EMERGING MARKET LOCAL DEBT—WHAT WILL DRIVE RETURNS IN 2013?

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Investors were well compensated for investing in riskier fixed income sectors in 2012. With U.S. Treasuries and investment-grade securities offering reduced income potential, many investors rushed to higher-yielding sectors in what could be characterized as a relentless pursuit of income. Total returns for sectors such as U.S. High Yield and Emerging Market (EM) USD Sovereigns were bolstered by significant compression in the additional amount of yield that investors demand for assuming credit risk. EM local currency debt also enjoyed significant principal returns as local rates declined in step with aggressive central bank rate cuts.

We believe 2013 will be a different story. Selectivity and fundamentals are poised to play a more critical role in generating returns this year. In other words, the relentless pursuit of income may evolve into a more prudent pursuit of income. Investors and managers may more selectively target opportunities and anticipate lower absolute returns but continue to search for additional ways to generate income in their portfolios.

Looking ahead, investors should be asking what the primary driver of returns in fixed income will be in 2013. In emerging markets, we believe a majority of central banks have completed their cycle of interest rate cuts. This year, we believe that returns from EM local debt will largely be comprised of interest income and returns from currency appreciation against the U.S. dollar.

While we believe there will be a more balanced return (between income and currency appreciation) from EM local debt in 2013, we think a bias toward quality will offer differentiated performance to investors this year. Similar to our note about EM currency performance in 2012, EM Europe performed well after unnerved markets were calmed by the European Central Bank's (ECB) debt purchasing scheme. Going forward, we believe EM Asia and EM Latin America should perform well when a focus on economic fundamentals returns to the market.

That said, last year the WisdomTree Emerging Markets Local Debt Fund (ELD) had its best calendar year performance since its inception in 2010. In fact, emerging market local debt as an asset class had better returns than even high-yield debt in 2012 thanks to aggressive interest rate cuts by many EM central banks.[1] While the future path of U.S. fixed income may be subject to debate, we believe investors should also be focusing on the potential drivers of return in international fixed income and emerging markets when making portfolio allocation decisions.

With less central bank activity, we believe interest rates in emerging market government debt will remain near current levels in 2013. As of January 31, 2013, ELD had a yield to maturity of 4.59% and duration of 4.84 years. By comparison, the current Five-Year U.S. Treasury Note has a comparable duration of 4.8 years.[2] While investors are exposed to foreign currency risk, we believe that these yield levels provide significant income potential from a portfolio that is currently comprised of 96% in investment-grade[3] securities.

Another potential driver in 2013 could be returns from changes in currency. Since ELD's

inception,[4] currency performance has actually had a negative impact on the Fund's returns. However, we do not believe this will always be the case. Based on the Fund's current exposures, the currencies in the Fund are down by 2.42% versus the U.S. dollar since inception.[5] While we believe in the long-term prospects of EM currencies, appreciation will occur gradually. The rationale behind this belief is that as these countries continue to grow at faster rates than the U.S., there may be a bias for the currency to appreciate against the U.S. dollar. Eventually, as these countries transition from export-driven economies to more consumer-based ones, an appreciating currency will benefit as they import more products from abroad.

For investors seeking to increase their portfolio's yield and gain exposure to a depreciating U.S. dollar, we believe emerging market local debt could continue to be an attractive asset class in 2013.

[1]Bloomberg, December 31, 2012 [2]Bloomberg, January 31, 2013. [3]Credit ratings based on the highest rating of Standard & Poor's, Moody's and Fitch. [4]August 9, 2010. [5]WisdomTree, Bloomberg, 2012.

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DEFINITIONS

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

EM USD Sovereigns : Debt denominated in U.S. dollars issued by emerging market governments.

EM local currency debt : Debt denominated in the local currencies of emerging market governments.

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.

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.