

AVOIDING THE JUNKYARD

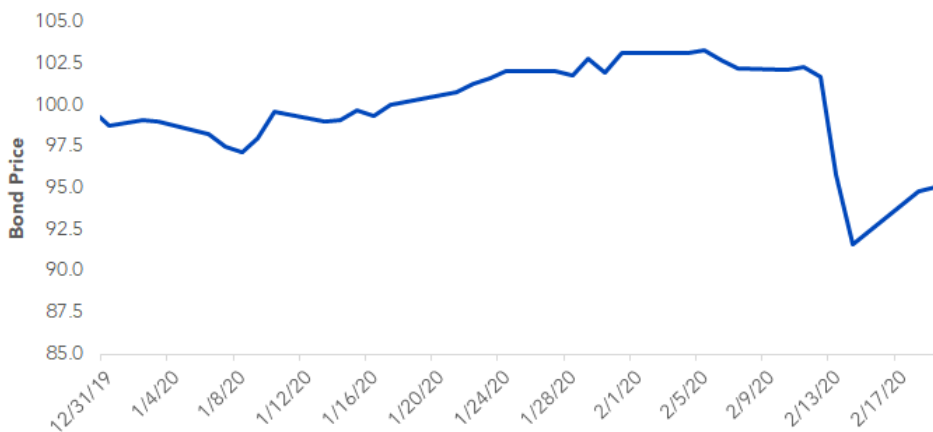
Kevin Flanagan — Head of Fixed Income Strategy, Josh Shapiro — Quantitative Strategist
02/26/2020

There’s nothing like a Friday downgrade surprise from the ratings agencies. But what if there was a fixed income strategy that could potentially neutralize such news events while also avoiding the junkyard?

Let’s take a look at the most recent case study: Joining a ratings action by [Fitch](#) on February 14, [S&P](#) also moved to downgrade Kraft Heinz Company’s (KHC) long-term debt to [high yield \(HY\)](#), or [junk status](#). With two out of three major rating agencies now in HY, KHC became the latest “big-name” credit issuer to gain attention for losing its [investment grade \(IG\)](#) status.

Needless to say, prices on Kraft’s bonds sold off materially, in some cases more than 10%. Consider the price of the Kraft Heinz largest [corporate bond](#) (4 3/8% due 6/1/46), with an amount outstanding of \$3 billion. After disappointing earnings and the downgrades by S&P and Fitch, the bonds fell from \$101.75 on Wednesday, February 12, to \$91.58 by end of day on Friday, February 14, a drop of 10.2 cents on the dollar. By Wednesday, February 19, the bonds have recovered by 3.47 cents on the dollar but still are significantly depressed.

Large KHC Bond Price (12/31/19–2/19/20)
KHC 4 3/8 6/1/46



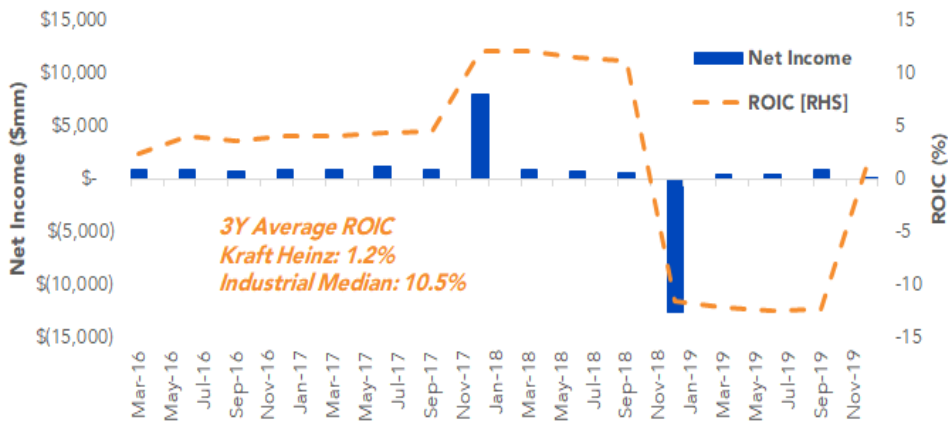
Source: Bloomberg, as of 2/19/20. Past performance is not indicative of future results.

In addition to prices falling because of investors reassessing the riskiness of Kraft’s bonds, dropping from IG to non-IG status presents technical headwinds. There are many investment mandates that restrict a fixed income portfolio to only investment-grade securities, and after a downgrade to HY, there may be forced sales that drive prices down further.

WisdomTree believes that there are trends in corporate bond [fundamentals](#) that can be used to systematically identify problematic credits. Our WisdomTree Corporate Bond Indexes use three metrics to screen out bonds: [return on invested capital \(ROIC\)](#), total [debt to total assets](#), and [free cash flow to debt](#) service. All three metrics screened poorly for Kraft Heinz, and the corporate bond for Kraft was subsequently excluded from the WisdomTree Corporate Bond Indexes.

One metric that stood out was ROIC, which deteriorated significantly over the past two years. The large drop in ROIC in Q4 2018 was due to a fall in net income, an input into the ROIC ratio. Kraft Heinz had a \$16 billion goodwill and intangibles write-off. This one-time write-off occurred because management believed they were overvaluing their brands.

Kraft Heinz Quarterly Net Income and Return on Invested Capital



Source: Factset, as of 2/19/20. Past performance is not indicative of future results.

Conclusion

The bottom line is that this screening process enabled us to avoid having KHC in both of our strategies, the [WisdomTree U.S. Short-Term Corporate Bond Fund \(SFIG\)](#) and the [WisdomTree U.S. Corporate Bond Fund \(WFIG\)](#). That’s what we call avoiding the junkyard...

Unless otherwise stated, all data sourced is Factset as of February 19, 2020.

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. 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 Funds attempt to limit credit and counterparty exposure, the value of an investment in the Funds may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Funds’ portfolio investments. Please read each 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](#).

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, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch 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

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

Junk Bond : A high-yield or non-investment grade bond. Junk bonds are fixed-income instruments that carry a rating of ‘BB’ or lower by Standard & Poor’s, or ‘Ba’ or below by Moody’s. Junk bonds are so called because of their higher default risk in relation to investment-grade bonds.

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

Corporate Bonds : a debt security issued by a corporation.

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

Return on Invested Capital (ROIC) : Measures the efficiency of invested capital and how it relates to generated returns.

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.