TOP FIVE REASONS WHY INVESTORS SHOULD CONSIDER SMART BETA FIXED INCOME

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While smart beta has become prevalent for equity strategies, its application to fixed income is still more or less in its infancy. Over the next several weeks, we plan to highlight takeaways from our research behind the development of WisdomTree's fundamentally weighted fixed income Indexes. Let's state our primary conclusion upfront: **Not every company that issues a bond is worthy of your investment.** For the uninitiated, this sounds like common sense. For a legion of professional investors, owning the benchmark (no matter how ill conceived) is the bedrock of their investment process. In a market capitalization-weighted index such as the Barclays U.S. Aggregate Index (Agg), the more debt a borrower issues, the greater a share those bonds deserve in a portfolio. Below, we highlight the top five reasons why a different (i.e., fundamentally based) approach to indexing adds value. **#1: Traditional Benchmarks Are Issuer-Centric, Not Investor-Centric** Whereas market cap-weighted equity indexes represent the market's perception of a company's relative worth, market cap bond indexes are driven by a company's level of debt. The more debt a company issues, the greater its weight within an index. Unfortunately, increasing one's debt burden does not translate into increasing the returns to existing investors in a way that rising in prominence in an equity index might. But in a perverse twist, bond indexers actually reward this behavior in order to ensure that they mimic the benchmark. In our view, basing an investment strategy on this approach ultimately leads to a portfolio dictated more by issuance than intuition. Through our fundamental approach, we seek to delink the amount of debt outstanding from portfolio exposures. **#2: Market Cap Weighting Debt Implies Indifference to Valuations** If market cap weighting was the most efficient way to construct a portfolio, why don't investors hold securities in the same proportion across their equity and fixed income allocations? The simple answer is that certain sectors (such as Financials or Telecom) require greater amounts of debt to operate their businesses. As a result, the investable universe based on market cap can look vastly different between equity and fixed income. From the benchmark perspective, the more debt a company issues, the more an investor should be willing to invest. Unfortunately, this approach completely ignores the economic rationale or risk of such an investment. While all corporate bonds are subject to credit and interest rate risk, not all bonds will perform the same across market cycles. Without taking into account fundamentals, investors are creating allocations based solely on market presence as opposed to value. **#3: Beta Is Difficult to Define for Fixed Income** While many investors adopt the definition of beta as "the market," the concept of beta is more nuanced for fixed income investors because investability of individual issues cannot be taken for granted. This may be why many investors' portfolios remain tied to the whims of a commonly followed benchmark. However, each benchmark adheres to a variety of constraints, such as minimum or maximum credit rating, years to maturity, issuance size, country of domicile or risk, call type, coupon type, etc. While nearly all fixed income investors are familiar with the Agg, is this benchmark actually appropriate if your strategy only holds corporate bonds and no mortgages? Ultimately, benchmark selection, in our view, boils down to

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suitability and convenience. **#4: High-Yield (HY) Index Returns Are Currently Dominated by Commodity Sectors** Market cap weighting all but guarantees an average portfolio. During risk-on environments, a rising tide has the potential to lift all boats. However, we would strongly advocate against this approach in the high-yield market. While high-yield credit spreads have fallen dramatically from their February wide levels—from 839 basis points (bps) to under 600 bps—savvy investors need to understand what drove that move.[1] HY energy credit spreads declined from 1778 bps to 856 bps! Given the Energy sector's 14% weight in some indexes,[2] **this move of 922 bps in spreads explains more than 50% of the move for the index!** In other words, over the last 18 months, the returns of the HY Energy sector have had undue influence on the returns of the asset class. While some investors may be comfortable calling a bottom in energy prices, expressing this view via a passive bond strategy seems ill advised. Regardless, asset allocators may be unaware of the risks they are taking. In our view, allocating a meaningful percentage of a portfolio to a sector that poses serious credit uncertainty simply because that sector has issued a large amount of debt is dangerous. **#5: Fundamentals Matter after Periods of Expansion** How well are the companies doing in your investment-grade bond portfolio? In all honesty, many investors simply rely on credit ratings agencies to determine whether a security is suitable for their portfolio. This may be acceptable in the initial stages of an expansion when there is a lot of low-hanging fruit, but we are currently seven-plus years into the current expansion. While we still believe the credit cycle has room to run, opportunities may be more varied. In short, fundamentals matter. As a result, our Indexes currently only invest in companies that also have publicly traded equity. Therefore, we receive quarterly updates on the financial health of the companies we analyze to construct our portfolios. In upcoming blog posts we intend to discuss our research that shows that weighting by fundamentals has the ability to potentially boost returns and lower risk relative to market cap.

[1]Source: Barclays, as of 5/12/16. [2]Barclays U.S. High Yield Index.

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DEFINITIONS

Smart Beta : A term for rules-based investment strategies that don’t use conventional market-cap weightings.

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.

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

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.

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

Coupon : The annual interest rate stated on a bond when it’s issued. The coupon is typically paid semiannually. This is also referred to as the “coupon rate” or “coupon percent rate.&rdquo.

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

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

Basis point : 1/100th of 1 percent.

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

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor’s, Moody’s or Fitch.

credit cycle : the process in which the pricing of and access to credit evolves over time.

Barclays U.S. Corporate High Yield Index : Covers the universe of fixed-rate, non-investment-grade corporate debt.