FIXED INCOME SMART BETA: AN EVOLUTIONARY TALE

Kevin Flanagan – Head of Fixed Income Strategy
07/19/2017

While it has not been completely "stealth-like" in nature, the evolution of the fixed income market over the last couple of years seems to have gone at least a little bit under the radar. Indeed, the emergence of what is called "smart beta" in the equity arena has certainly garnered its share of headlines, but this movement in fixed income is just gaining momentum and promises to be the next step in the evolution of solutions for bond market investing.

In broader terms, fixed income smart beta strategies seek to address—perhaps correct is the better term—the counterintuitive features that are a hallmark of market cap-based investing. WisdomTree has been at the forefront of smart beta for some time and has applied this methodology in the fixed income universe utilizing two distinct approaches: yield-enhanced core strategies and fundamental corporate strategies. Let's think of them as Smart Beta v. 1.0 and Smart Beta v. 2.0, respectively.

Highlighting WisdomTree Fixed Income Smart Beta Solutions

Smart Beta v. 1.0	Smart Beta v. 2.0
• Benchmark Aware: Tilting from an index to improve risk/return within targeted levels of relative risk. • Macro-based strategies • **EXAMPLE: Yield-Enhanced Core Strategies** –Exploit income and diversification opportunities –Mitigate redundancy –Maintain risk	• Benchmark-Agnostic: The investment universe is simply a starting point. • Strategies with a micro-level and security-level focus • **EXAMPLE: Fundamental Corporate Strategies** *Screen for Quality and Tilt for Income* –Avoiding the lowest quality issuers –Assessing return and income opportunities among stronger fundamental bonds –Boost potential return and lower risk
Yield-Enhanced U.S. Aggregate Strategy ***Yield-Enhanced Short-term U.S. Aggregate Strategy***	***U.S. Fundamental Corporate Bond Strategy*** ***U.S. Short-term Fundamental Corporate Bond Strategy*** ***U.S. Fundamental High Yield Strategy*** ***U.S. Short-term Fundamental High Yield Strategy***

Source: WisdomTree, as of 7/17/17.

The inherent flaws in the market cap-based approach to fixed income were fully evident in the realities and reaction to the financial crisis and Great Recession of 2007–2009 and highlight the need for an alternate or improved approach. Specifically, aggressive central bank policies, such as quantitative easing (QE), along with subpar growth and a lack of inflation, all served to push yield levels to historically low readings, where they continue to reside. As a result, low-yielding government bonds have risen to visibly over-weight positions in global bond indexes, subjecting fixed income investors to sacrificing income and heightened interest rate risk at the same time. The search for income in this yield-starved environment can lead to a riskier approach: moving out on the maturity curve (duration risk) and/or going down in credit quality (credit risk).

The WisdomTree yield-enhanced, or Smart Beta 1.0, rules-based strategy is more macro based in nature and focuses on core investing. It reweights the sectors of an existing index in order to boost income potential while maintaining a familiar risk profile. It generates over-weights to investment-grade credit and under-weights Treasuries, and it also comes in a "short-term" version for investors who wish to mitigate the potential for higher rates.

The WisdomTree fundamental corporate, or Smart Beta 2.0, rules-based approach has more of a micro and security-level focus. The first part of the process defines the universe, employing a stringent issue- size criterion and including only public issuers domiciled in the U.S. The emphasis then shifts to the balance sheet, where factors that have worked consistently over time, such as free cash flow over debt service, leverage ratio and return on invested capital, are used to screen for quality. The process then tilts the weighting toward bonds with more favorable income characteristics.

Conclusion

The landscape for fixed income investing in the U.S. promises to remain a challenging one as we look ahead. The prospects for rates remaining relatively low, the Federal Rese rve (Fed) beginning to normalize policy and uncertainty in the fiscal policy outlook all combine to create an environment in which bond investors will no doubt be searching for "smarter" fixed income solutions.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. 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.

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.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

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

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Inflation : Characterized by rising price levels.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Government bonds : A debt securities issued by a government to support fiscal spending.

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Micro : Focused on issues impacting individual companies as opposed to those impacting the broader economic landscape.

Securitized : a debt security whose value is backed by an asset or pool of assets such as a mortgage.

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 tim.

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

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.