As the outlook for the money and bond markets evolves, investors continue to look for innovative fixed income solutions that can help meet strategic needs without necessarily requiring frequent changes. The U.S. Treasury sought to tap into the potential demand for short-term government bond allocations by issuing floating rate notes (FRNs). The option to invest in floating rate debt issued by the U.S. government may be attractive for those who prefer to limit their exposure to credit risk, but who still want to participate in the potential for higher yields should interest rates remain at, or rise above, present levels. In our view, U.S. floating rate debt helps bridge an important gap between short-maturity Treasury Bills and longer-maturity, fixed rate Treasury Bonds.

The U.S. Treasury completed its first floating rate auction on January 29, 2014, issuing $15 billion of a note with a two-year stated maturity. This was the first new class of issuance by the Treasury since it issued Treasury Inflation-Protected Securities (TIPS) in 1997. The Treasury auctions a new two-year note every quarter, with re-openings of the new issue in the two months that follow. As another means for the Treasury to meet growing investor demand and to diversify its sources of funding, the issuance and increasing investor adoption of floating rate Treasuries has, and should continue, to grow over the next several years. By comparison, TIPS has grown to become a market of over a trillion since 1997.

Bond Basics: What Is a Floating Rate Treasury Note?

For many investors, exposure to bonds generally starts and stops with fixed income securities, which customarily pay a fixed rate of interest and refund the principal balance at maturity. However, floating rate notes are slightly different. Although floating rate Treasuries make payments to holders each quarter, the size of these payments is based on a rate that is reset daily in reference to a rate that is determined weekly. This reference rate is based on the high yield determined at the weekly auction of 13-week Treasury Bills, which is generally held every Monday.

Therefore, if yields at the Treasury Bill auction rise week to week, investors could receive greater compensation than with a fixed coupon payment from a traditional fixed income investment. This reset frequency also helps mitigate price fluctuations in floating rate notes compared to fixed income bonds of similar maturities. Given that these securities are issued by the U.S. government, they could serve as reference benchmarks for a variety of floating rate issuers in the same way that U.S. Treasury Bonds serve as interest rate benchmarks for all other U.S. dollar-denominated fixed income issuance.

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1 Floating rate notes: A debt instrument whose coupon payments are tied to a short-term borrowing rate such as a U.S. Treasury Bill Rate or the London Interbank Offered Rate (LIBOR).
2 Credit risk: The risk that a borrower will not meet their contractual obligations in conjunction with an investment.
3 Treasury Bill: A short-term debt obligation backed by the U.S. government with a maturity of less than one year.
4 Treasury Bonds: A debt obligation backed by the U.S. government with a maturity of more than ten years.
5 U.S. Department of the Treasury, 1/29/14.
6 Treasury Inflation-Protected Securities (TIPS): Bonds issued by the U.S. government whose coupon and principal payments are linked to the Consumer Price Index.
7 Bloomberg.
With the shape of the Treasury yield curve being flat, or in some instances inverted (short-term yields are higher than intermediate/longer-term yields), investors are able to capture a yield advantage without taking on the potential interest rate risk embedded in longer-dated maturities. Treasury floating rate notes fall into this category and offer additional cushion in the event that rates do rise, given their adjustable mechanism.

**What Role Can Floating Rate Treasuries Play in Investor Portfolios?**

Although funds that hold these Treasury securities should not be viewed as “money market funds,” in our view, floating rate Treasuries can function as a core alternative for short-term bond exposure with reduced interest rate and credit risk. Given that U.S. government securities are assumed to be free of default risk, the value of the security is determined by the interest rate at each weekly auction.

The Treasury decided to offer this floating rate option as an alternative to investors who were rolling three-month Treasury Bills every quarter. Floating rate Treasuries can help investors reduce transaction costs and extend the holding period of their investments. From an operational perspective, floating rate Treasuries can be an important addition to the investment opportunity set available to today’s investor.

Although interest rate risk is not as prevalent on the minds of many investors these days, we believe that floating rate Treasury securities represent an effective way for investors to help reduce their exposure to rising interest rates, if such concerns do re-emerge. In addition, they generate income payments that are backed by the full faith and credit of the U.S. government. Whereas other investments may also pay a rate of interest that resets each month or quarter, such securities are exposed to credit risk or the risk that the borrower will not be able to meet its financial obligations.

**Introducing USFR—Floating Rate Notes Without Credit Risk**

The WisdomTree Floating Rate Treasury Fund (USFR) seeks to track the price and yield performance of the Bloomberg Barclays U.S. Treasury Floating Rate Bond Index.

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8 Interest rate risk: The risk that an investment’s value will decline due to an increase in interest rates.
At WisdomTree, we do things differently. We build our ETFs with proprietary methodologies, smart structures and uncommon access to provide investors with the potential for income, performance, diversification and more.

For more information about USFR, contact your WisdomTree representative or visit WisdomTree.com.

You cannot invest directly in an index.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Fund before investing. To obtain a prospectus containing this and other important information, call 866.909.9473 or visit WisdomTree.com. Investors should read the prospectus carefully before investing.

There are risks associated with investing, including the possible loss of principal. Securities with floating rates can be less sensitive to interest rate changes than securities with fixed interest rates, but may decline in value. The issuance of floating rate notes by the U.S. Treasury is new and the amount of supply will be limited. Fixed income securities will normally decline in value as interest rates rise. 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. Due to the investment strategy of this 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.

Bloomberg Barclays U.S. Treasury Floating Rate Bond Index: A rules-based, market capitalization-weighted index engineered to measure the performance of floating rate U.S. Treasury bonds.

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