

SCREENING FOR BAD APPLES IN YOUR BOND BASKET

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The impact of COVID-19 reared its ugly head over the last couple of weeks in the U.S. corporate bond market. Certainly the twin effects of the virus and the plunge in crude oil prices resulted in [credit spreads](#) widening out in a rather visible fashion, especially in more recent trading sessions. With the markets sometimes fluctuating wildly on a daily basis, it is of little use to quote actual numbers (they get stale rather quickly). However, what has been underscored of late is that investors are encouraged to adopt a strategy that helps screen for [quality](#).

Here at WisdomTree, our approach emphasizes the potential to avoid “fallen angel candidates” ([investment-grade](#) issuers that are downgraded to [high yield](#)) by focusing on the fundamentals. The WisdomTree Issuer Fundamental Scores effectively quantify the [balance sheet](#) strength of corporate bond issuers. Without a strong balance sheet, companies may have difficulty servicing their debt and ultimately end up getting downgraded to junk status. We use three metrics to screen our universe of investment-grade corporate bonds: [free cash flow to debt service](#), [total debt to assets](#) and [return on invested capital](#). We remove those which screen poorly on these fundamentals.

Find below the issuers who scored worst using our fundamental scores within the Industrials sector, the most broad sector classification provided by Bloomberg Barclays, excluding Financial and Utility issuers.

Worst 10 Industrial Issuers by WisdomTree Corporate Fundamental Score as of 3/10/2020

Issuer	Industry	Industry	WisdomTree Issuer Fundamental Score	Free Cash Flow to Debt Service	Total Debt to Assets	Return on Invested Capital	Trailing 12M Equity Return	Index Eligible Debt (\$bn)
Autodesk Inc	BBB	Technology	-0.83	1.99	44.1%	-17.27	6.8%	1.7
Cheniere Energy	BBB	Energy	-0.69	0.29	89.9%	0.69	-41.7%	10.8
National Oilwell Varco	BBB	Energy	-0.55	2.26	20.9%	-13.33	-54.0%	2.0
Noble Energy Inc	BBB	Energy	-0.53	-1.42	34.8%	-4.27	-57.0%	5.5
General Electric Co	BBB	Industrial	-0.50	-0.03	35.7%	-4.85	-10.2%	32.7
TC PipeLines LP	BBB	Energy	-0.40	3.09	71.6%	2.54	4.3%	1.2
Apache Corp	BBB	Energy	-0.39	-0.25	39.8%	0.29	-65.8%	7.1
Ryder System Inc	BBB	Industrial	-0.38	-1.13	54.2%	5.37	-41.5%	4.8
Kinder Morgan Inc	BBB	Energy	-0.37	0.52	47.6%	1.58	-15.4%	25.1
Energy Transfer LP	BBB	Energy	-0.37	-0.02	52.1%	3.54	-45.0%	36.4
Industrial MEDIAN				1.79	33.6%	10.47		

Source: WisdomTree, FactSet as of 3/10/2020. WisdomTree Issuer Fundamental Scores are standardized values which aggregate three fundamentals used to evaluate each issuer's creditworthiness, specifically Free Cash Flow to Debt Service, Total Deb to Assets, and Return on Invested Capital.

In our last quarterly rebalance at the end of February, we identified a handful of relatively sizable issuers that scored poorly using issuer fundamentals: Cheniere Energy, General Electric, Kinder Morgan and Energy Transfer. Overall leverage levels for these companies are noticeably higher than comparable investment-grade issuers. Similarly, they also screen low for their ability to generate free cash flow relative to their debt service liabilities. Equity returns for these issuers over the past year are mixed, but we don't find it particularly surprising that many of them have sold off more

than 40%.

In an effort to address these concerns about issuer fundamentals, the [WisdomTree U.S. Corporate Bond Index \(WFCIG\)](#) was designed to provide an alternative to blindly allocating across the credit spectrum. It offers an intuitive approach, seeking to identify debt issues with quality fundamentals and attractive income profiles. The table below illustrates the construction of WFCIG, how the Index is impacted by removing the bottom 20% of issuers with poor fundamentals, and how we believe weighting bonds by our income score boosted the yield profile of the Index.

Bloomberg Corporate Bond Index		Universe of Public Issuers		Post Fundamental Cut		Post Income Tilt	
Characteristics		Characteristics		Characteristics		Characteristics	
Yield	2.60%	Yield	2.45%	Yield	2.33%	Yield	2.63%
Duration	8.2	Duration	8.4	Duration	8.5	Duration	8.7
# of Issues	6,334	# of Issues	5,045	# of Issues	3,312	# of Issues	3,278
# of Issuers	765	# of Issuers	551	# of Issuers	412	# of Issuers	409
Industry Breakdown		Industry Breakdown		Industry Breakdown		Industry Breakdown	
Communications	9%	Communications	8%	Communications	9%	Communications	11%
Consumer Discretionary	7%	Consumer Discretionary	6%	Consumer Discretionary	6%	Consumer Discretionary	6%
Consumer Staples	8%	Consumer Staples	10%	Consumer Staples	9%	Consumer Staples	9%
Energy	11%	Energy	8%	Energy	4%	Energy	6%
Financials	28%	Financials	26%	Financials	27%	Financials	28%
Health Care	11%	Health Care	11%	Health Care	10%	Health Care	10%
Industrials	7%	Industrials	9%	Industrials	9%	Industrials	9%
Materials	4%	Materials	3%	Materials	3%	Materials	3%
Technology	7%	Technology	9%	Technology	11%	Technology	9%
Utilities	9%	Utilities	10%	Utilities	10%	Utilities	9%

Source: WisdomTree, Bloomberg as of 3/10/2020. Past performance is not indicative of future results. You cannot invest directly in an index. Weights subject to change.

Conclusion

At the end of the day, we believe investors want their investment-grade portfolio to stay investment grade. The [WisdomTree U.S. Corporate Bond Fund \(WFIG\)](#), which is designed to track the aforementioned WFCIG, offers investors the potential to avoid the pitfalls of corporate bond investing that seem to be getting highlighted on a daily basis in the current environment.

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DEFINITIONS

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

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.

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

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

Balance sheet: refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new positions.

Free cash flow over debt service: A common measure of solvency that measures the relationship between the cash a company generates vs. what is required to meet their borrowing obligations.

Debt-to-Asset Ratio: a leverage ratio that defines the total amount of debt relative to assets.

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