U.S. FIXED INCOME: GET SMART ... BETA

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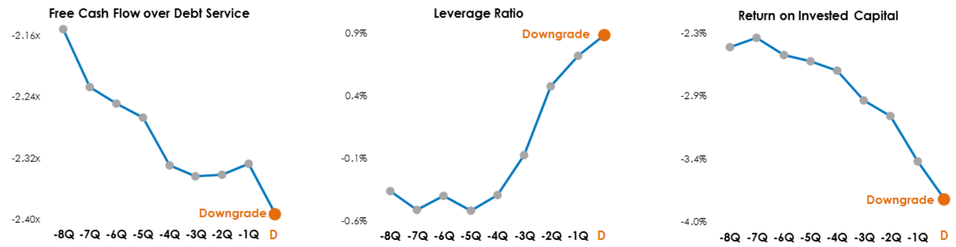
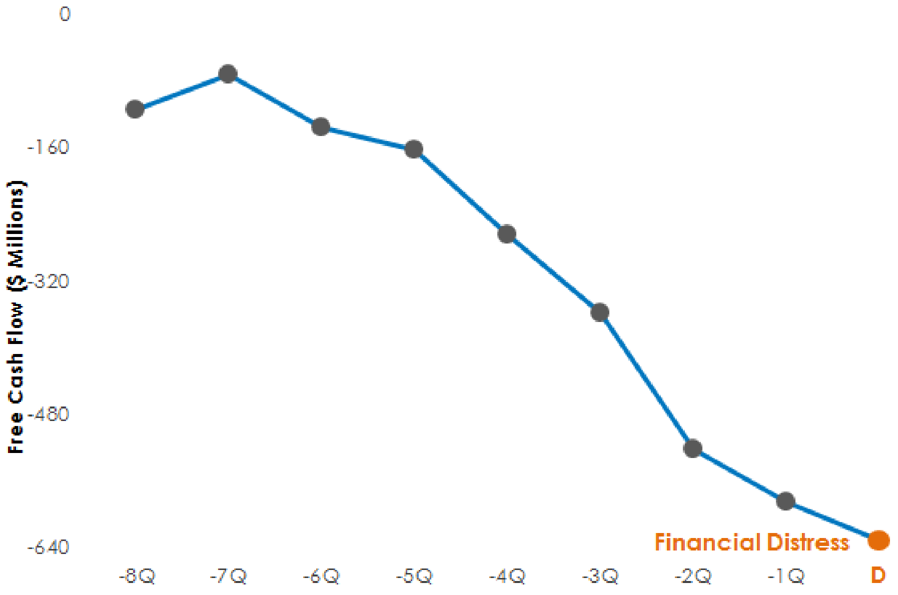
Trading activity in the U.S. corporate bond market thus far in 2016 has certainly resembled a roller-coaster ride. Indeed, two distinct patterns have been on display, as early weakness has given way to a newfound trend of improvement. This volatility has highlighted the notion that credit quality will remain an active consideration for the fixed income investor. The pertinent question to ask is, has the fundamental backdrop changed all that much over the last three to four months? Certainly, the widening in credit spreads that occurred earlier in the year was a function of the broader markets reacting to disappointing economic data here in the U.S., as well as concerns about global growth prospects, with a particular focus on China. In addition, the plunge in oil prices played an integral role, resulting in heightened anxieties regarding the risks of a potentially elevated pace of downgrades, and more importantly defaults, for energy-related issues. Although the U.S. corporate bond market has rebounded in a visible fashion from midwinter, investors are still faced with the prospect of potentially negative headlines. To provide some perspective, additional news stories regarding potential default fallout from the plunge in energy prices remains a distinct possibility. Conventional wisdom seems to be gravitating toward the U.S. speculative-grade, or high-yield, default rate rising to the 6% threshold, or essentially double the 3.17% trailing 12-month figure that Moody's Investors Service registered in December 2015. Our research has identified some key factors to focus on when trying to foreshadow future downgrades and defaults. For investment-grade (IG) corporates, we found that analyzing quarterly levels of free cash flow over debt service, leverage ratio (total debt vs. total assets) and return on invested capital (ROIC) over time helped identify potential downgrade candidates by one of the major ratings agencies (figure 1). **Figure 1: Trailing 8Q Median of Fundamental Factor Levels Relative to Sector Peers Prior to Downgrade**



