ENHANCING CORE FIXED INCOME 2.0

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Several years ago, WisdomTree helped Barclays develop a strategy that relied on the same investable universe as the Bloomberg Barclays U.S. Aggregate Index (Agg) but sought to boost yield in a risk-efficient way. The rationale of this approach was to enhance income (and expected returns) while broadly maintaining comparable levels of risk. Since we launched our exchange-traded fund (ETF) on the index, this rules-based approach has outperformed the Agg by 93 basis points (bps) per year with comparable volatility.[1] In version 2.0, we've taken a similar framework, but limited exposures to bonds with one to five years to maturity, resulting in a strategy with significantly less interest rate risk. Below, we discuss the construction of the Bloomberg Barclays U.S. Short Aggregate Enhanced Yield Index (Short Agg Enhanced Yield) and why we feel this strategy can be an attractive option at the core of investor portfolios.

Step 1: Divide into Buckets

In the first step, the one-to-five-year portion of the Agg is separated into 13 buckets across sector, maturity, and credit quality. While each component retains a reasonable size for investability and liquidity purposes, each bucket presents unique opportunities for risk and reward.

13 Buckets across Sector, Quality, and Maturity

Sector		Years to Maturity: 1–3 Years	Years to Maturity: 3–5 Years
Sector	Govt.	Treasury 1–3	Treasury 3–5
Sector	Govt.	Agency 1–3	Agency 3–5
Sector	Credit	Credit 1–3 Baa	Credit 3–5 Baa
Sector	Credit	Credit 1–3 A	Credit 3–5 A
Sector	Credit	Credit 1–3 Aaa–Aa	Credit 3–5 Aaa–Aa
Sector	Securitized	Commercial Mortgage–Backed Securities WAL 1–5	
Sector	Securitized	Asset–Backed Securities WAL 1–5	
Sector	Securitized	Conventional MBS 15 yrs	

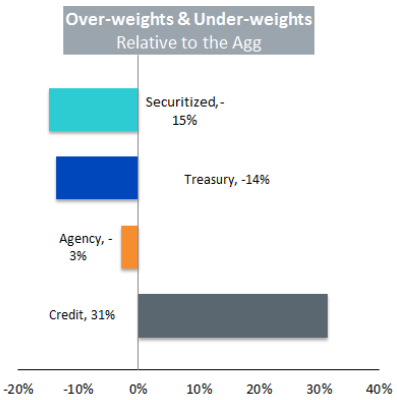
Source: Bloomberg, as of 4/30/17. MBS = mortgage-backed securities. WAL = Weighted average life.

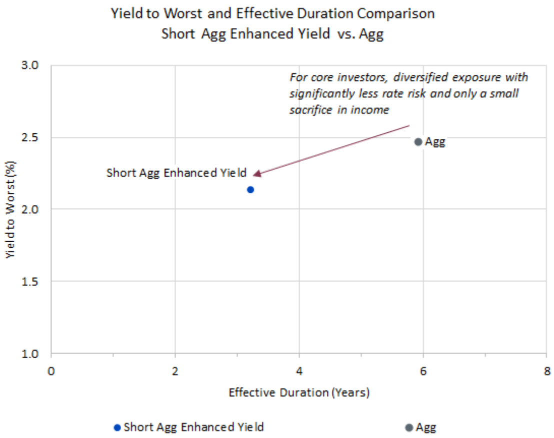
Step 2: Screen Securities and Apply Constraints

Next, a series of constraints are applied in order to limit risk and turnover. Compared to the Short Agg Composite, the index is allowed to be .5 years longer in duration but must keep sector differences to less than 30%. To ensure volatility remains similar, the index optimizer limits tracking error volatility to 17.5 bps per month.[2]

Index Characteristics Contrasted

From the perspective of investors who bench to the Agg, this process effectively cuts their interest rate risk in half (3.05 years vs. 5.96 years), while reducing income by approximately 37 bps to 2.16%.[3] Assuming all other factors remain constant, interest rates would only need to rise by approximately 12 bps in order to break even on this trade. Given our defensive positioning on rates, we believe this strategy could be a prudent step, with rates actually lower year-to-date.





Source: Bloomberg, as of 4/30/17.

While we are the first to admit that every little bit of income can help in the current low rate environment, we currently believe that the balance of risk favors credit over rates. As a result, for investors who remain closely linked to the Agg as their benchmark, this rules-based approach to risk management could provide yet another tool for investors to further refine their bond exposure.

[1]Performance comparison based on the total returns of the Bloomberg Barclays U.S. Aggregate Enhanced Yield Index against the Bloomberg Barclays U.S. Aggregate Index for the period 7/9/15–4/30/17.

[2]A final check ensures that turnover is limited to 5%.

[3]Source: Bloomberg, as of 4/30/17.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. 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.

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DEFINITIONS

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

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.

Basis point : 1/100th of 1 percent.

Maturity : The amount of time until a loan is repai.

Interest rate risk : The risk that an investment’s value will decline due to an increase in interest rates.

Bloomberg Barclays U.S. Short Aggregate Enhanced Yield Index (Short Agg Enhanced Yield) : a constrained, rules-based approach that reweights the sector, maturity and credit quality of the Barclays U.S. Aggregate Index across various subcomponents in order to enhance yield maturing in one to five years.

Credit quality : A measure of a borrowers potential risk of default.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Short Agg Composite : represents a subset of securities in the Bloomberg Barclays U.S. Aggregate Index which mature between 1 and 5 years.

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