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# HOW TO INVEST IN A RISING RATES ENVIRONMENT

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One of the big takeaways since Donald Trump won the U.S. presidential election on November 8 has been the direction of [interest rates](#) in the U.S. This is likely the result of market participants factoring in, right away, the potential impact of new fiscal, regulatory and tax policies on U.S. [gross domestic product](#) growth, [inflation](#) and federal deficits—in late 2017, 2018 and the years that follow.

[Yields](#) on [10-Year U.S. Treasuries](#) have backed up about 100 [basis points \(bps\)](#) since yields bottomed at 1.36% on July 8, 2016. This has affected various asset classes since the summer, and the sudden acceleration of rates since Trump's surprise election victory has created a chain reaction across asset classes since November 8.

While some debate whether interest rates and the dollar have risen too far, too fast, investors ought to be open-minded to the possibility that rates may well continue to rise as the U.S. labor markets tighten and wage pressures begin to take hold inside the economy. WisdomTree has several simple solutions to help investors navigate a rising interest rate environment, using WisdomTree exchange-traded funds (ETFs). This blog post is the first of a series that will highlight some of our best ideas, spanning U.S. equity, international equity, currency, fixed income and alternative strategies.

For U.S. equity investors, I believe that U.S. [mid-](#) and [small-cap](#) stocks may continue to lead the market for the next 12 to 18 months. Companies that derive most of their revenue and profit from within the 50 states are more likely to benefit from faster economic growth and the easing of regulations within the U.S., and from higher take-home pay for U.S. workers that should occur if individual tax rates are lowered. They are also less vulnerable to a strengthening U.S. dollar, which could become a headwind for U.S. multinationals. Finally, mid- and small-cap companies may get a larger benefit from any reduction in corporate tax rates, as a good portion of [large-cap](#) profits are generated overseas. Not surprisingly, U.S. mid- and small-cap indexes have led the rally higher since the election, and it would not surprise me to see this relative outperformance continue in 2017, assuming the lion's share of President-elect Trump's domestic economic agenda passes the Republican-controlled Congress.

Although past performance does not guarantee future results, the past performance of two WisdomTree ETFs during previous rising interest rate environments is notable.

The table below shows how the [WisdomTree SmallCap Earnings Fund \(EES\)](#) and the [WisdomTree MidCap Earnings Fund \(EZM\)](#) have performed during previous periods over the past 10 years when interest rates rose in the U.S. (Please click each Fund for standardized performance.)

Start Date	End Date	Increase/Chg in 10-Year Yield	Total Return for Period		EES Excess Return vs. S&P 500	Total Return for Period		EZM Excess Return vs. S&P 500
			WisdomTree SmallCap Earnings Fund	S&P 500		WisdomTree MidCap Earnings Fund	S&P 500	
3/7/2007	6/12/2007	0.81	5.0%	7.7%	-2.7%	8.0%	7.7%	0.3%
9/10/2007	9/20/2007	0.37	5.3%	4.7%	0.6%	4.3%	4.7%	-0.4%
12/3/2007	12/14/2007	0.39	-1.0%	-0.2%	-0.8%	-0.7%	-0.2%	-0.5%
1/22/2008	2/25/2008	0.46	8.5%	4.9%	3.5%	9.8%	4.9%	4.9%
3/17/2008	6/16/2008	0.96	8.6%	7.1%	1.6%	13.1%	7.1%	6.0%
9/15/2008	10/14/2008	0.69	-19.1%	-16.2%	-2.9%	-19.9%	-16.2%	-3.7%
12/30/2008	6/10/2009	1.89	25.0%	6.8%	18.2%	23.4%	6.8%	16.6%
10/1/2009	4/5/2010	0.81	18.3%	16.5%	1.8%	23.9%	16.5%	7.5%
10/7/2010	2/8/2011	1.35	17.8%	15.1%	2.7%	19.3%	15.1%	4.3%
9/22/2011	10/27/2011	0.68	20.5%	13.9%	6.6%	17.5%	13.9%	3.5%
1/31/2012	3/19/2012	0.58	4.9%	7.8%	-2.9%	7.1%	7.8%	-0.7%
7/24/2012	12/31/2013	1.64	62.8%	42.6%	20.2%	62.6%	42.6%	20.0%
1/30/2015	3/6/2015	0.60	4.9%	4.1%	0.8%	5.2%	4.1%	1.0%
4/17/2015	6/10/2015	0.62	0.6%	1.5%	-0.9%	0.9%	1.5%	-0.6%
10/14/2015	11/9/2015	0.37	4.1%	4.4%	-0.3%	2.6%	4.4%	-1.8%
2/11/2016	3/11/2016	0.32	16.5%	10.8%	5.7%	14.9%	10.8%	4.1%
7/8/2016	10/14/2016	0.44	4.0%	0.7%	3.3%	1.7%	0.7%	1.0%
<b>Average When Interest Rates Rose</b>								
Average		0.76	11.0%	7.8%	3.2%	11.4%	7.8%	3.6%
Compound Cumulative			398.6%	226.9%	171.7%	428.4%	226.9%	201.5%
<b>Average When Interest Rates Declined</b>								
Average		-0.93	-5.2%	-3.2%	-2.0%	-4.8%	-3.2%	-1.7%
Compound Cumulative			-62.3%	-44.6%	-17.7%	-59.6%	-44.6%	-15.0%
<b>All Periods</b>								
Average Annual Return			6.7%	6.3%	0.4%	8.1%	6.3%	1.8%
Compound Cumulative			87.7%	80.9%	6.8%	113.3%	80.9%	32.4%

Sources: WisdomTree, Bloomberg, as of 10/14/16. Data calculated at net asset value.

