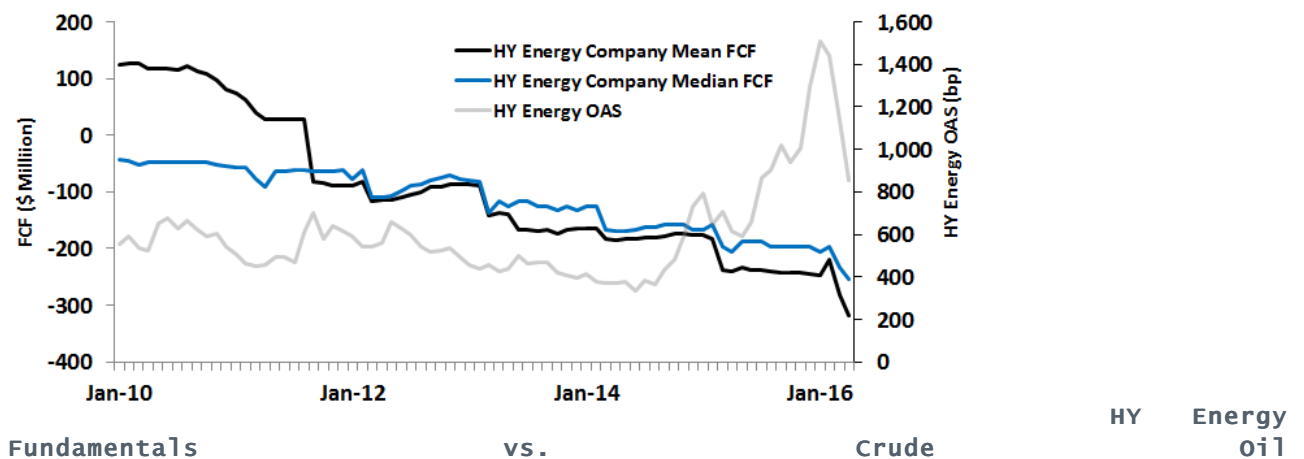
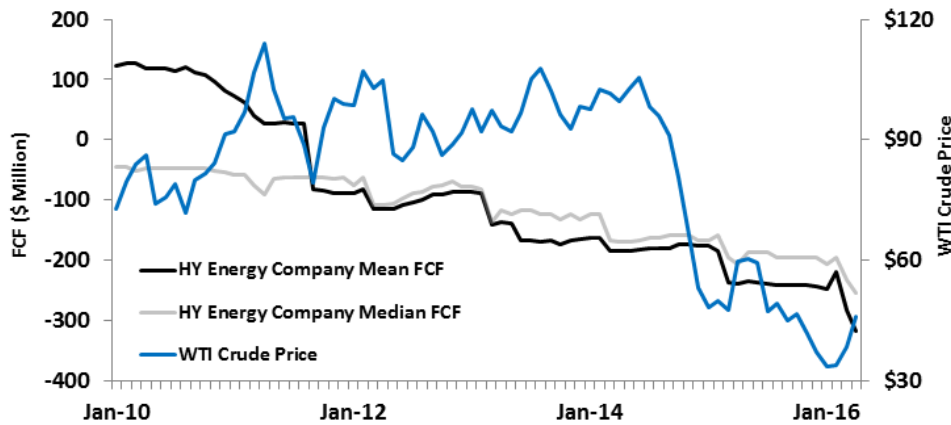


