# OUR FUNDAMENTAL APPROACH TO INVESTMENT GRADE CORPORATE CREDIT

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We believe it is counter-intuitive to construct portfolios based solely on the amount of debt a company has issued. In our view, creating an effective approach to indexing should be based on investment intuition. Additionally, we believe fundamentals can be an effective way to screen out potentially weaker credits. Below, we highlight the key findings of our research on fundamental analysis for U.S. investment-grade corporate credits (IG credit). Given that our Index methodology relies on the timely updating of audited financial statements, our investable universe is limited to bond issuers that also have a corresponding publicly traded equity. Over time, our research has shown that an equally weighted combination of three specific factors yields the most promising and intuitive results. The three fundamental factors we identified for our investment-grade Indexes are: **1. Free Cash Flow over Debt Service** Defined as the three-year annual weighted average of free cash flow over debt service, where debt service is calculated as short-term debt plus interest payments plus lease payments. **2. Leverage Ratio** Defined as the last four-quarter average of total debt over total assets. **3. Return on Invested Capital (ROIC)** Defined as the trailing three-year average of net income over shareholders' equity plus long-term debt. After we rank each issuer by each factor relative to its sector peers, we compute a composite factor score by averaging each company's ranks. In our view, constructing an optimal investment-grade portfolio is oftentimes more about avoiding mistakes than about unlocking deep value. In order to test this intuition, we separated the investable universe into five quintiles. As illustrated in the table below, bonds exhibiting the weakest fundamental scores were shown to have the lowest total returns and the highest levels of volatility. As a result, if our strategies could exclude the companies with less attractive fundamentals, we could potentially add value. Another interesting element of this table is that quintiles 1 through 4 did not show a meaningful difference in terms of returns or volatility. As we suspected, IG credit may be more about avoiding downgrades than about identifying upgrade candidates over market cycles. **RISK STATISTICS [December 31, 2002 – March 31, 2016]**

**Investment-Grade Credits: Fundamental Factor Score by Quintile Buckets**

| | Q1: Best Scores | Q2 | Q3 | Q4 | Q5: Worst Scores |
|---|---|---|---|---|---|
| Annualized Return | 5.7% | 5.4% | 5.6% | 5.7% | 4.9% |
| Annualized Volatility | 5.6% | 5.7% | 5.6% | 5.6% | 7.0% |
| Annualized Sharpe Ratio | 1.02 | 0.95 | 1.00 | 1.03 | 0.73 |
| Beta | 0.94 | 0.97 | 0.95 | 0.96 | 1.11 |

Sources: WisdomTree, FactSet. Past performance is not indicative of future results.

*For definitions of terms in the chart, visit our glossary.* In our view, screening by fundamentals is one way investors can inject investment intuition into their index construction process. While a quality portfolio may not outperform in all market environments, we believe corporate fundamentals may become increasingly important as the current seven-year expansion continues to mature.

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## DEFINITIONS

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

**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.

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