

WHAT TESLA CAN TEACH US ABOUT THE HIGH-YIELD BOND MARKET

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Tesla may be a great company that builds exciting cars, but we wonder if investors are being compensated enough to lend Tesla money. Given its current state of production, Tesla burns mountains of cash and has routinely undershot guidance on delivering cars to eager customers. As a result, [free cash flow](#) has been negative since the inception of the business. When companies eventually run out of cash due to persistent negative free cash flow, they have only a limited set of options to avoid distress: sell something (new equity, assets or presale of vehicles) or borrow more money (via loans, term debt, [revolvers](#)).

When WisdomTree created our fundamental [high-yield \(HY\) bond](#) Indexes¹, we sought to focus on free cash flow as the primary determinant to avoid the pitfalls of [market cap weighting](#). Interestingly, these Indexes avoid Tesla given its persistent negative free cash flows. We examine the characteristics of Tesla's bonds compared to broad high-yield bond indexes² and then highlight why, at this stage of the [credit cycle](#), it makes sense to favor a fundamental discipline like the one WisdomTree developed.

Fixed Income Characteristics & Fundamentals

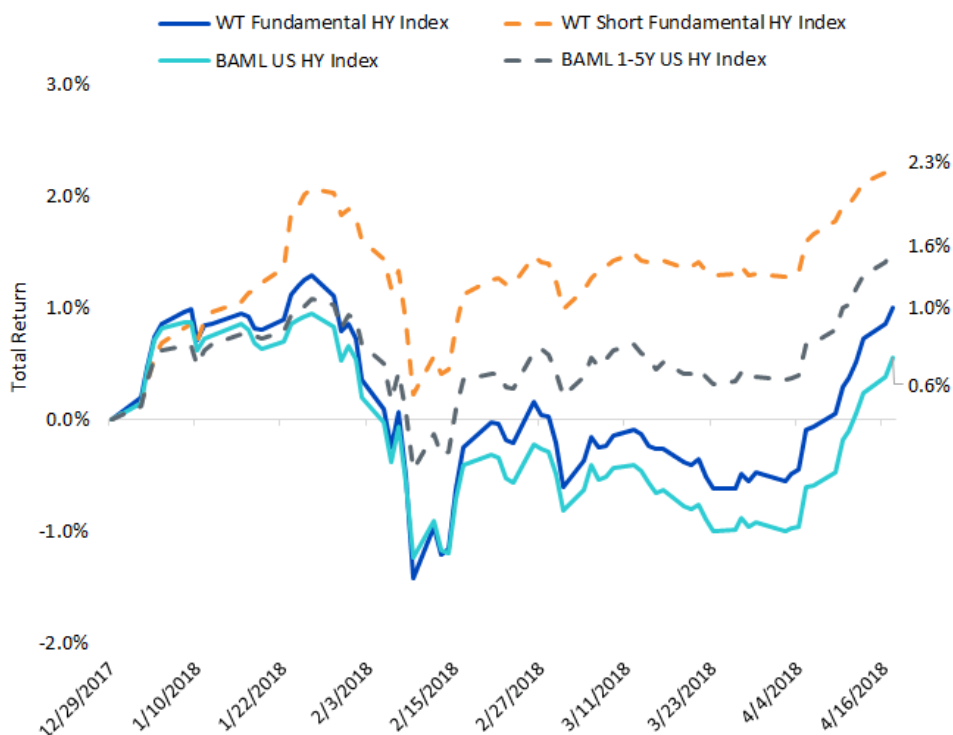
Statistics	BAML HY	WT Fundamental HY	BAML 1-5 Y HY	WT Fundamental Short-Term HY	Tesla 5.3% 8/15/25
Yield	6.15	6.16	6.02	6.40	7.15
Duration	3.94	3.79	2.27	2.24	5.81
OAS	323	324	313	375	424
Solvency (5Y FCF / Debt)	4.2%	6.2%	2.8%	6.7%	-15.8%
Interest Coverage	3.99	3.99	3.80	3.44	0.02
Net Leverage	4.24	4.43	4.54	4.91	1747.98
EBITDA Margin	22%	22%	20%	20%	3.0%

Sources: BAML, WisdomTree, Bloomberg, as of 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Each of the WisdomTree strategies has a significant premium over market cap for our measure of solvency, five-year free cash flow over debt, and maintains attractive yields. Our short-term strategy is yielding 35 [basis points \(bps\)](#) more than the respective market cap index.

Tesla has a bond maturing in August 2025, with a yield of 7.15% and a duration of 5.81. The yield compensation in Tesla's bond is not currently pricing too dire an economic situation for Tesla. While Tesla may ultimately turn things around, it will not qualify for inclusion in our fundamental fixed income Indexes unless its free cash flow situation improves markedly. When compared to the broader high-yield bond market, we believe increasing [quality](#) at this point in the credit cycle could be prudent.

