

# TRACKING DOWNGRADES ACROSS INVESTMENT-GRADE CORPORATES

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With the debt of numerous high-profile, blue-chip corporations (most recently, Ford) being placed on negative watch, investors are taking another look at [credit quality](#) across the [U.S. investment-grade corporate debt](#) universe. Additionally, many investors are starting to take note of the increasing concentration in issues rated [BBB](#) (the lower end of the investment-grade spectrum). While the benign credit environment of recent years may be softening, we believe domestic economic strength will continue to support corporate profitability and [solvency](#) in quality companies. However, companies with weaker [fundamentals](#) could be more vulnerable to downgrades as rates rise. In our view, prudent investors should start to assess whether the underlying [credit risks](#) in their portfolios are worth taking.

## Contrasting Our Approach to Credit

To address these concerns about issuer fundamentals, the [WisdomTree Fundamental U.S. Corporate Bond Index \(WFCIG\)](#) was designed to provide an alternative to blindly allocating across the credit spectrum. It offers an intuitive approach to identifying debt issues with quality fundamentals and attractive income profiles—case in point, WFCIG does not currently hold any issues of Ford Motor Company.<sup>1</sup>

A key difference between WFCIG and the [ICE BofAML U.S. Corporate Index](#) is that fewer bonds in WFCIG have been downgraded to non-investment-grade or [junk](#) status. When companies lose their investment-grade rating, many managers may be forced to sell these positions, according to their investment policy statements. As a result, these bonds often underperform in the short run after being downgraded.

## Fallen Angels in U.S. Corporate Bond Indices

\*2/28/16–9/28/18

Index	# of Bonds Downgraded to Junk	# Bonds Downgraded to Junk/Avg No. of Bonds	Cumulative % of Par Falling to Junk
WisdomTree Fundamental U.S. Corporate Bond Index	26	0.90%	0.48%
ICE BofAML U.S. Corporate Index	287	3.89%	3.45%

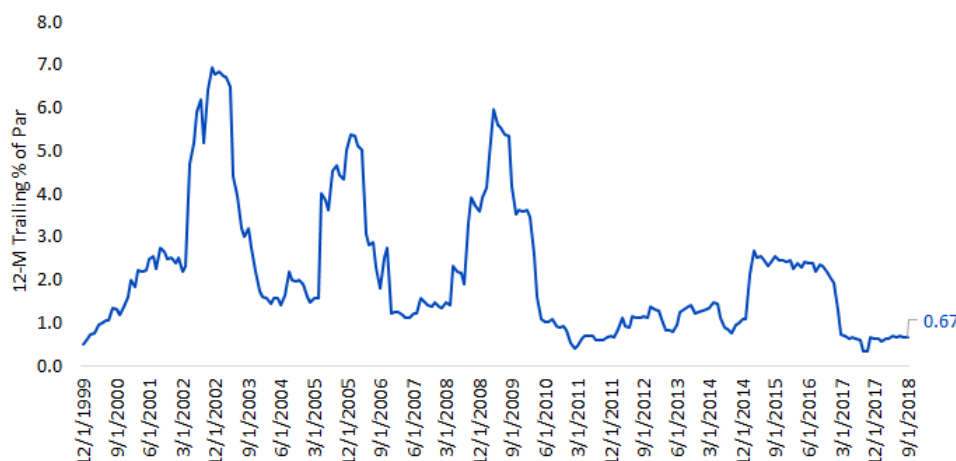
Sources: WisdomTree, Bloomberg, as of 9/28/18. Past performance is not indicative of future results. You cannot invest directly in an index. \* Inception date for the WisdomTree Fundamental U.S. Corporate Bond Index was 2/28/16.

The table above shows that, of all the bonds held since WFCIG's inception, only 0.90% have fallen into junk status. By comparison, in the broad market, 3.89% of bonds have been downgraded to junk. In terms of par amount, 0.48% of WFCIG has fallen to junk, while the broad market has seen 3.45% fall to junk. The results suggest that the Index has performed as intended.

## Putting Current Credit Conditions in Context

In the chart below, we plot the rolling 12-month percentage of the U.S. investment-grade corporate bond market which has been downgraded to non-investment grade status.

### Rolling 12-M Fallen Angels as a Percentage of Par within the ICE BofAML U.S. Corporate Index



Sources: WisdomTree, Bloomberg, as of 9/28/18. Past performance is not indicative of future results. You cannot invest directly in an index.

As of the end of September 2018, only 0.67% of the investment-grade index was downgraded to junk status over the trailing 12 months. Put another way, this period ranks in the 90th percentile among the most benign periods in the last 20 years. In our view, should the current trend begin to normalize, the WisdomTree Fundamental U.S. Corporate Bond Index could provide a defensive stance to better weather the performance impact of bonds falling to junk. Next, we compare the impact these developments have had on index returns.

### Performance Summary as of 10/24/18

Index	1M	3M	YTD	1Y	Since Inception (common period annualized) *
<b>US Corporate Bonds</b>					
WisdomTree Fundamental U.S. Corporate Bond Index	-0.67%	-0.44%	-2.93%	-1.81%	2.94%
ICE BofAML U.S. Corporate Index	-0.52%	-0.38%	-2.99%	-2.04%	3.01%
Markit iBoxx USD Liquid Investment Grade Index	-1.04%	-1.02%	-4.45%	-3.28%	2.88%
<b>US Short-term Corporate Bonds</b>					
WisdomTree Fundamental US Short-term Corporate Bond Index	0.13%	0.51%	0.57%	0.49%	1.94%
ICE BofAML 1-5 Year U.S. Corporate Index	0.15%	0.51%	0.24%	0.12%	1.99%
Markit iBoxx USD Liquid Investment Grade 0-5 Index	0.09%	0.44%	0.39%	0.30%	1.73%

Sources: WisdomTree, Bloomberg, as of 10/24/18. Past performance is not indicative of future results. You cannot invest directly in an index. \*The WisdomTree Fundamental U.S. Corporate Bond Index and WisdomTree Fundamental U.S. Short-term Corporate Bond Index have an inception date of 2/29/16.

Since inception in February 2016, the WisdomTree Fundamental U.S. Corporate Bond Indexes are neck and neck with market-cap-based approaches. Similarly, over the past year, the WisdomTree Fundamental Indexes have performed in line with the broadest representation of the U.S. investment-grade bond market, the ICE BofAML U.S. Corporate Index.

However, compared to a more concentrated index, our fundamental approaches are outperforming by a considerable margin. In fact, the WisdomTree Fundamental U.S. Corporate Bond Index has outperformed the [iBoxx USD Liquid Investment Grade Index](#) by 1.47%.

## Conclusion

While our base case is that the current credit cycle remains benign for the next two years, we believe the time to begin dialing down exposure could be upon us. By relying on strategies that focus on fundamentals, investors may be able to avoid some of the potential pitfalls inherent in credit-based investing.

<sup>1</sup>Holdings subject to change. For current holdings of the WisdomTree Fundamental U.S. Corporate Bond Index click [here](#).

For the top 10 holdings of WFIG please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/fixed-income/wfig>

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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](#)

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You cannot invest directly in an index.

## **DEFINITIONS**

**Credit quality** : A measure of a borrower's potential risk of default.

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

**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.

**Economic solvency** : Attention to a more medium- to long-term perspective relating to how spending relates to revenue and the ability of programs or policies of particular importance are viewed as to their longevity.

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

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

**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.

**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.

**iBoxx \$ Liquid Investment Grade Index** : The index is designed to represent a subset of the broader USD corporate bond market which can be used as a basis for tradable product.