HOW TO MAINTAIN INCOME POTENTIAL WHILE BETTING ON RISING INTEREST RATES

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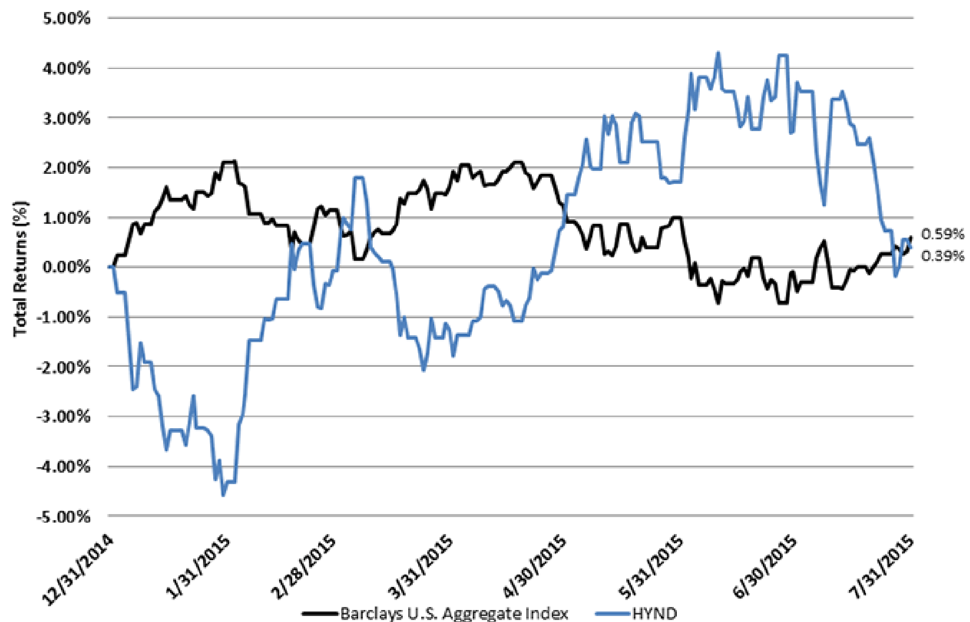
Over the last several months, the Federal Reserve (Fed) has continued to reiterate its stance that any shifts in monetary policy will depend on continued improvement in economic data. Over this period, employment data has continued to show signs of improvement, making it increasingly likely that the Fed will finally lift rates on September 17. In the Fed's opinion,[1] it may be only a matter of time until decreases in the employment rate ultimately lead to gains in economic growth and a coincident rise in inflation. One of the biggest conundrums for investors has been how to prepare for a coming shift in interest rates. Many investors have moved to shorten the duration of their portfolios – thinking long-term interest rates could not remain stuck near historically low levels. While a Fed rate hike is likely the first step, an important determinant of longer-term rates is what usually happens when the Fed starts to allow its balance sheet to shrink. Without the Fed continuing to reinvest the proceeds of maturing securities, the size of its balance sheet would begin to decline, ultimately weighing on the long end. This likely reaction would be primarily due to the disappearance of the Fed as a captive buyer in the market. In our view, exposure to a high-yield debt strategy with negative duration could be one way to accrue income while waiting on rising interest rates. **Return Driver 1: Rising Rates** Typically when interest rates rise, bond prices fall. How much they fall can be approximated through a measure of a security's duration. The price of a bond with a seven-year duration will fall by approximately 7% for every 1% increase in interest rates. Therefore, if an investor is short a security with a seven-year duration, the investor stands to profit by 7% in the above scenario. While most hypotheticals assume a parallel shift in the yield curve—for example, interest rates rise by 1% across every point—this rarely occurs. Below, we illustrate this through an examination of the exposures of the WisdomTree BofA Merrill Lynch High Yield Bond Negative Duration Fund (HYND). This strategy invests in high-yield bonds and then shorts Treasury futures contracts in order to achieve a negative-seven-year duration. **HYND Portfolio Construction: Embedded Income Yield and Effective Duration**

HYND Exposures	Net Portfolio	Long Portfolio Exposure	Short Hedges
Breakdown of Duration Exposures	A =	B +	C
0-1 Year	10.3%	10.3%	0.0%
1-2 Years	29.5%	29.5%	0.0%
2-3 Years	38.5%	38.5%	0.0%
3-5 Years	-7.1%	18.6%	-25.7%
5-7 Years	-47.7%	0.0%	-47.7%
7-10 Years	0.0%	0.0%	0.0%
10+ Years	-34.4%	0.0%	-34.4%
Embedded Income Yield (%)	3.86%	6.02%	-2.16%
Effective Duration (Years)	-7.32	2.06	-9.39

Source: WisdomTree, as of 8/14/15. Holdings subject to change. Past performance is not indicative of future results.

