ProShares®

STRATEGIES FOR A RISING RATE ENVIRONMENT

Capitalizing on Narrowing Credit Spreads

Investors are always looking for ways to improve the return profile of their holdings. One often overlooked way to profit from bonds is to capitalize on narrowing credit spreads. A credit spread is the difference between the yield on a corporate bond and the yield on a Treasury security of similar maturity. Corporate credit spreads typically narrow, or improve, as the economy grows and companies' financial health improves. This narrowing benefits corporate bonds, both investment grade and high yield. Credit conditions have improved considerably in the United States over the past few years, and many experts believe credit spreads will remain stable or become narrower as interest rates (i.e., Treasury yields) move to higher levels.

However, rising rates tend to hurt bond portfolios, because interest rates and bond prices move in opposite directions. To prepare their portfolios for rising rates, many investors have turned to bonds with shorter durations or floating rate bonds. But in doing so, they have given up much of the benefit of owning bonds with credit risk. Credit spreads are usually wider for bonds with longer durations, so moving to securities with little or no duration eliminates much of the potential reward coming from narrowing credit spreads.

An alternative approach—one that would allow you to benefit from narrowing credit spreads—would be to keep your exposure to longer duration investment grade or high yield bonds, and minimize the impact of rising rates by using a hedge against interest rate risk.

Credit Spreads Narrow in Periods of Rising Rates

Let's look at the past decade to see what happened to credit spreads when Treasury yields rose significantly.

The chart below shows the Treasury yields along with corporate investment grade and high yield credit spreads weekly starting in February 2004. As you can see, in the past 10 years, Treasury yields rose by more than 1% four times (highlighted areas), the most recent being May through December 2013. During each of these periods of rising yields, holders of both investment grade and high yield bonds were rewarded with narrowing credit spreads.

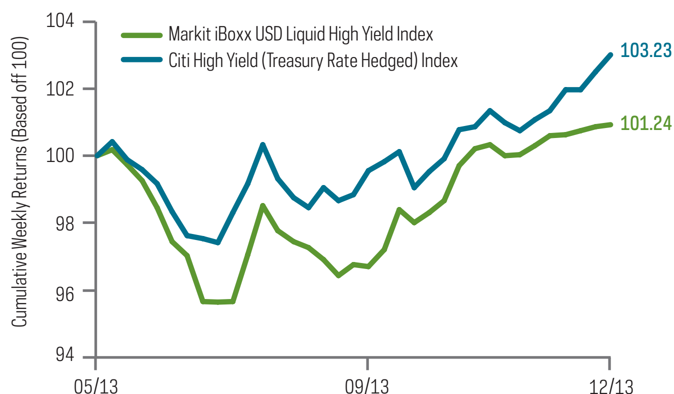
Source: Bloomberg, 2/2004–3/2015. Credit spreads are based on the Barclays U.S. Agg Corporate and Barclays U.S. High Yield Option-Adjusted Spread Indexes. The data shown represents the yield differential between the indexes and comparable maturity U.S. Treasury securities, adjusted for the effects of embedded options, a call feature in which the issuer retains the right to retire the debt, fully or partially, before the scheduled maturity date. Index returns are for illustrative purposes only and do not represent fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged, and one cannot invest in an index. **Past performance does not guarantee future results.**

How an Interest Rate Hedged Index Performed—One Example

Let's look at the most recent time period we just examined when Treasury yield rose—May through December 2013—to see how an index performed that isolates the credit spread by hedging out the interest rate risk. The chart below shows the performance of a hedged high yield benchmark against an unhedged high yield benchmark.

During the period, the Citi High Yield (Treasury Rate Hedged) Index returned 3.00% as Treasury yields rose and credit spreads narrowed. The Markit IBoxx USD Liquid High Yield Index returned just over 1%, and has a similar credit risk. This return difference of roughly 2% in an approximately eight-month period demonstrates the potential benefit of isolating credit risk exposure from interest rate risk exposure in a rising rate environment.

