SECTOR LESSONS FROM 2016

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01/19/2017

If one notes the level of the 10-Year U.S. Treasury yield at the start of 2016 (2.27%) and the end of 2016 (2.44%), it would appear that there wasn't much change—certainly not a magnitude great enough to warrant expectations of a significant impact on equities.[1] However:

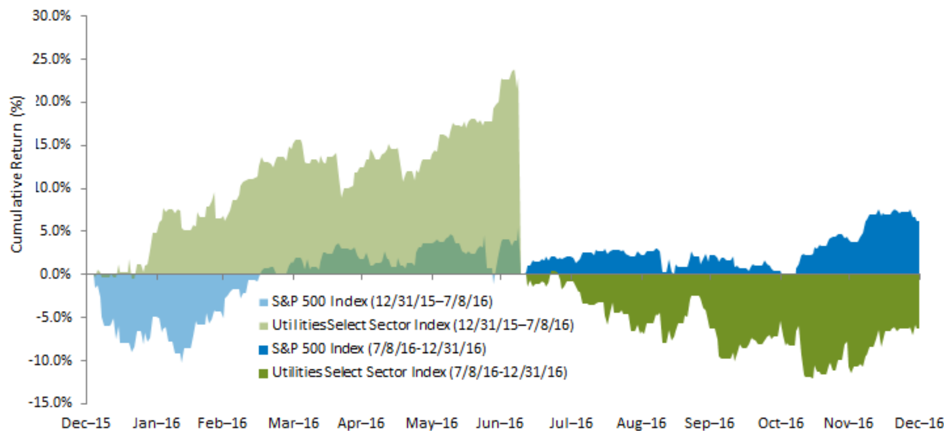
- From the start of 2016 to July 8, 2016, the 10-Year Treasury saw a drop in its yield of almost 100 basis points (bps), a major move.
- From July 8, 2016, to the end of the year, the U.S. 10-Year Treasury yield rose more than 100 basis points.

2016 was thus a "tale of two periods" that showcased how shifts in interest rates can explain important inflection points in the performance of different equity strategies.

The S&P 500 Index Rose Nearly 12% in 2016

This 12% gain for the S&P 500 was its calendar year return.[2] The chart that follows shows how the Utilities sector contributed quite differently to this result during the first-half (falling rate) and second-half (rising rate) environments.

How the Utilities Sector Responded to Falling & Rising Rates in 2016



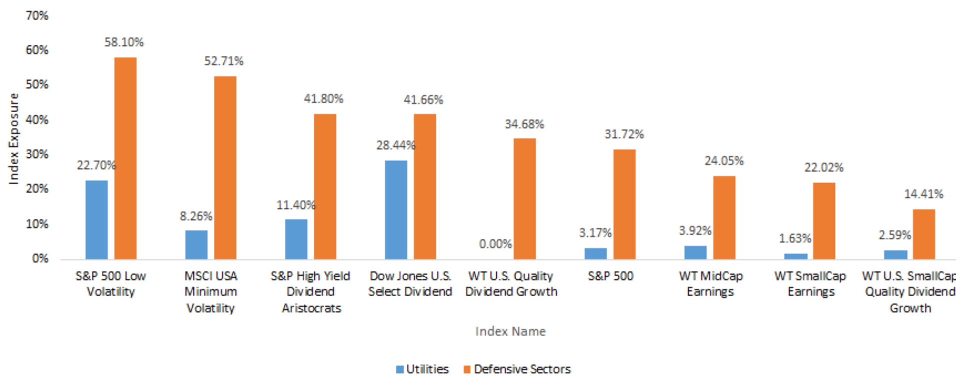
Sources: WisdomTree, Bloomberg. Contrasting periods from 12/31/2015 to 7/8/2016 and then from 7/8/2016 to 12/31/2016 are shown. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, visit our glossary.

So What?

Many investors out there may not utilize sector-specific U.S. strategies and may be thinking that our discussion of the Utilities sector is not overly relevant. However, to put things in better context, we note a few strategies that we know people do follow closely, in both the Utilities and overall defensive sector exposures.