As of 8/14/15 the corresponding SEC 30-Day Yield, distribution yield, and yield to maturity for the Fund are 5.13%, 3.73%, and 6.02%, respectively. *Click here for more complete information about the Fund's performance.* While the total duration of the portfolio is approximately negative seven years, you can see that it achieves this exposure by selling futures in the 3-7 Years and 10+ Years segments of the yield curve. Therefore, if rates rise only at the short end, the strategy could underperform. But if the yield curve steepens (long rates tend to rise faster than short rates), this portfolio should perform quite well. During the most recent period of rising rates this year,[2] this is precisely what occurred. **Return Driver 2: High-Yield Credit** In addition to exposure to interest rate risk, HYND is also exposed to credit risk. In our view, any increase in rates by the Fed should be taken as an endorsement by policy makers that the strength of the U.S. economy is continuing to improve. With the economy strong, the probability that risky borrowers will default should continue to remain low. As a result, we believe investors can enhance return by assuming additional credit risk. At the portfolio level, the long positions in high-yield bonds help to finance the cost of the short positions. Should credit spreads and nominal interest rates remain unchanged, an investor could potentially accrue income in excess of 3% per year while waiting for the thesis of rising rates to play out.[3] So far in 2015, credit has underperformed as commodity prices fell and fears of a Greek exit from the eurozone weighed down certain non-investment grade borrowers. However, with stability potentially creeping back into the market, we believe that credit risk could be attractively priced. Compared to other rising rate strategies that only short securities, investors in HYND have the potential to accrue income in excess of the Barclays U.S. Aggregate Index (Agg) while maintaining a negative duration portfolio. In fact, during the most recent period of rising rates in 2015, HYND has been a valuable diversifier for strategies with similar exposures to the Agg, as we show below. Although returns are comparable between the two strategies for the entire period, the drivers of returns differ drastically. Longer-term interest rates rose dramatically from the end of January through mid-July, ultimately driving strong performance for HYND. However, rates eventually retraced to unchanged on the year through the end of July. This move allowed the Agg to turn modestly positive year-to-date after spending the last several months in negative territory. **Comparable but Differing Drivers of Total Returns Barclays U.S. Aggregate Index vs. HYND YTD:**



Source: Bloomberg, as of 7/31/15. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays, or for any actions taken in reliance on information contained herein.
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12/31/14–7/31/15

The Risks of an Anti-Recession Portfolio Now that we've discussed and witnessed the potential drivers of return in real time, it is important to understand the risks. HYND can largely be viewed as an anti-recession strategy. If it appears that a recession may be coming, high-yield spreads would likely widen, and long-term interest rates could fall—resulting in negative performance for both bets in HYND. Additionally, it is possible that interest rates could rise at the short end, but not necessarily the long end. In this environment, an investor would have the right trade rationale, but ultimately not be able to profit from the resulting move in the market. Ultimately, our view continues to be that the U.S. economy can continue to expand at a moderate pace. In response, it may only be a matter of time until stronger growth ultimately leads to a rebound in inflation expectations. Through the combination of higher nominal interest rates and historically low levels of default risk, we believe that HYND could make sense for an investor who wants to accrue some income while positioning portfolios to benefit from a rise in longer-term rates.

[1]Source: Based on comments made by Atlanta Federal Reserve President Dennis Lockhart, "A Story of Economic Progress," Federal Reserve Bank of Atlanta, 8/10/15. [2]Refers to period 1/31/15–7/13/15. [3]Source: WisdomTree, as of 7/31/15.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Inflation : Characterized by rising price levels.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Embedded Income Yield : Represents the annualized rate of return generated by a fund's investments in both fixed income securities and derivatives exclusive of interest rate changes and movement in foreign exchange spot rates. The calculation is intended to capture the Fund's potential to earn income return over the following year given current holdings and market conditions. The embedded income yield will differ from the portfolio's yield to maturity, due to the incorporation of derivatives in the embedded income yield. Embedded income yield and portfolio yield to maturity may differ from a Funds actual distribution and SEC yield and do not reflect Fund expenses.

Effective Duration : This statistic provides a measure of the sensitivity of the Fund's price to changes in interest rates and is calculated as the weighted average of the individual blond effective durations. Effective duration recognizes that changes in interest rates may also change the expected cash flows generated by any underlying bonds with embedded options. The calculation is expanded to incorporate the contribution of derivatives to the overall interest rate risk sensitivity to the portfolio. Credit ratings apply to the underlying holdings of the Fund, and not to the Fund itself. S&P and Moody's study the financial condition of an entity to ascertain its creditworthiness. The credit ratings reflect the rating agency's opinion of the holdings financial condition and histories.

SEC 30-Day Yield : The yield figure reflects the dividends and interest earned during the period, after deduction of the Fund's expenses. This is also referred to as the "standardized yield.&rdquo.

Fund Distribution Yield : The fund distribution yield is calculated by annualizing the most recent fund distribution and dividing by the fund's current NAV. The yield represents a single distribution from the fund and does not represent the total returns of the fund.

Yield To Maturity : Portfolio Yield to Maturity represents the weighted average yield to maturity of a Fund's investments in money market securities and fixed income securities as a specified date. Yield to maturity is the rate of return generated on these securities, assuming interest payments and capital gains or losses as if the instrument is held to maturity. The weighted average yield is calculated based on the

market value of each security. The calculation does not incorporate yield from any derivative instruments that are part of the Fund’s investments.

Steepen : an increase in the spread between short-term interest rates and longer-term rates.

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

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Non-investment grade debt : Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.