During a Rising Rate Environment, Narrowing Credit Spreads Helped Drive Hedged High Yield Higher



Source: Bloomberg, 5/3/2013-12/31/2013.

The takeaway

As you position your portfolio for rising rates, consider investments that not only reduce interest rate risk, but can also benefit from narrowing credit spreads. Many investors who move to short duration or floating rate bonds to flee interest rate exposure often sacrifice credit exposure that could be beneficial when rates rise. A potentially better way to reduce interest rate risk is to hedge. Investment grade and high yield ETFs that hedge interest rate risk can both mitigate the effect of rising rates, while also allowing you to benefit as credit spreads tighten.

Your bond portfolio. Prepared.

ProShares Interest Rate Hedged Bond ETFs offer diversified bond portfolios similar to unhedged bond funds. They include built-in hedges that use short Treasury futures to target a duration of zero, offering virtually no sensitivity to interest rates.

ProShares Investment Grade—Interest Rate Hedged

ProShares High Yield—Interest Rate Hedged

Find out more

Visit ProShares.com or consult your financial advisor.

Investing involves risk, including the possible loss of principal. These ProShares ETFs entail certain risks, which include the use of derivatives (futures contracts), imperfect benchmark correlation, leverage and market price variance, all of which can increase volatility and decrease performance. Bonds will generally decrease in value as interest rates rise. High yield bonds may involve greater levels of credit, liquidity and valuation risk than higher-rated instruments. Narrowly focused investments typically exhibit higher volatility. Please see summary and full prospectuses for a more complete description of risks. **There is no guarantee any ProShares ETF will achieve its investment objective**.

IGHG and HYHG do not attempt to mitigate factors other than rising Treasury interest rates that impact the price and yield of corporate bonds, such as changes to the market's perceived underlying credit risk of the corporate entity. IGHG and HYHG seek to hedge investment grade bonds and high yield bonds, respectively, against the negative impact of rising rates by taking short positions in Treasury futures. These positions lose value as Treasury prices increase. Investors may be better off in a long-only investment grade or high yield investment than investing in IGHG or HYHG when interest rates remain unchanged or fall, as hedging may limit potential gains or increase losses. No hedge is perfect. Because the duration hedge is reset on a monthly basis, interest rate risk can develop intra-month, and there is no guarantee the short positions will completely eliminate interest rate risk. Furthermore, while IGHG and HYHG seek to achieve an effective duration of zero, the hedges cannot fully account for changes in the shape of the Treasury interest rate (yield) curve. IGHG and HYHG may be more volatile than a long-only investment in investment grade or high yield bonds. Performance of IGHG and HYHG could be particularly poor if investment grade or high yield credit deteriorates at the same time that Treasury interest rates fall. There is no guarantee the fund will have positive returns.

Carefully consider the investment objectives, risks, charges and expenses of ProShares before investing. This and other information can be found in their summary and full prospectuses. Read them carefully before investing. Obtain them from your financial adviser or broker/dealer representative or visit ProShares.com.

"CITI" is a trademark and service mark of Citigroup Inc. or its affiliates, is used and registered throughout the world, and has been licensed for use by ProShares. ProShares ETFs based on the "Citi Corporate Investment Grade (Treasury Rate-Hedged) Index" or "Citi High Yield (Treasury Rate-Hedged) Index" are not sponsored, endorsed, sold, or promoted by Citigroup Index LLC ("Citi Index") or its affiliates (collectively, "Citigroup"), and they make no representation regarding the advisability of investing in ProShares ETFs. CITI INDEX MAKES NO EXPRESS OR IMPLIED WARRANTIES OF ANY KIND, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall Citigroup be liable for any direct, indirect, special or consequential damages in connection with any use of the "Citi Corporate Investment Grade (Treasury Rate-Hedged) Index." Or "Citi High Yield (Treasury Rate-Hedged) Index."

ProShares are distributed by SEI Investments Distribution Co., which is not affiliated with the funds' advisor. ©2015 PSA 2015-2268