FUNDAMENTAL CORPORATE BOND STRATEGIES: WHY WE TILT WEIGHTS TOWARD INCOME

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In our previous discussions about our approach to fixed income indexing, we focused primarily on the fundamental side of our research. By screening bonds based on select fundamental factors, it would have been possible to boost risk-adjusted returns. While we believe this to be significant, we also understand that many investors ultimately allocate to bond strategies for income. Therefore, even though expected total returns may appear compelling, tilting toward higher quality often involves a sacrifice in yield. In this discussion, we seek to acknowledge this potential challenge to indexing and explain our approach to overcome it. Figure 1 below illustrates the yield sacrifice that a quality approach to fixed income has encountered over time.[1] As expected, when we apply fundamental factors to remove lower-quality credits, we become more defensive and lower yielding. While the yield sacrifice for investment grade appears modest, the average level of spreads during this period (including the global financial crisis) is approximately 160 basis points (bps).[2] In the case of high yield, the reduction in yield can be meaningful. However, investors should recall that a quality approach to high yield boosted total returns by 130 bps per year despite the sacrifice in yield.[3]

Figure 1: Calendar-Year Yield Differentials (in basis points) [December 31, 2002 – December 31, 2016]

Yield Loss (in bp) Due to the Fundamental Cut Step													
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Investment Grade	-29	-18	-18	-9	-9	-10	-9	-4	-8	-14	-11	-12	-15
High Yield				-51	-82	-263	-334	-112	-128	-132	-93	-72	-129

Sources: WisdomTree, Merrill Lynch. Past performance is not indicative of future results. Investment grade and high yield proxied by the BofA Merrill Lynch U.S. Corporate Index and the U.S. High Yield Index, respectively. Data begins on 12/31/05 due to data availability for the high-yield strategy.

During a rally when spreads tighten aggressively, lower-quality bonds may generate significant outperformance, which a strict quality strategy may not capture. In order to overcome this potential shortfall, we describe our process to enhance the income profile of the strategy in the second step described below.

The Income Tilt: Balancing Quality With Value

To implement the income tilt, we first establish an income score for each bond. The income score calculates a bond's incremental income, as proxied by the option-adjusted spread, adjusted by multiple risk factors, including probability of default, interest rate risk[4] and potential recovery values. In this step of the process, we are seeking to enhance the incremental income of the strategy while continuing to control for risk. For investment-grade bonds, interest rate risk plays a critical role in generating returns. Because of this, the risk-adjusted income score seeks to control for the amount of interest rate risk. For high-yield bonds, the focus is on the credit risk and recovery value (in the case of default). At the end of the day, we don't necessarily want to own only bonds with seemingly attractive spreads. By qualifying spreads by the risks they entail, we are attempting to avoid investing in bonds that are trading cheap for a reason. Next, income scores of all the bonds are ranked against

sector peers to establish a percentile ranking from 0% to 100%. Top bonds are ranked closer to 100, average bonds near 50 and lower-scoring bonds near zero. Therefore, if we multiply the bonds' rank by 2, average bonds (50th percentile) receive no additional weight. Bonds with high income scores will receive a greater weight, and low-income-score bonds see their weight reduced[5]. Investors can think about this process as attempting to add incremental income via spread while qualifying that incremental spread to a unit of risk. Ultimately, the goal of this tilt is to increase the income return potential of the Index while retaining quality from the fundamental cut. Below, we show a hypothetical application of the income score adjustment process. **Figure 2: Hypothetical Income Score Application**

Index Constituent	Income Score	Rank vs. Peers	% Rank	Multiplier		Original MV		Tilted MV	Final Index Weight
Bond 1	200	1	100%	2	x	$1000M	=	$2,000M	20%
Bond 2	175	2	90%	1.8	x	$1,000M	=	$1,800M	18%
Bond 3	150	3	80%	1.6	x	$1000M	=	$1,600M	16%
...	...	...	...	...		...		...	...

Source: WisdomTree. Past performance is not indicative of future results.

Ultimately, our approach of tilting toward income seeks to close the deficit in yield by increasing weights to quality bonds in a thoughtful way. While quality will not always outperform, we believe that our fundamental approach to fixed income could add value over market cycles. By adjusting the final weights of the Index with a focus on risk-adjusted yield, we seek to bring the income characteristics of our approaches back in line with market-capitalization weighted strategies.

[1]Compared to the BofA Merrill Lynch U.S. Corporate Index and the BofA Merrill Lynch U.S. High Yield Index. [2]Source: BofA Merrill Lynch, as of 3/31/16. [3]Source: WisdomTree, as of 3/31/16. [4]An interest rate risk adjustment is applied to only investment-grade strategies due to the greater sensitivity of that market to changes in nominal interest rates. [5]The final Index weights are scaled proportionally to add up to 100%.

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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

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Risk-adjusted returns : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.

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.

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.

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

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Basis point : 1/100th of 1 percent.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Option-adjusted spread (OAS) : Represents a measure of income. Spread represents the portion of the bond's yield that compensates investors for taking credit risk. OAS adjusts the spread to take into account embedded options within the bond (if any).

Default Rates : the frequency in which borrowers fail to fulfill their contractual obligations.

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

Recovery rate : The percentage of principal and interest that is ultimately recovered in the event of bankruptc.

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

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

BofA Merrill Lynch U.S. Corporate Index : tracks the performance of U.S. dollar denominated investment grade corporate debt securities issued in the U.S.

BofA Merrill Lynch U.S. High Yield Index : tracks the performance of U.S. dollar denominated below investment grade corporate debt securities issued in the U.S.