Source: WisdomTree, FactSet, 12/31/02–3/31/16. Past performance is not indicative of future results.
Investment Grade Universe: Companies studied were publicly-traded and had outstanding debt issues that were rated investment grade with minimum par amounts of at least $100 million and at least one year left to maturity.
Free Cash Flow over Debt Service represented by: three-year average of the ratio of Free Cash Flow to Equity over Debt Service (short term debt + interest payments + lease payments).
Leverage Ratio represented by the average last four quarters of Total Debt/Total Assets.
Return on Invested Capital represented by: trailing three-year average of Net Income/ (Shareholders' Equity + Long-Term Debt).

For the high-yield (HY) universe, it is important to note that a large majority of companies in distressed situations tend to begin with cash flow problems. Against this backdrop, similar to the IG analysis, our work revealed that companies with sustained negative free cash flow often experienced an eventual downgrade (figure 2). It is important to keep in mind that within the HY sector there is less cushion on this front, and downgrades can lead to default concerns quickly. **Figure 2: High-Yield Corporates: Free Cash Flow Prior to Distress**



Sources: WisdomTree, FactSet, 5/31/06 – 3/31/16 . Data begins on 5/31/06 due to data availability for the high yield strategy.

Past performance is not indicative of future results. You cannot invest directly in an index. High Yield Universe: Publicly-traded Issuers with outstanding debt issues rated BB-/Ba1 or below and having at least $100 million in par amount and at least one year to maturity. Financial Distress refers to the bond falling to a rating of C or below, indicating that it is in distressed status. Free Cash Flow for each of these bonds was looked at for each of the 8 quarters prior to the distress point and averaged. A trend was found that Free Cash Flow on average looks to be declining in the quarters prior to the bonds entering distressed status.

WisdomTree has been at the forefront of smart beta for some time, and we are now taking the next step forward for investors, and that is using this same approach for fixed income. Specifically, the fundamental, or smart beta, methodology follows a rules-based approach to fixed income investing with the emphasis being on fundamentals, not market cap. In this case, we utilize the above analysis, and for IG, cut the worst 20% from the defined universe. In HY, we eliminate all issuers with negative free cash flow and also remove the 5% with the lowest estimated liquidity. WisdomTree fixed income fundamentally-based, or smart beta, products- The WisdomTree Fundamental U.S. Corporate Bond Fund (WFIG) the WisdomTree Fundamental U.S. Short-Term Corporate Bond Fund (SFIG) the WisdomTree Fundamental U.S. High Yield Corporate Bond Fund (WFHY) and the WisdomTree Fundamental U.S. Short-Term High Yield Corporate Bond Fund (SFHY) emphasize a qualitative approach, with a tilt toward income. With interest rates expected to remain in a range-bound pattern and credit concerns (downgrades and defaults) making headlines, fixed income investors will likely be searching for solutions that provide relative income opportunities in an environment in which increased credit quality is desired. With that in mind, we believe fixed income investors would benefit from a fundamental, rules-based approach to investing. **Conclusion** The WisdomTree fundamental fixed income Funds can be used as either a substitute or complement in a fixed income portfolio. They fit inside WisdomTree's suite of fixed income products, potentially serving as the allocation to U.S.-based fixed income, specifically in the credit sector.

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High-yield or "junk" bonds have lower credit ratings and involve a greater risk to principal.

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You cannot invest directly in an index.

DEFINITIONS

Corporate Bonds : a debt security issued by a corporation.

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

Credit quality : A measure of a borrowers potential risk of default.

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

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

Investment Grade : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

Leverage Ratio : Total amount of debt given a total amount of assets i.e., total Debt divided by total asset.

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

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

Market Capitalization : 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.

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

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.