

NAVIGATING CREDIT CYCLES WITH ACTIVELY MANAGED ETFs

Rick Harper — Chief Investment Officer, Fixed Income and Model Portfolios

12/01/2014

As a result of a recent [decision](#) by the Securities and Exchange Commission, the debate over [transparency](#) in [actively managed](#) exchange-traded products has splashed back into the headlines. The key question is whether there is a benefit to investors in **not** knowing the contents of their portfolios on a daily basis. In our opinion, daily transparency is one of the primary reasons why investors consider exchange-traded funds (ETFs). WisdomTree launched its first actively managed ETFs in May 2008. Since that time, we believe that transparency has served a variety of useful purposes. Principal among them is that it gives investors a unique insight in to what the portfolio manager is thinking. In our experience, daily transparency has enhanced the dialogue between advisors and investment managers, raising questions such as: In the case of [corporate bonds](#), what sectors look attractive? How much [interest rate risk](#) should this portfolio target? Are investors being sufficiently compensated for assuming [credit risk](#) in [high-yield](#) investments versus investment-grade corporate bonds? What countries, developed or emerging, seem to provide the most interesting opportunities? What individual companies seem attractive when compared with their competition? Additionally, transparency can potentially help investors balance risk in other parts of their portfolios: How large is aggregate exposure across this portfolio to any individual company? In today's market environment, avoiding the losers may be as important as investing in winners, particularly during a shift in U.S. [monetary policy](#). With the low-hanging fruit of the [credit cycle](#) potentially picked, having a [fundamentally focused](#) investment process could assist investors in navigating the markets. In our view, focusing on fundamentals may help investors add a potential margin of error to their investment process. However, the skills required for analyzing credit may differ drastically from those needed to position portfolios in equity markets.

| U.S. Credit Spreads: U.S. | | | | vs. Emerging Markets (EM) | | | | [in Basis Points (bp)] | |
|---------------------------|------------|------------|-----------------|----------------------------------|------------|------------|-----------------|------------------------|--|
| U.S. Credit Spreads (bp) | 12/31/2013 | 11/19/2014 | YTD Change (bp) | EM Corporate Credit Spreads (bp) | 12/31/2013 | 11/19/2014 | YTD Change (bp) | | |
| AAA | 57 | 67 | 10 | AAA | 105 | 63 | -42 | | |
| AA | 64 | 74 | 10 | AA | 147 | 137 | -10 | | |
| A | 91 | 106 | 15 | A | 167 | 168 | 1 | | |
| BBB | 150 | 161 | 11 | BBB | 289 | 299 | 10 | | |
| BB | 269 | 304 | 35 | BB | 444 | 519 | 75 | | |
| B | 316 | 373 | 57 | B | 678 | 732 | 54 | | |
| CCC | 591 | 734 | 143 | C | 1791 | 1646 | -145 | | |

Sources: Barclays, J.P. Morgan, as of 11/19/14. Credit ratings displayed based on Standard & Poor's ratings scale, which ranges from AAA (highest) to D (lowest). U.S. credit proxied by the Barclays Corporate Index and the Barclays U.S. Corporate High Yield Index. EM corporate bonds proxied by the J.P. Morgan CEMBI Broad.

Click for definition of [credit ratings](#). As we show in the tables above, credit spreads have generally [widened](#) so far this year. However, the market's perception of high-[credit quality](#) borrowers in emerging markets has actually improved, decreasing credit spreads. Additionally, BBB-rated credits have outperformed A-rated credits in the U.S. Due to a variety of factors, credit may not always be priced in a linear fashion. This is precisely why WisdomTree chose to partner with Western Asset Management Company ("Western") to launch actively managed corporate bond strategies. As part of its investment process, Western relies on teams of analysts that seek to identify the risks ultimately worth taking in a portfolio. As a result, it may be possible to exploit these divergences in pricing or avoid the pitfalls of agnostic credit investing, all in a transparent structure. Ultimately, the underlying approaches to portfolio management in actively managed ETFs are largely the same approaches that many managers have historically employed in other investment wrappers. In the case of ETFs, [portfolio turnover](#) may tend to be lower, and the portfolio may skew toward more [liquid](#) securities in certain instances, but the overall DNA remains intact. Through our partnership with Western, we have packaged two distinct approaches to active portfolio management in corporate bonds: the [WisdomTree Strategic Corporate Bond Fund \(CRDT\)](#) and the [WisdomTree Emerging Markets Corporate Bond Fund \(EMCB\)](#). CRDT provides a broad-based approach to corporate

bond investments, strategically investing in corporate bonds across the credit spectrum and across the world. EMCB takes a more targeted approach, investing in one of the world's fastest-growing bond markets, U.S. dollar-denominated bonds issued by EM corporations. Both processes integrate [top-down](#) macro analysis with [bottom-up](#) fundamental credit analysis. While the debate over approaches to active management will undoubtedly continue to rage, we believe that transparency is one of the core characteristics advisors look for when investing in ETFs. In our view, the ETF's daily transparency provides investors with valuable information to help manage risk across their portfolio.

Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. 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. Unlike typical exchange-traded funds, there is no index that these Funds attempt to track or replicate. Thus, the ability of the Funds to achieve their objective will depend on the effectiveness of the portfolio manager. Please read each Fund's prospectus for specific details regarding each Fund's risk profile. Western Asset Management is not affiliated with ALPS Distributors, Inc.

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, Jianing Wu, and Brian Manby 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

Transparency : The extent to which investors have ready access to any required financial information about a company, such as price levels, market depth and audited financial reports.

Actively managed ETFs : Investment strategy where a manager selects securities in an attempt to outperform the performance benchmark.

Corporate Bonds : a debt security issued by a corporation.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

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

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

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

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

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

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

Basis point : 1/100th of 1 percent.

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor's, Moody's or Fitch.

Widen : an increase in the amount of compensation bond holders require to lend to risky borrowers. When spreads widen, the market is implying that borrowers pose greater risk to lenders.

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

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

Top-down : A method of analysis that involves looking at the "big picture" first and then analyzing the details of smaller components.

Bottom-up : An investment approach that de-emphasizes the significance of economic and market cycles. This approach focuses on the analysis of individual securities.