

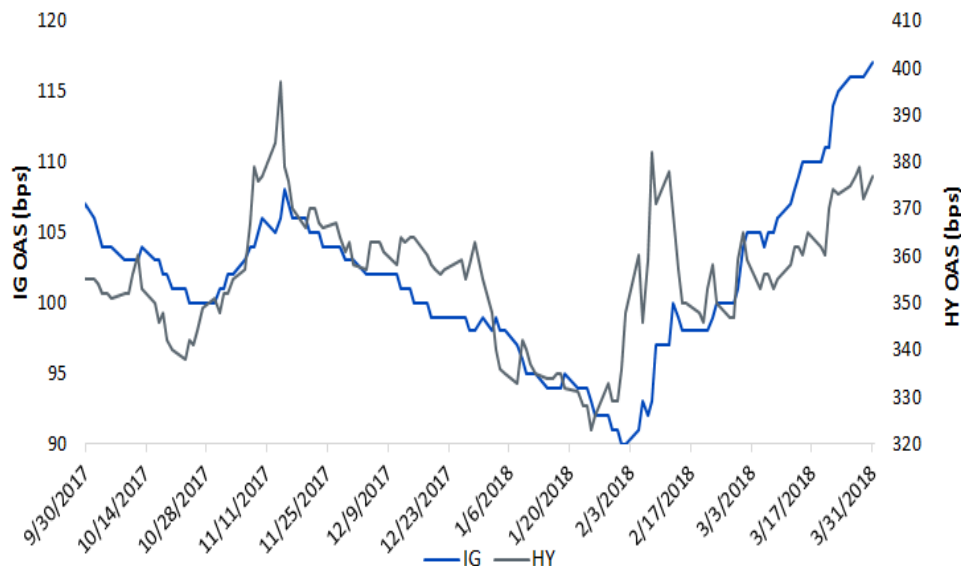
IF FOCUSING ON FUNDAMENTALS, BUY THE DIP IN IG CREDIT

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Over the last few weeks, several articles have been published about the implications of a widening in [investment-grade \(IG\) credit spreads](#). As we show below, this widening primarily has been driven by technical factors rather than [fundamentals](#). We believe now could be a particularly apt time to review the case for a fundamentally screened and income-tilted approach as the credit cycle matures.

After making fresh cycle lows in early February, IG credit¹ spreads have widened by approximately 24 [basis points \(bps\)](#) over the last two months. In our view, if this was the beginning of the end for this credit cycle, we would have expected to see this move confirmed by a similar shift in [high-yield \(HY\) credit² spreads](#). Over long periods of time, IG and HY credit spreads tend to have a fairly strong [correlation](#) because credit spreads serve as a barometer of risk. When the economy is healthy, corporate bonds pose less risk of being downgraded or falling into distress. When the credit cycle is turning, spreads widen as investors sell out of risky debt. Curiously, the most recent move appears to have affected IG more than HY.

U.S. IG and HY Option Adjusted Spread



Source: Bloomberg, as of 3/31/18. Past performance is not indicative of future results. OAS: option-adjusted spread.

Balancing Supply and Demand

While financial media seeks to explain why markets react a certain way each day, the

simple answer can largely be summed up by supply and demand. If the market goes up on a given day, there were likely more people looking to buy than sell. On days where prices fall, more people were looking to sell than buy.

In the case of IG fixed income, supply declined by 31% year-over-year in January.³ After touching some of the tightest levels since 2007, issuance started to ramp up in the first quarter (as it usually does). In February, supply ticked up 17% amid a general increase in macro [volatility](#). In March, CVS raised \$40 billion in new debt to finance its acquisition of Aetna, one of the biggest deals of last year.⁴ As supply continued to increase, investor appetite for new issues softened amid a general rise in yields. In fact, several companies issuing new debt over the past two months were forced to pay higher coupons to attract investors. With volatility picking up in other markets, softness in the market spread more broadly.

As tech firms right-size their financing mix after tax reform, it's likely that we'll see a general slowdown in bond issuance in the coming months. As a result, we would advocate buying the dip in the current market environment based on our view of fundamentals that we discuss below.

Contrasting Fundamentals

One of the key differences between WisdomTree's approach to constructing fixed income indexes and simply weighting by market cap is that we seek to incorporate company fundamentals into our screening and weighting methodology. Through our research, we found that by focusing on [free cash flow](#) over debt service, [leverage](#) and profitability, we could meaningfully improve the [risk-adjusted returns](#) in IG fixed income. Below, we contrast some key fundamental metrics between market cap-weighting and our fundamental approach.

[WisdomTree Fundamental U.S. Corporate Bond Index \(WFCIG\)](#) vs. [ICE BofAML US Corporate Index \(COA0\)](#)

Stats	WFCIG	COAO
YTW	3.73%	3.80%
Duration (Years)	6.98	7.18
Total Debt/EBITDA	2.57x	2.93x
Net Debt/EBITDA	1.91x	2.23x
Operating Margin	17.96%	15.18%
Interest Coverage	8.45x	6.13x
ROE	20.39%	15.57%
5Y Sales Growth	3.56%	2.76%
Earnings Margin	26.97%	25.09%
FCF/Debt	21%	15%