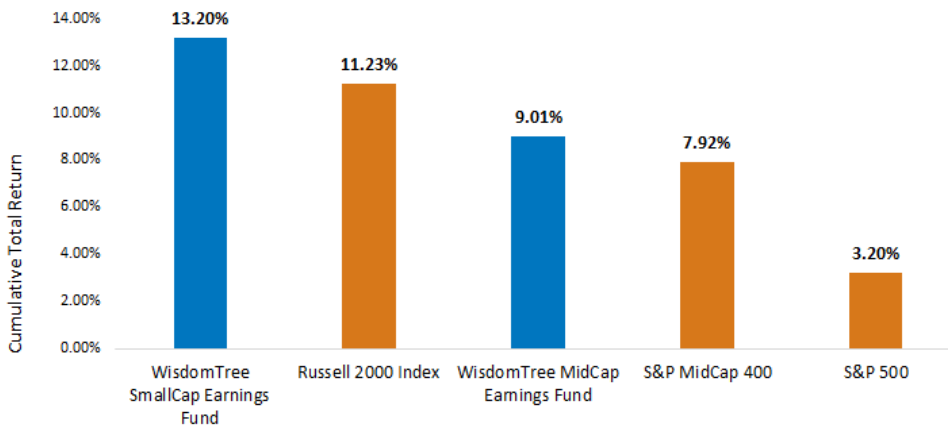
**Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at [www.wisdomtree.com](http://www.wisdomtree.com).**

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

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

The table shows that when rates rose, EES generated returns that on average surpassed the [S&P 500 Index](#) by 320 bps. EZM generated average excess returns of 360 bps over those same 17 periods. In two of the periods with the greatest increase in rates—spanning 2009 and 2013—EES beat the S&P 500 by 18.2 and 20.2 percentage points, respectively. Similarly, EZM beat that large-cap barometer by more than 16 percentage points in the 2009 period and by 20 percentage points from mid-2012 through the end of 2013. Since Trump's election victory, we have seen a similar setup developing. As the chart below shows, EES has outperformed the [Russell 2000 Index](#), as small-cap stocks have beaten large caps. And EZM has beaten the [S&P MidCap 400 Index](#), as mid-caps have also trumped large caps.

**Cumulative Total Return Since Presidential Election  
11/8/16 to 11/29/16**



Sources: WisdomTree, Bloomberg as of 11/29/16. Data calculated at net asset value. Past performance is not indicative of future results. You cannot invest directly in an index. Double-digit returns were achieved primarily during favorable market conditions. Investors should not expect that such favorable returns can be consistently achieved. A fund's performance, especially for very short time periods, should not be the sole factor in making your investment decision.

EES and EZM have been able to establish a compelling performance history over nearly 10 years against comparable [cap-weighted](#) indexes and against [actively managed funds](#) because they do something fairly unique. First, the indexes they track only include profitable companies at the time of their annual [rebalance](#) in December; second, component weights are based on the profits companies earn, not on their market values. The earnings-weighted indexes they track, in effect, make an active bet against the market once a year. This results in different sector exposures. And for the past decade, this investment process has resulted in portfolios that typically exhibited lower aggregate [price-to-earnings \(P/E\) ratios](#) and higher [return-on-equity \(ROE\)](#) ratios compared to their benchmark peers at the annual rebalance, which occurs each December. Presently, both Funds are overweight financial, industrial and consumer discretionary stocks relative to their cap-weighted peers, and underweight the interest rate- sensitive real estate sector.

**Conclusion**

For investors looking to gain exposure to small- and mid-company stocks, consider EES and EZM for the small- and mid-cap sleeves of your portfolio. They have proven themselves over nearly a decade, and may be uniquely aligned to benefit from the new macro environment being ushered in by the new administration coming to power in Washington.

*Unless otherwise noted, data source is Bloomberg, as of 11/30/2016.*

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There are risks associated with investing, including possible loss of principal. 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. Please read each Fund's prospectus for specific details regarding each Fund's risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

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**U.S. investors only:** Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

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You cannot invest directly in an index.

## DEFINITIONS

**Interest rates**: The rate at which interest is paid by a borrower for the use of money.

**Gross domestic product (GDP)**: The sum total of all goods and services produced across an economy.

**Inflation**: Characterized by rising price levels.

**Yield**: The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

**10- Year Treasury**: a debt obligation of the U.S. government with an original maturity of ten years.

**Basis point**: 1/100th of 1 percent.

**Mid-Cap**: Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

**Small caps**: new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

**Large-Capitalization (Large-Cap)**: A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

**S&P 500 Index**: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

**Russell 2000 Index**: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**S&P MidCap 400 Index**: provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

**Market capitalization-weighting**: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

**Actively managed ETFs**: Investment strategy where a manager selects securities in an attempt to outperform the performance benchmark.

**Rebalance**: An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.

**Price-to-earnings (P/E) ratio**: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**Return on Equity (ROE)**: Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.