
GIVING CREDIT WHERE CREDIT IS DUE

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When [volatility](#) returned with a vengeance in 2018, few markets or asset classes were spared. As asset prices declined, investors have started to question if this is a momentary blip or the start of a larger move. Below, we discuss what recent moves have meant for U.S. [high-yield \(HY\) bonds](#) and why our [fundamental](#) approach to credit has outperformed all other credit exchange-traded funds (ETFs) and an overwhelming majority of [active managers](#).

Thoughts on Macro

The [Federal Reserve](#), while projecting more [dovish](#) comments and “data dependency” assurances of late, is still forecasting at least two more [rate hikes](#) for this year. To us, this indicates strong fundamental underpinnings in the economy. In fact, the U.S. saw wage growth hit a nine-year high, according to the Labor Department’s report in November. In our view, corporate and economic data continues to be strong while inflation remains low.

So, where are we? Is this the end of the cycle as we know it? Is there more pain for the markets ahead? Or is it all noise, and the recent downturns in the market are merely buying opportunities?

The truth is, no one can really know for certain what path we are heading down. What has become clear, though, is that volatility due to uncertainty seems to be the status quo moving forward. In our view, investors need to think smarter about where and how they’re allocating, particularly in credit.

U.S. High-Yield Credit

At the beginning of 2018, HY corporate bonds were considered to be a very attractive asset class, with high levels of income and companies ready to benefit from continued market and economic growth. However, as we came to learn, simply owning the market was not enough.

The HY corporate market, as represented by the [Bloomberg Barclays U.S. Corporate High-Yield Index](#), experienced a bit of a whipsaw effect last year. The market saw positive, albeit modest, gains through the first three quarters of last year, as spreads remained low to flat. However, the fourth quarter saw a drop-off across all classes, and market performance took a significant hit, ending the year in negative territory.

Additionally, with an average duration throughout the year of about four years,¹ higher

nominal [interest rates](#) eroded away total returns. By allocating to the “shorter” maturing bonds within the high-yield corporate market, as represented by the [BoFA Merrill Lynch 0--5 Year US High Yield Index](#), this simple adjustment helped boost returns by 2.03%. However, this was not enough to avoid negative total returns for the year. In order to do that, investors needed to focus on fundamentals.

WisdomTree’s Approach to HY

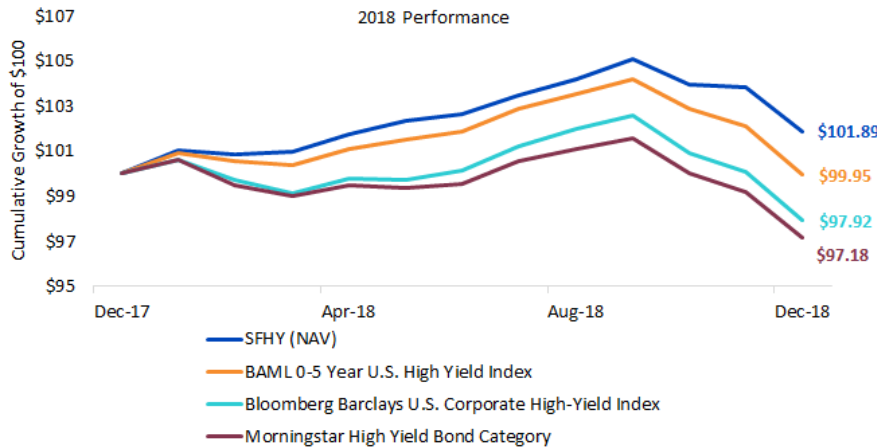
We continue to advocate for a more intuitive way of accessing the market. By screening based on issuer fundamentals, our approach to credit can effectively target bonds that exhibit favorable fundamentals while presenting opportunities for income and screen out those that don’t. WisdomTree has helped pioneer this market by creating an entire suite of fundamentally weighted corporate bond ETFs. One fund in the suite that we are very excited about moving forward is the [WisdomTree Fundamental U.S. Short-Term High Yield Corporate Bond Fund \(SFHY\)](#).