# WHY OUR HIGH YIELD INDEX IS UNDER WEIGHT ENERGY CREDITS

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05/31/2016

At the end of February, WisdomTree launched a suite of [fundamentally](#) weighted fixed income Indexes. Over the course of our research on the [high-yield \(HY\)](#) bond market, we found that [free cash flow \(FCF\)](#) was among the most significant predictors of future [credit ratings](#) downgrades or companies falling into financial distress. As a result, our Indexes include only bonds from companies with positive FCF over the previous five years (on average). During the course of our conversations about the strategies, one of the most frequent questions we've received is how our methodology has reacted to the swoon in energy credit fundamentals. As of April 29, 2016, the [WisdomTree Fundamental U.S. High Yield Corporate Bond Index](#) had a 2% weight to high-yield energy credit. This represents the most significant under-weight (11%) compared to a [market cap-weighted](#) benchmark.<sup>1</sup> Below, we examine the trends in issuer fundamentals in the Energy sector against [credit spreads](#)<sup>2</sup> and movements in the price of oil. In our view, blindly allocating to many of these credits via a market capitalization-based approach could lead to dramatic underperformance, should oil prices fail to stabilize above \$50-\$55. **Even at Higher Oil Prices, Energy Fundamentals Were Declining** In the top panel below, we highlight the trend in FCF for the sector average and median on the left axis. This shows that even during periods of higher energy prices, there was a downward trend in FCF. While the operating cash flow side of the equation was reasonable, many energy firms were continuing to increase borrowing to reinvest in their businesses via new [capital expenditure](#). Additionally, credit markets through early 2014 were comfortable lending to borrowers at around +400 [basis points \(bps\)](#) over [U.S. Treasuries](#) (right axis). However, this dynamic began to change in 2014 when we saw borrowing costs double over the course of a few months (from 400 bps to 800 bps).<sup>3</sup> Shortly after, we also saw a meaningful acceleration in the deterioration of HY energy fundamentals. With oil prices continuing to decline, credit spreads continued to widen, peaking at over 1600 bps in February 2016. **Energy Sector Fundamentals, 12/31/09-4/29/16**





Sources: FactSet, Bloomberg, as of 4/29/16.

In the bottom panel, we also show the relationship between energy FCF and oil prices. While there does appear to be a modest [correlation](#), the price of oil impacts the various subsectors of the energy market differently. Companies associated with oil exploration are impacted much more significantly than businesses further downstream. However, the dramatic decline in the price of oil in early 2014 had a massive impact on borrowing costs for high-yield energy companies. While technical definitions for financial distress may vary, many market participants acknowledge that credit spreads in excess of 1000 bps generally imply distress. The recent recovery in oil from \$30 to \$48 has generated a massive reversal in high-yield energy credits, pushing spreads below distressed levels. Given the lag between fundamentals and changes in the price of oil, the magnitude of the rally could overstate the underlying improvement in energy credit. With the solvency of some businesses dependent on further extension of the rally in energy commodities, we don't feel comfortable making such a binary bet. Instead, if one wants to bet on an oil rally, betting on oil directly is a far simpler approach. While the trend in energy prices will continue to have a significant impact on high-yield energy credit total returns, we continue to believe that the trend in fundamentals can have a meaningful impact on potentially reducing risk and boosting total returns. While a quality approach may not outperform all the time, we believe the current market environment in energy credit continues to warrant caution. As a result, we do not believe market cap-based strategies with significant exposures to high-yield energy provide enough compensation, given the risks currently facing the market. <sup>1</sup>As represented by the [The BofA Merrill Lynch US High Yield Index](#). <sup>2</sup>As measured by [Option-adjusted spread \(OAS\)](#). <sup>3</sup>As represented by the [Barclays U.S. High Yield Energy Index](#).

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.

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## DEFINITIONS

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

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

**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.

**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.

**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.

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

**Capital expenditures**: Spending by a company typically made to enhance longer-term productive capacity.

**Basis point**: 1/100th of 1 percent.

**Treasury**: Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

**Correlation**: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

**The BofA Merrill Lynch US High Yield Index**: tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of \$100 million.

**Option-adjusted spread (OAS)**: Represents a measure of income. Spread represents the portion of the bond's yield that compensates investors for taking credit risk. OAS adjusts the spread to take into account embedded options within the bond (if any).

**Barclays U.S. High Yield Energy Index**: Represents the energy sector component of the Barclays U.S. Corporate High-Yield Index which measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.