) Although hedging over this period reduced total returns, a blended approach incorporating zero duration, core plus strategies provided positive returns while reducing risk. In the case of the 50% Core Plus / 50% Zero Core Plus blend, an investor who reduced their interest rate risk by 50% underperformed by 1.84%. With rates at some of the lowest levels since mid-2013, we

continue to believe that the risk of higher rates far outweighs the risk of lower rates. 3) Negative duration strategies and blends underperformed as long-term interest rates fell more than short-term rates. Given that credit spreads also widened over this period, a more opportunistic trade may be to increase exposure to negative duration, high-yield strategies as a way to address rate and credit spread normalization. While the ultimate evolution of the path of U.S. interest rates remains uncertain, we believe these new strategies for risk management give investors a [powerful tool kit](#) for refining their fixed income exposure. Even though rates have fallen over this period, the blended approaches shown above resulted in positive total returns for all but the most aggressive approach. In our view, the ability for investors to maintain traditional bond exposures while reducing interest rate risk can add value once rates begin to normalize.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Non-investment-grade debt securities (also known as 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 duration Funds seek 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 duration Funds 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 duration Funds. While the duration Funds attempt to limit credit and counterparty exposure, the value of an investment in the duration Funds may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of each Fund’s portfolio investments. Investors should anticipate that due to the negative duration target, those Funds will be highly sensitive to interest rate changes. The higher (whether positive or negative) a bond fund’s duration, the greater its sensitivity to interest rates changes, and fluctuations in value, whether positive or negative, will be more pronounced. 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 each Fund’s prospectus for specific details regarding each Fund’s risk profile.