HOW TO AVOID NEGATIVE FIXED INCOME RETURNS IN 2018

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02/07/2018

If fixed income strategists are right, investors' core fixed income portfolios could generate zero total returns in 2018. With median forecasts[1] calling for a rise in U.S. bond yields of approximately 50 basis points (bps), the resulting price loss of the Bloomberg Barclays U.S. Aggregate Index (Agg) would be approximately 3%. With yields on the Agg starting the year at 2.71%, price losses will more than fully offset income. In order to avoid the fate of the performance benchmark, we would advocate reducing interest rate risk, increasing credit risk or a combination of both.

Reducing Interest Rate Risk

The Federal Open Market Committee will likely hike interest rates three times in 2018. This need not necessarily lead to losses for bond holders, but any resurgence in inflation will. This logic stems from the fact that the Federal Reserve (Fed) can influence short-term interest rates, whereas the outlook for growth and inflation impact yields at the longer end of the curve. While much has been made about the implications of a flattening yield curve, one consequence is that investors receive only incrementally higher yields for extending maturity. Put another way, the implicit opportunity cost of reducing interest rate risk is diminished. In our view, one simple way for investors to potentially add value versus the Agg is to reduce interest rate risk by at least one year.

Accepting Credit Risk

Few can argue that U.S. investment-grade credit is "cheap," but we recently highlighted a few positive catalysts that could result from U.S. tax reform. The primary reason why we would advocate increasing exposure to credit risk at the expense of Treasuries is that this approach increases income opportunities. If we accept that rates will likely rise and that economic growth can continue, then increasing exposure to credit can boost returns. In our view, while 90 bps[2] over Treasuries is below historical averages, we see few reasons why credit spreads should meaningfully deteriorate in the medium term. As such, investors should accept the opportunities that the market is providing for the time being.

Combining Views into a Portfolio

While some investors may prefer to outsource decisions to an active manager, we believe a more intuitive approach to indexing can provide comparable benefits. When WisdomTree seeks to create a performance-driven Index, our goal is to incorporate investment intuition into the process. While performance benchmarks may provide reasonable approximations of the market, there is no guarantee that they will achieve the objectives of all investors. In the current environment, we would advocate reducing interest rate risk and increasing credit risk. Through our collaboration with Barclays, we helped create the Bloomberg Barclays U.S. Short Aggregate Enhanced Yield Index (Short Agg Enhanced Yield).

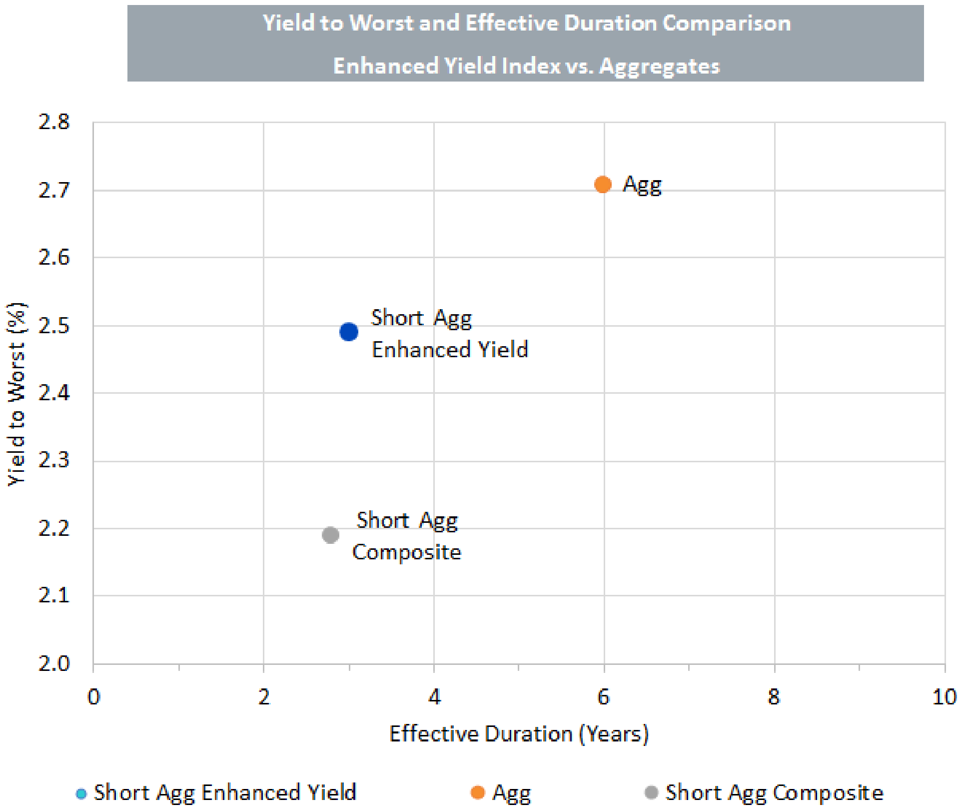
In this approach, we use the same investable universe as the Agg, but then we apply a series of constraints to meet our investment objectives.

Step 1: Limit eligible securities to between one and five years to maturity to limit interest rate risk.

Step 2: Divide the investable universe into 13 subcomponents across maturity, sector and credit quality.

Step 3: Maximize yield across each bucket while applying constraints to tracking error, duration, sector, credit quality and turnover

As the chart below shows, if investors seek only to reduce duration, it's going to reduce yield by over 50 bps (proxied by the Short Agg Composite). However, by boosting exposure to credit risk, the enhanced-yield strategy was able to add back about 30 bps of income. In this approach, the trade-off became a 20 bps sacrifice in yield while cutting interest rate risk in half.



Source: Bloomberg, as of 12/31/17. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the chart, please visit our glossary.

While strategist forecasts may inevitably evolve over the course of 2018, we believe investors should consider a variety of ways to boost income while reducing interest rate risk. By combining these two market views into a single strategy, we believe the WisdomT ree Barclays Yield Enhanced U.S. Short-Term Aggregate Bond Fund (SHAG) can serve as a powerful tool to efficiently bundle these exposures for investors.

[1]Source: Bloomberg, as of 1/16/18.

[2]As measured by the Bloomberg Barclays U.S. Credit Index, as of 12/31/17.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Fixed income investments are subject to interest rate risk; their value normally will decline as interest rates rise. 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. Investing in mortgage- and asset-backed securities involves interest rate, credit, valuation, extension and liquidity risks and the risk that payments on the underlying assets are delayed, prepaid, subordinated or defaulted on. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of SHAG please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/fixed-income/shag

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You cannot invest directly in an index.

DEFINITIONS

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.

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.

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

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

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

Inflation : Characterized by rising price levels.

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

Curve-flatten : a relative-value position that benefits if the spread between short and long maturity securities declines.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

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.

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

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

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.

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

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