FUNDAMENTAL SCORE CARD FOR INVESTMENT-GRADE CORPORATES

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In recent weeks, many investors have started to question the state of U.S. credit markets. To aid in this analysis, we have compiled a Fundamental Score Card for the U.S. corporate bond market. Central to our analysis is understanding the overall quality of the various indexes. In developing our suite of fundamentally weighted strategies, our research identified deteriorating cash flows, rising leverage and weakening profitability compared to peers as effective markers for potential credit concerns.

For companies in the U.S. corporate bond universe with publicly available financials (90% of the ICE BofAML U.S. Corporate Index), we examine fundamental credit metrics including leverage ratios, coverage ratios, profitability and banking quality. While none of the current fundamentals are necessarily flashing red, we believe investors should be taking a closer look at the underlying risks they're assuming in their portfolios.

Leverage and Interest Coverage Ratios

When leverage is deployed effectively, investors win. The total leverage ratio for the WisdomTree Fundamental U.S. Corporate Bond Index (WFCIG) is only 2.56x while the total leverage ratio for the market-cap index is 3.28x. This is consistent for both the investment-grade universe as a whole and the BBBs within WFCIG. Notice the total leverage for BBBs in WFCIG is only 2.87x compared to 3.40x in the market-cap index. When examining leverage through other lenses such as net debt to EBITDA or debt to assets, similar patterns emerge.

In terms of interest coverage ratios, a common rule of thumb is for businesses in most industries to maintain a comfortable cushion of at least 3.5x EBIT to interest expense. While market-cap-weighted approaches currently pass with coverage in excess of 5x, our fundamental approach sports a near 40% improvement in interest coverage ratios. In our view, this additional margin of safety puts these businesses on an even more stable footing should the economy decelerate over the next several years.

Fundamentals Score Card for Investment-Grade Indexes as of 10/25/18

		IG			BBBs in Index		
Credit Factor	Statistic	WisdomTree Fundamental US Corporate Bond Index	ICE BofAML U.S. Corporate Index	Score	WisdomTree Fundamental US Corporate Bond Index	ICE BofAML U.S. Corporate Index	Score
Leverage	Total Debt to Ebitda	2.56	3.28	▲	2.87	3.40	▲
	Net Debt to Ebitda	1.98	2.67	▲	2.49	3.03	▲
	Debt to Assets	30%	32%	▲	32%	35%	▲
Interest Payment Coverage Ratios	EBITDA Coverage LTM	10.32	9.23	▲	9.52	7.33	▲
	EBIT Coverage LTM	7.62	5.46	▲	6.69	5.13	▲
Profitability	Sales Growth 1Y	8%	7%	▲	8%	7%	▲
	Gross Margin LTM	37%	33%	▲	35%	32%	▲
	EBITDA Margin LTM	29%	30%	▼	25%	29%	▼
	EBITDA Growth YoY	8%	8%	▲	8%	9%	▬
	ROIC	10%	8%	▲	10%	8%	▲
Liquidity and Free Cash Flow	FCF LTM	$ 2,359	$ 1,291	▲	$ 1,437	$ 905	▲
	FCF Ave 5Y	$ 2,630	$ 1,251	▲	$ 1,213	$ 833	▲
	FCF to Debt LTM	21%	12%	▲	18%	11%	▲
	ST Debt / FCF LTM	27%	34%	▲	34%	41%	▲
	Current Ratio LTM	1.2	1.1	▲	1.24	1.05	▲
Banking Quality	Loans to Deposits	72%	82%	▲	89%	97%	▲

Source: FactSet, as of 10/25/18. Past performance is not indicative of future results. You cannot invest directly in an index. * Fundamentals calcualted as the median value across the universe of bonds. Green scores indicate higher quality values, yellow scores indicate values in-line with the market-cap benchmark and red values indicate fundamentals which are worse off than the market cap index.

Profitability, Cash Flow and Quality

The primary reason why corporate balance sheets remain reasonable by historical standards has been the sustained levels of above-trend profitability. High single-digit sales growth, attractive margins and near double-digit earnings growth portend a benign credit environment. Similarly, robust free cash flow and low levels of liquidity risk also point to a manageable level of risk. Perhaps the only potential storm cloud on the horizon is the BBB segment of the banking sector. With loan to deposit ratios rising to almost 100% in market-cap-weighted approaches, we are continuing to monitor this development. However, with other corporate balance sheets looking strong overall, it could be a factor of banks seeking to be more aggressive in improving their own profitability.

Takeaways

Investors ultimately care about performance. In our view, some investors may have been lulled into a false sense of complacency amid the current bull market. By anchoring bond portfolios to fundamentals, we believe our approach has the potential to avoid the pitfalls that will likely emerge as we enter the later stages of the credit cycle. By avoiding potential downgrades, WFCIG has the ability to boost returns and limit volatility relative to market-cap-weighted approaches. Based on our research, we believe the score card suggests that WFCIG has identified issuers with stronger credit fundamentals. Across all categories of credit factors, we see improved metrics for the WisdomTree Fundamental Index. Ultimately, we believe that all these metrics suggest the issuers in the suite of WisdomTree Fundamental investment-grade indexes are in a stronger position to make interest payments and repay their debts.

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You cannot invest directly in an index.

DEFINITIONS

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.

ICE BofAML US Corporate Index(C0A0) : The ICE BofAML US Corporate Index tracks the performance of the universe of US dollar denominated investment grade corporate debt publicly issued in the US market.

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

Coverage ratio : Also referred to as interest coverage ratio, which compares earnings before interest and taxes to interest expense.

Profitability metrics : financial identities and ratios that assess how effectively a company is able generate revenue in excess of its expenses.

Banking Quality : The overall financial health of a financial institution.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

BBB- : Standard & Poor's credit rating that implies the borrower has adequate capacity to meet financial commitments, but may be more vulnerable to adverse economic conditions. This rating represents the lowest level of investment-grade.

Net Debt-to-EBITDA : A financial ratio that expresses an entity's capacity to pay its debt, based on generated Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Higher levels are considered less favorable, as it indicates that a company has larger debt liabilities that it must pay which are in line with the operating income it generates.

Debt-to-Asset Ratio : a leverage ratio that defines the total amount of debt relative to assets. .

Interest Coverage : A measure of a firms earnings before interest and taxes divided by interest expense.

Earnings before interest and taxes (EBIT) : A measure of a firm's profit that includes all expenses except interest and income tax expenses.

Interest Expense : The cost incurred by an entity for borrowed funds.

Margins : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

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.

Loan-to-Deposit Ratio : A liquidity ratio generally applied to banks or financial institutions which compares the total loans it makes to consumers and business to the total deposits its received from others over a time period, expressed as a percentage. Higher ratios are generally considered unfavorable, as it indicates the institution has a propensity to over-lend and may not have enough liquidity to meet unforeseen funding obligations.

Bullish : a position that benefits when asset prices rise.

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