SFHY’s underlying Index, the [WisdomTree Fundamental U.S. Short-term High Yield Corporate Bond Index](#), employs a multistep process: it screens on fundamentals to identify bonds with maturities between one and five years and with favorable characteristics, and then tilts to those that offer attractive income characteristics. Key to this process is the exclusion of issues with a negative free cash flow.

This methodology has avoided many of the defaults that occurred in the market in 2018. As a percentage of par, 1.46% of the overall HY market was affected by defaults, whereas only 0.04% was affected in SFHY.

Figure 1: Performance & Ranks for SFHY

Performance & Ranks as of 12/31/18	2018	Since Inception (4/27/16)
SFHY NAV Performance	1.89%	4.60%
vs. All Credit ETFs (Median)	-1.12%	1.76%
Ranking	1 of 109	15 of 79
Percentile	1st	19th
vs. Morningstar High Yield Bond Category (Median)	-2.92%	4.12%
Ranking	8 of 697	224 of 613
Percentile	2nd	36th



Sources: WisdomTree, Zephyr StyleADVISOR, Morningstar, Bloomberg, BofA Merrill Lynch, 12/31/17-12/31/18.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total Returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

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Please click [here](#) for standardized performance and [here](#) for month end performance of SFHY.

For definitions of terms in the chart, please visit our [glossary](#).

Going back to our prior example, figure 1 illustrates how screening for fundamentals provided excess levels of returns in 2018. SFHY (on a NAV total return basis) had outperformance of 397 **basis points (bps)** over the HY corporate market and 194 bps over the short-term market. Additionally, SFHY exhibited lower levels of volatility in an otherwise volatile year: 3.05% versus 3.33% versus 3.56%, respectively.²

Figure 2: Average Yields and Durations in 2018 for SFHY vs. HY Markets

2018 Statistics, as of 12/31/18	Average 2018 Yield	Average 2018 Duration (years)
SFHY	5.63%	2.08
BofA Merrill Lynch 0-5 Year US High Yield Index	6.47%	2.42
Bloomberg Barclays U.S. Corporate High-Yield Index	6.40%	3.92

Sources: WisdomTree, Bloomberg, BofA Merrill Lynch, as of 12/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Some may say, “By screening out the negative cash flow bonds, aren’t you potentially sacrificing on yield since these risks are already priced into the market? wouldn’t something like this lag in performance?”

While this may feel like a satisfying soundbite, that wasn’t necessarily the case. In fact, SFHY was the **#1 performing credit ETF for 2018**³. Furthermore, it ranked in the second percentile among all mutual funds and ETFs in the Morningstar High Yield Bond category for 2018.⁴ Clearly, our rules-based approach was not simply priced into the market.

HY in 2019

Through all of our discussions with investors, we continue to encourage people to think about how they are allocating via models and portfolios. While we do not believe that 2019 will represent the end of the current cycle, we do believe investors should start focusing more on fundamentals. In our view, this approach can help investors capture higher levels of returns than less risky assets but allows them to avoid some of the potential pitfalls in the market before they occur. As volatility continues to increase in markets, a fundamental approach could help investors navigate a more dynamic credit environment.

¹Source: Bloomberg, as of 12/31/18.

²Source: WisdomTree, Bloomberg, BofA Merrill Lynch, Zephyr StyleADVISOR, as of 12/31/18.

³Source: Bloomberg, as of 12/31/18. There were 109 Corporate Bond ETFs in 2018.

⁴Source: Morningstar, as of 12/31/18. There were 697 funds in the High Yield Bond category for 2018.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer’s ability to make such payments will cause the price of that bond to decline. While the Fund attempts to limit credit and counterparty exposure, the value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund’s portfolio investments. Please read the Fund’s prospectus for specific details regarding the Fund’s risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

view the online version of this article [here](#).

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DEFINITIONS

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

High Yield Corporate (Bond): a type of corporate bond that offers a higher rate of interest because of its higher risk of default.

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

Active manager: Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Dovish: Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Rate Hike: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

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

Interest rates: The rate at which interest is paid by a borrower for the use of money.

BofA Merrill Lynch 0-5 Year US High Yield Constrained Index: tracks the performance of short-term US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

Basis point: 1/100th of 1 percent.