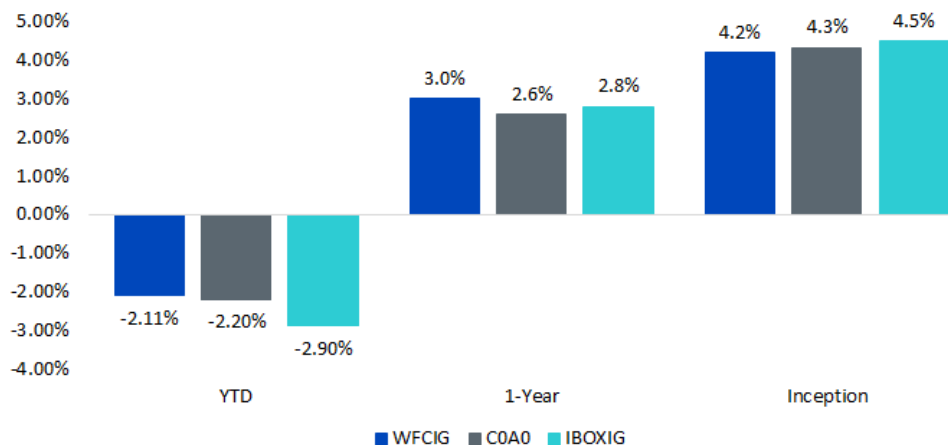
Source: FactSet, WisdomTree, as of 3/26/18. Past performance is not indicative of future results. You cannot invest directly in an index. Yield to Worst (YTW): the rate of return generated assuming a bond is redeemed by the issuer on the least desirable date for the investor. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Effective duration is a calculation used to approximate the actual, modified duration of a callable bond. It takes into account that future interest rate changes will affect the expected cash flows for a callable bond. Earnings before interest, taxes, depreciation and amortization (EBITDA). Total Debt/EBITDA is gross leverage and Net Debt/EBITDA is net leverage. Operating Margin is a measure of profitability calculated as operating earnings over revenue. Interest coverage is the percentage of earnings needed to service interest payments to lenders. ROE is return on common equity, a measure of quality. Earnings margin is how much of revenue is turned into earnings before paying interest payments on debt, amortization and depreciation expenses. FCF/Debt is free cash flow to the firm as a percentage of overall debt.

Concerns about the current fixed income market largely boil down to three factors: leverage, capital efficiency and free cash flow. As we show in the table above, WisdomTree's fundamental IG Index represents corporate bond issuers that are less dependent on leverage, that have higher margins, have much stronger [return on equity \(ROE\)](#) and generate higher free cash flow per unit of debt. Simply put, the companies represented in this Index are more-efficient and higher-quality companies. While WisdomTree believes owning quality late in the cycle makes sense, it's also interesting that the WFCIG net yield remains comparable to that of a general market cap-weighted approach, despite having modestly lower duration. In our view, if we're able to boost [quality](#), reduce [interest rate risk](#) and maintain attractive levels of income, the WFCIG approach should compare favorably over a market cycle versus a cap-weighted approach.

Translating Fundamentals into Performance

One of the key risks of simply owning a higher-quality bond portfolio is that you're likely to underperform because of lower yields. This is precisely why we sought to incorporate a second step to our process to boost yield after screening for fundamentals. As we show below, our fundamental IG approach has been able to provide comparable levels of return to larger competitors despite our bias to quality and lower-duration profile. Over the last year, U.S. interest rates have continued to rise as the [Federal Reserve \(Fed\)](#) sought to [normalize](#) policy. Year-to-date, we know that [nominal rates](#) have increased and credit spreads have widened. As a result, our quality approach has tended to outperform market cap as well as other longer duration indexes.

IG Fixed Income Returns, 2/29/16-3/31/18



Source: Bloomberg, as of 3/31/18. Markit iBoxx USD Liquid Investment Grade Index (IBOXIG) represents the returns of U.S. dollar-denominated, investment-grade corporate bonds. Returns of less than one year are cumulative. Past performance is not indicative of future results. You cannot invest directly in an index.

In our view, as investors consider which risks are worth taking in fixed income, we believe our lower-duration quality approach makes sense for the current environment. While we remain favorably disposed to U.S. corporate credit, we would advocate a bias to quality as we go later in the cycle. Given that our base case is for a continuation of the move higher in rates, maintaining a slightly defensive posture on interest rate risk makes sense in the current environment.

¹As proxied by the [ICE BofAML US Corporate Index \(COAO\)](#).

²As proxied by the [ICE BofAML US High Yield Index \(H0A0\)](#).

³Source: Citi, as of 3/6/18.

⁴As of 3/31/18, the WisdomTree Fundamental U.S. Corporate Bond Index (WFCIG) had a 1.22% and .42% exposure to CVS and Aetna, respectively. For current holdings of WFCIG, click [here](#).

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

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

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U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

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You cannot invest directly in an index.

DEFINITIONS

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

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

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

Basis point: 1/100th of 1 percent.

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

Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Volatility: A measure of the dispersion of actual returns around a particular average level.

Free Cash Flow: A measure of how much cash is left in the company after taking into account all the necessary expenses, including net capital expenditures.

Leverage: Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

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.

ICE BofAML US Corporate Index(COA0): The ICE BofAML US Corporate Index tracks the performance of the universe of US dollar denominated investment grade corporate debt publicly issued in the US market.

Return on Equity (ROE): Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Quality: Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

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

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

Normalization: The process by which a policy or action returns to its historically normal levels.

Nominal interest rate: Interest rate that does not account for the impact of inflation.

ICE BofAML US High Yield Index (H0A0): The ICE BofAML US High Yield Index tracks the performance of the universe of US dollar denominated below investment grade corporate debt publicly issued in the US market.