

Your Toolkit for Rising Rates

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2015 could be the year we finally see rising interest rates in the U.S. This creates an opportunity to reassess portfolios and asset classes and evaluate how they performed during historical periods of rising interest rates. While the past can never guarantee the future, historical context is important for understanding a phenomenon that we really haven't seen in a longer-term trend for approximately 30 years. **Bonds vs. Stocks** The critical question here—as in many environments—is stocks versus bonds. By design, the fixed nature of bond interest payments creates a bit of a headwind as rates rise. On the other hand, rising interest rates usually occur in tandem with rising inflation, and stocks have historically grown their dividends at a level above that of inflation over long periods.¹ **Big Picture:** To the extent that rising interest rates reflect rising growth expectations and rising inflation expectations, we believe that equities can see a tailwind and perform quite well over the medium to long term, even if U.S. Federal Reserve (Fed) activity (or inactivity) can cause some short-term volatility. **Further Distinctions to Be Made** Also here—as in many environments—it's not just stocks versus bonds, but types of stocks versus types of bonds. Within equities, we wanted to look at three categories: large caps (the [S&P 500 Index](#)), small caps (the Russell 2000 Index) and high-yielding dividend payers (the Dow Jones U.S. Select Dividend Index). While this certainly doesn't exhaust all equity possibilities, it does provide an interesting cross-section of a few major categories—indicating how they reacted in different periods of rising interest rates. Within fixed income, we examined the difference between a pure government bond exposure (interest rate risk, but not credit risk), a high-quality bond index and a high-yield bond index (less interest rate risk, more credit risk). Within equities, we looked at dividend-paying stocks. We'd expect higher-yielding dividend payers to face a headwind, while more growth-oriented companies could be better positioned to grow their dividends with rising interest rates and rising inflation. **We looked at times when the U.S. 10-Year Treasury note rose 100 basis points (bps) or more and saw the following:**

- **High-Quality and U.S. Government Fixed Income Faced a Headwind:** Both the U.S. 10-Year Treasury note and the Barclays U.S. Aggregate Index experienced negative average returns during our rising rate periods.
- **High-Yield Fixed Income Performed Better:** While the BofA Merrill Lynch High Yield Index delivered differentiated performance with respect to the other two fixed income options, it was still able to generate a positive average return during the rising rate periods. It actually outperformed an index of high-yielding dividend payers on an average annual basis over these periods.
- **Equities Strong to Quite Strong:** Both the S&P 500 Index and the Russell 2000 Index tended to perform better during the rising rate periods than over the entire period. This fits with what we mentioned earlier—that equities can perform well when rising rates are signaling improvements in growth and generally rising inflation.
- **Small Caps Were Especially Strong in Rising Rates:** With the exception of the first rising rate period, from October 15, 1993, to November 7, 1994, the

Russell 2000 Index delivered a double-digit return in every period. Its average annual return during the rising rate periods was 15.1%, versus its average annual return during the full period at 8.6%.

		10/15/1993 - 11/7/1994	1/18/1996 - 6/12/1996	10/5/1998 - 1/20/2000	11/7/2001 - 4/1/2002	6/13/2003 - 6/14/2006	6/1/2005 - 6/28/2006	12/30/2008 - 6/10/2009	10/7/2010 - 12/15/2010	5/2/2013 - 9/5/2013	Average Return Rising Rates	Full Period Avg. Ann. Return
Fixed Income Returns	U.S. 10-Year Treasury Return	-12.1%	-7.6%	-9.2%	-6.6%	-0.6%	-4.8%	-13.9%	-8.4%	-9.5%	-8.1%	5.5%
	Barclays U.S. Aggregate Index	-4.8%	-3.4%	-1.4%	-2.1%	1.8%	-0.8%	-0.3%	-3.0%	-4.9%	-2.1%	5.6%
	BofA Merrill Lynch High Yield Index	0.5%	0.7%	3.0%	4.1%	8.6%	5.4%	33.0%	1.2%	-2.3%	6.0%	7.7%
Large Caps	S&P 500 Index	2.1%	11.4%	34.3%	3.1%	9.1%	6.2%	9.4%	6.9%	5.4%	9.8%	8.7%
High-Yielding Dividend Payers	Dow Jones U.S. Select Dividend Index	1.5%	9.0%	2.7%	16.6%	13.5%	6.1%	-6.0%	4.5%	1.2%	5.5%	10.9%
Small Caps	Russell 2000 Index	-1.3%	19.4%	38.9%	14.6%	15.3%	12.0%	13.2%	12.4%	11.8%	15.1%	8.6%

*Average Return Rising Rates: Average cumulative total return during periods of rising rates shown in the chart.

**Full Period Average Annual Return: Average annual total return for each Index from 10/15/1993 to 9/5/2013.

Source: Bloomberg. Data measured from 10/15/1993 to 6/30/2015. Periods of rising rates determined by an increase of at least 100 basis points in the 10-Year Treasury note interest rate. Past performance is not indicative of future results. You cannot invest directly in an index.

Rising Rate Solutions for Your Toolkit: • **The WisdomTree U.S. Dividend Growth Fund (DGRW):**

DGRW tracks the performance of the WisdomTree U.S. Dividend Growth Index before fees and expenses. This Index includes dividend-paying companies with relatively high growth and quality characteristics, historically placing very low weight in the Utilities and Telecommunication Services sectors. •

The WisdomTree U.S. SmallCap Dividend Growth Fund (DGRS): DGRS tracks the performance of the WisdomTree U.S. SmallCap Dividend Growth Index before fees and expenses. This Index includes small-cap, dividend-paying companies with relatively high growth and quality characteristics, historically placing very low weight within the Utilities and Telecommunication Services sectors. • **The WisdomTree BofA Merrill Lynch High Yield Bond Negative Duration Fund (HYND):** HYND tracks the performance of the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Negative Seven Duration Index before fees and expenses. This Index takes short positions in longer-maturity U.S. Treasury futures contracts to have the potential to profit if interest rates at the longer-maturity part of the yield curve rise. In the meantime, the underlying high-yield bonds may mitigate the cost of applying the Treasury futures positions while waiting for rates to rise. 1Source: Professor Robert Shiller, with data measured from 12/31/1957 to 6/30/2015 for the S&P 500 Index universe.

Important Risks Related to this Article

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. 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. HYND may engage in “short sale” transactions, 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 Your Toolkit for Rising Rates. If 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. 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. Dividends are not guaranteed, and a company’s future ability to pay dividends may be limited. A company currently paying dividends may cease paying dividends at any time. The Dow Jones U.S. Select Dividend Index is calculated, distributed and marketed by Dow Jones Indexes, a licensed trademark of CME Group Index Services LLC, and has been licensed for use. Merrill Lynch, Pierce, Fenner & Smith Incorporated’s 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, ANY RELATED INFORMATION, ITS TRADEMARKS OR THE PRODUCT(S) (INCLUDING, WITHOUT LIMITATION, THEIR QUALITY, ACCURACY, SUITABILITY AND/OR COMPLETENESS). Foreside Fund Services, LLC., is not affiliated with BofA Merrill Lynch.