HIGH-YIELD MARKET YAWNS AT DETERIORATION IN INVESTOR PROTECTION

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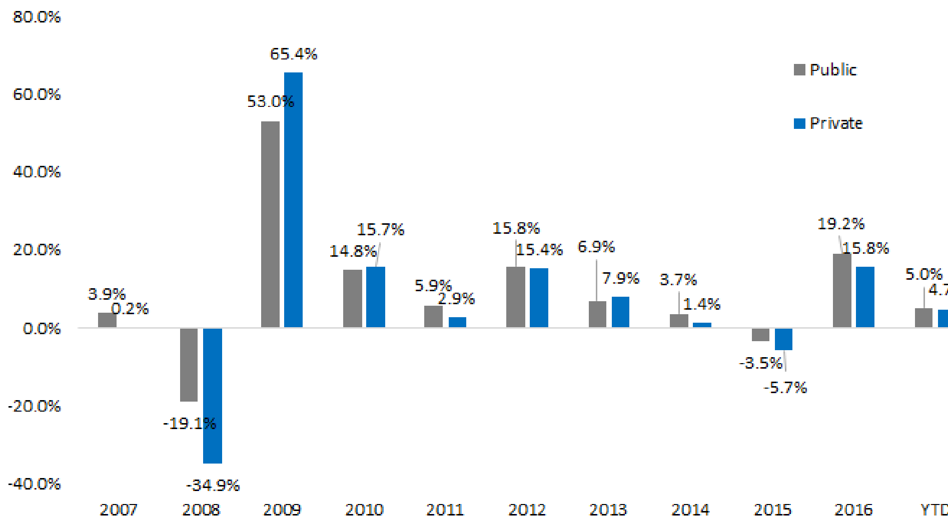
Over the past few weeks, the financial press has latched on to a report by Moody's Investor Service that notes the rise in so-called "covenant lite" bond deals.[1] The market's response? It doesn't seem to care, at least for now. Below, we highlight how this issue can affect investors and how WisdomTree sought to mitigate potential problems by eliminating private borrowers from our high-yield bond index construction process.

Covenant Lite

Compared to the equity market, which tends to have only a single share class, companies will generally issue several different bonds over time. In each new issue, the terms of the underwriting are negotiated. The current concern about the high-yield market is twofold. First, the cost of credit for many risky borrowers is near the lower end of the range in the current cycle. This is primarily a function of the economic environment: earnings are rising, the economy is expanding, and default rates remain below historical averages. But with borrowing costs already low, borrowers appear to have the upper hand. Instead of pressing for ever-lower borrowing costs, they're instead negotiating with lenders by reducing financial covenants that must be maintained as a condition of selling the debt. Greater financial flexibility for the company implies fewer safeguards for investors. The key question for today is: Will investors ultimately regret a lessening of standards?

In Moody's analysis, it appears that covenant lite deals seem to occur much more frequently among companies that are owned by private equity firms. From the private equity firms' perspective, if the cost of increased financial flexibility and fewer debt covenants is essentially free, why wouldn't they push for them? Unfortunately for investors, by defaulting to a market cap-weighted approach to owning high-yield bonds, approximately 20% of that market is made up of debt issued by private companies.[2] In our research, the debt of private companies has tended to underperform the debt of public companies by about 180 basis points (bps) per year.[3] Similarly, the volatility of issues with publicly traded equity is generally lower than with privately funded peers. Below, we expand further on the rationale for why the WisdomTree Fundamental U.S. High Yield Corporate Bond Indexes exclude private companies from their investable universe.

Public vs. Private High-Yield Issuers



Sources: Merrill Lynch, FactSet. Public returns represented by the BofA Merrill Lynch US High Yield Public Issuer Index and the BofA Merrill Lynch US High Yield Private Issuer Index, as of 6/30/17.

Allowing Fundamentals to Dictate Investment

WisdomTree's approach to the high-yield bond market differs from market cap in three distinct ways: we invest only in the debt of publicly traded companies, we invest only in businesses that generate positive free cash flow and we seek to overcome our quality bias by increasing exposure to bonds that provide favorable income characteristics relative to their fundamentals. While we believe that each factor can add value over time, focusing our investments in companies with publicly traded equity helps us mitigate a few key risks.

Primarily, companies that have publicly traded equity are under far greater scrutiny from investors, analysts and regulators than private companies. While many companies may believe public scrutiny to be burdensome, investors are ultimately better served when given their access to information in a transparent, standardized way. Similarly, publicly traded equity market prices also provide bond investors with an additional assessment of a firm's value or prospects. Although markets may not always be efficient, publicly traded prices generally should reflect the value of a company over the medium term. In both instances, access to information is key. Given that our approach relies on company fundamentals and underlying market prices, access to this information is paramount.

In closing, the current market environment appears to tilt in favor of borrowers rather than lenders. In such an environment, we believe a fundamental approach to the high-yield bond market could potentially avoid risks that may be starting to form under the surface. It may be possible that the current credit cycle could continue to expand, but we know that market excesses will ultimately be corrected. In our view, fundamentals can help protect investors from lending to firms where risk does not necessarily match reward.

[1]US High-Yield Bond Covenant Quality Plummets in June as High-Yield Lite Soars," Moody's Investor Service, 7/11/17.

[2]Sources: BofA Merrill Lynch, WisdomTree, as of 6/30/17.

[3]Source: BofA Merrill Lynch, 12/31/06–6/30/17.

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DEFINITIONS

Covenants : Agreements within financial securities that specify certain obligations that need to be met at distinct points in time.

High-yield Bonds : A high yield bond is a debt security issued by a corporation with a lower than investment grade rating. It is a major component of the leveraged finance market.

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.

Market capitalization-weighting : 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.

Basis point : 1/100th of 1 percent.

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.