YTD Cumulative Returns for HY Indexes



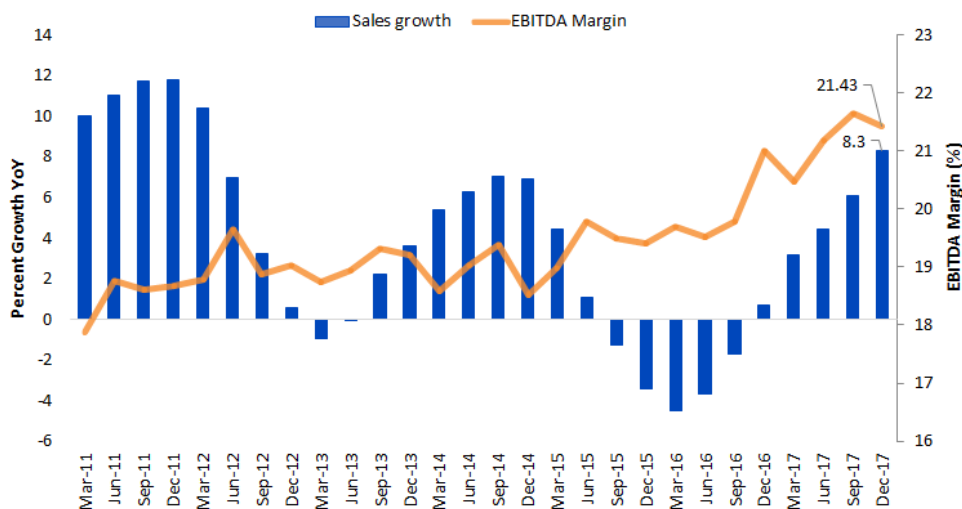
Source: Bloomberg, as of 4/16/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Seventh-Inning Stretch in Credit Cycle

To borrow a baseball analogy, we're not in the late innings of the credit cycle, but we may be nearing the seventh-inning stretch. While many investors fret about the length of the current cycle/market expansion, we continue to remind them that [bull](#) markets seldom die of old age. Eventually, economic forces catch up to them. As a result, we believe we may be starting to see a divergence in market returns between the broader market and fundamentally weighted strategies.

In the chart above, we highlight the YTD returns of our short-maturity high-yield Index along with our intermediate-maturity strategy versus market cap-weighted indexes. As you can see, shorter-maturity indexes have outperformed because of higher nominal interest rates. What is also interesting is that we're starting to see a divergence between the market and fundamentals. The [WT Fundamental High Yield Index](#) has outperformed the [BAML US High Yield Index](#) by 40 bps, and the WT Short Fundamental HY Index has outperformed the [BAML 1-5Y US HY Index](#) by 70 bps. While some may see this warning as a good reason to reduce exposure to high yield, if you sell too early, you may leave a significant amount of returns on the table, particularly as we believe that the underlying trends in the economy and corporate earnings remain robust. Moody's baseline forecast for 2018's U.S. HY trailing 12-month [default rate](#) is only 2.4%.³ The glue that holds it together is that high-yield corporate borrowers are, for the most part, fundamentally sound.

Growth In Revenue and Profitability for HY Issuers



Source: WisdomTree, as of 12/31/17. Past performance is not indicative of future results.

An important part of the high-yield market's strong performance in 2017 was in part due to corporate tax cuts and expectations that corporate earnings would improve. In aggregate, HY issues have not disappointed. Throughout 2017, sales growth YoY trended higher, as depicted in the chart above, and HY issuers reported an average 8% YoY sales growth in Q4 2017.⁴ As earnings growth and profitability have remained robust for most borrowers, credit conditions have generally remained favorable.

However, as we've seen in recent months, the market for [credit risk](#) can experience periods of volatility just like the equity market. WisdomTree believes that our fundamental approach can provide attractive levels of income while investing in higher-quality businesses.

¹The [WisdomTree Fundamental U.S. High Yield Corporate Bond Index \(WT Fundamental HY\)](#) and the [WisdomTree Fundamental U.S. Short-term High Yield Corporate Bond Index \(WT Fundamental Short-Term HY\)](#).

²The [ICE BofAML US High Yield Index \(BAML HY\)](#) and the [ICE BofAML 1-5 Year US High Yield Index \(BAML 1-5Y HY\)](#).

³Source: Moody's Investor Service, as of 3/31/18.

⁴Sources: FactSet, Deutsche Bank Research, as of 3/31/18.

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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You cannot invest directly in an index.

DEFINITIONS

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.

Revolver : Term used for a revolving credit line.

High-yield Bonds : A high yield bond is a debt security issued by a corporation with a lower than investment grade rating. It is a major component of the leveraged finance market.

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

Basis point : 1/100th of 1 percent.

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.

Bullish : a position that benefits when asset prices rise.

BofA Merrill Lynch U.S. High Yield Index : tracks the performance of U.S. dollar denominated below investment grade corporate debt securities issued in the U.S.

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.

Default Rates : the frequency in which borrowers fail to fulfill their contractual obligations.

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