Using Sector Exposures to Gauge Rising Rate Sensitivity



Sources: WisdomTree, Bloomberg. Contrasting periods from 12/31/15 to 7/8/16 and then from 7/8/16 to 12/31/16 are shown. Past performance is not indicative of future results. You cannot invest directly in an index

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- **Minimum Volatility & Low Volatility Indexes:** What stands out among these strategies is that they each had more than 50% exposure to the defensive sectors. This is impactful in two ways. First, the defensive sectors do tend to have greater inherent sensitivity to rising interest rates, in that the higher-yielding sectors are included here. Second, if rising rates are related to improving economic growth expectations, cyclical sectors could indeed be poised to outperform. In the big picture, we know that investors do follow these types of strategies closely, and it is important to realize that rising rates could be an important friction or resistance to performance.

- **Dow Jones U.S. Select Dividend Index:** This strategy has tended to hold a large percentage of its exposure in the Utilities sector—nearly 30% as of December 31, 2016. While this positioning would have been tough to beat in the first part of 2016 as the U.S. 10-Year yield dropped by almost 100 basis points, it created a headwind as rates began to rise. Additionally, this strategy played into another important investor demand —along with the S&P High Yield Dividend Aristocrats Index: income. Both of these Indexes have a focus on relatively higher-yielding dividend payers. During the first part of 2016, one of the reasons the Utilities, Real Estate and Telecommunication Services sectors did well was that investors needed income and could not find it in fixed income options. If fixed income interest rates rise, that creates a source of competition for higher-yielding dividend payers, leading to a lower tolerance of equity risk in portions of the portfolio focused on income.

How to Manage Interest Rate Risk with Sector Exposures

As we look to 2017 and beyond, we find ourselves excited by the innovation in how U.S. equity indexes are created to select and weight different types of stocks. Investors who look under the hood have more options than ever before when considering how to manage risk and execute different economic theses. A few particular examples are:

- **WisdomTree U.S. Quality Dividend Growth Index:** When people see the word "dividend" in an index name, we believe their baseline expectations wouldn't include a 0% exposure to Utilities. The methodology here avoids firms that 1) tend to borrow money to pay dividends, 2) have slow earnings growth expectations and 3) use higher leverage. The result: no weight to Utilities and the introduction of an interesting tool to consider both growing income as well as managing interest rate risk.
- **Earnings Indexes:** The true strength of these approaches—and we show the WisdomTree SmallCap Earnings and MidCap Earnings Indexes here—is their management of valuation risk as a direct focus in their methodology. At each year's annual rebalance, we have seen the price-to-earnings (P/E) multiple drop, due to both elimination of unprofitable companies and weighting profitable firms by the earnings they generate. An interesting corollary is that, for those looking to tilt away from 1) Utilities and 2) defensive sectors, these strategies accomplish an important focus.
- **WisdomTree U.S. SmallCap Quality Dividend Growth Index:** For investors looking to mitigate interest rate risk in portfolios and thinking from a sector perspective, this Index could be the most interesting option. As of December 31, 2016, there was less

than 15% exposure to defensive sectors. Few indexes—especially ones that include only dividend payers—take it to this level, and we think it creates a particularly strong catalyst of interest when being thought of in broader portfolios.

[1]Sources: WisdomTree, Bloomberg, with data as of 12/31/15 and 12/31/16.

[2]Sources: WisdomTree, Bloomberg, with data for the period from 12/31/15 to 12/31/16.

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.

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You cannot invest directly in an index.

DEFINITIONS

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Basis point : 1/100th of 1 percent.

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.

Defensive sectors : Consumer Staples, Health Care, Telecommunication Services and Utilities.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

Dow Jones U.S. Select Dividend Index : The index is a modified market capitalization approach and weights by dividend yield. Stocks are selected for fundamental strength relative to their peers, subject to various screens such as dividend quality and liquidity.

S&P High Yield Dividend Aristocrats Index : Designed to track the performance of dividend-paying companies in the U.S. that have increased their annual dividend payments for the last 20 or more consecutive years.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

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.