AVOIDING THE JUNKYARD

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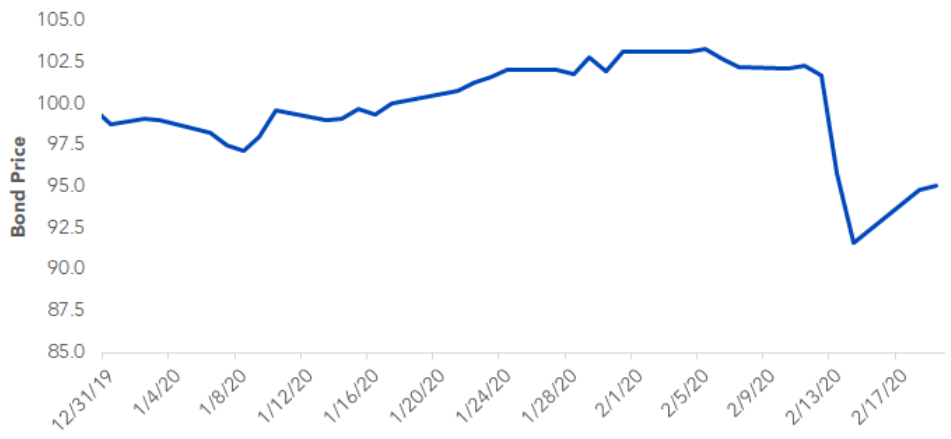
There's nothing like a Friday downgrade surprise from the ratings agencies. But what if there was a fixed income strategy that could potentially neutralize such news events while also avoiding the junkyard?

Let's take a look at the most recent case study: Joining a ratings action by Fitch on February 14, S&P also moved to downgrade Kraft Heinz Company's (KHC) long-term debt to high yield (HY), or junk status. With two out of three major rating agencies now in HY, KHC became the latest "big-name" credit issuer to gain attention for losing its investment grade (IG) status.

Needless to say, prices on Kraft's bonds sold off materially, in some cases more than 10%. Consider the price of the Kraft Heinz largest corporate bond (4 3/8% due 6/1/46), with an amount outstanding of $3 billion. After disappointing earnings and the downgrades by S&P and Fitch, the bonds fell from $101.75 on Wednesday, February 12, to $91.58 by end of day on Friday, February 14, a drop of 10.2 cents on the dollar. By Wednesday, February 19, the bonds have recovered by 3.47 cents on the dollar but still are significantly depressed.

Large KHC Bond Price (12/31/19–2/19/20)
KHC 4 3/8 6/1/46



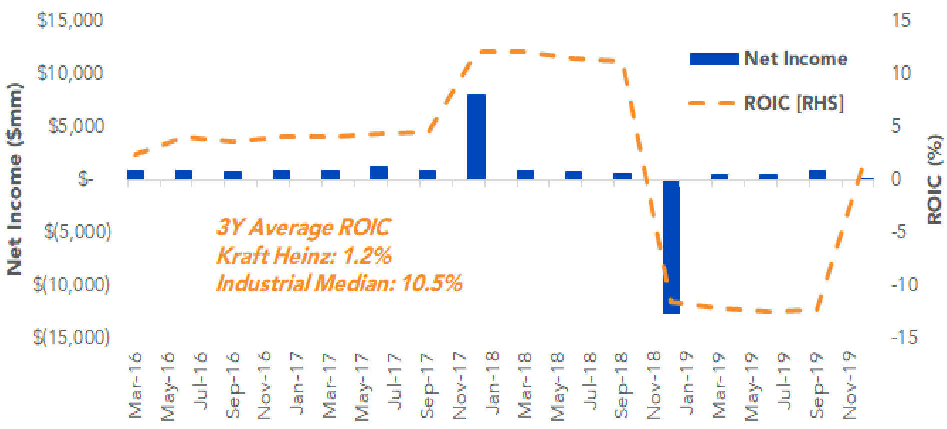
Source: Bloomberg, as of 2/19/20. Past performance is not indicative of future results.

In addition to prices falling because of investors reassessing the riskiness of Kraft's bonds, dropping from IG to non-IG status presents technical headwinds. There are many investment mandates that restrict a fixed income portfolio to only investment-grade securities, and after a downgrade to HY, there may be forced sales that drive prices down further.

WisdomTree believes that there are trends in corporate bond fundamentals that can be used to systematically identify problematic credits. Our WisdomTree Corporate Bond Indexes use three metrics to screen out bonds: return on invested capital (ROIC), total debt to total assets, and free cash flow to debt service. All three metrics screened poorly for Kraft Heinz, and the corporate bond for Kraft was subsequently excluded from the WisdomTree Corporate Bond Indexes.

One metric that stood out was ROIC, which deteriorated significantly over the past two years. The large drop in ROIC in Q4 2018 was due to a fall in net income, an input into the ROIC ratio. Kraft Heinz had a $16 billion goodwill and intangibles write-off. This one-time write-off occurred because management believed they were overvaluing their brands.

Kraft Heinz Quarterly Net Income and Return on Invested Capital



Source: Factset, as of 2/19/20. Past performance is not indicative of future results.

Conclusion

The bottom line is that this screening process enabled us to avoid having KHC in both of our strategies, the [WisdomTree U.S. Short-Term Corporate Bond Fund (SFIG)]() and the [Wisdom Tree U.S. Corporate Bond Fund (WFIG)](). That's what we call avoiding the junkyard…

Unless otherwise stated, all data sourced is Factset as of February 19, 2020.

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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.

Junk Bond : A high-yield or non-investment grade bond. Junk bonds are fixed-income instruments that carry a rating of 'BB' or lower by Standard & Poor's, or 'Ba' or below by Moody's. Junk bonds are so called because of their higher default risk in relation to investment-grade bonds.

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

Corporate Bonds : a debt security issued by a corporation.

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

Return on Invested Capital (ROIC) : Measures the efficiency of invested capital and how it relates to generated returns.

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.