

FIXED INCOME SMART BETA: AN EVOLUTIONARY TALE

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While it has not been completely “stealth-like” in nature, the evolution of the fixed income market over the last couple of years seems to have gone at least a little bit under the radar. Indeed, the emergence of what is called “[smart beta](#)” in the equity arena has certainly garnered its share of headlines, but this movement in fixed income is just gaining momentum and promises to be the next step in the evolution of solutions for bond market investing.

In broader terms, fixed income smart beta strategies seek to address—perhaps correct is the better term—the counterintuitive features that are a hallmark of market cap-based investing. WisdomTree has been at the forefront of smart beta for some time and has applied this methodology in the fixed income universe utilizing two distinct approaches: yield-enhanced core strategies and fundamental corporate strategies. Let’s think of them as Smart Beta v. 1.0 and Smart Beta v. 2.0, respectively.

Highlighting WisdomTree Fixed Income Smart Beta Solutions

Smart Beta v. 1.0	Smart Beta v. 2.0
<ul style="list-style-type: none"> • Benchmark Aware: Tilting from an index to improve risk/return within targeted levels of relative risk. • Macro-based strategies • EXAMPLE: Yield-Enhanced Core Strategies <ul style="list-style-type: none"> – Exploit income and diversification opportunities – Mitigate redundancy – Maintain risk <p><i>Yield-Enhanced U.S. Aggregate Strategy</i> <i>Yield-Enhanced Short-term U.S. Aggregate Strategy</i></p>	<ul style="list-style-type: none"> • Benchmark-Agnostic: The investment universe is simply a starting point. • Strategies with a micro-level and security-level focus • EXAMPLE: Fundamental Corporate Strategies <ul style="list-style-type: none"> Screen for Quality and Tilt for Income – Avoiding the lowest quality issuers – Assessing return and income opportunities among stronger fundamental bonds – Boost potential return and lower risk <p><i>U.S. Fundamental Corporate Bond Strategy</i> <i>U.S. Short-term Fundamental Corporate Bond Strategy</i> <i>U.S. Fundamental High Yield Strategy</i> <i>U.S. Short-term Fundamental High Yield Strategy</i></p>

Source: WisdomTree, as of 7/17/17.

The inherent flaws in the market cap-based approach to fixed income were fully evident in the realities and reaction to the financial crisis and Great [Recession](#) of 2007–2009 and highlight the need for an alternate or improved approach. Specifically, aggressive central bank policies, such as [quantitative easing \(QE\)](#), along with subpar growth and a lack of [inflation](#), all served to push [yield](#) levels to historically low readings, where they continue to reside. As a result, low-yielding [government bonds](#) have risen to visibly over-weight positions in global bond indexes, subjecting fixed income investors to sacrificing income and heightened interest rate risk at the same time. The search for income in this yield-starved environment can lead to a riskier approach: moving out on the maturity curve ([duration](#) risk) and/or going down in credit quality ([credit risk](#)).

The WisdomTree yield-enhanced, or Smart Beta 1.0, rules-based strategy is more macro based in nature and focuses on core investing. It reweights the sectors of an existing index in order to boost income potential while maintaining a

familiar risk profile. It generates over-weights to investment-grade credit and under-weights Treasuries, and it also comes in a “short-term” version for investors who wish to mitigate the potential for higher rates.

The WisdomTree fundamental corporate, or Smart Beta 2.0, rules-based approach has more of a [micro](#) and [security](#)-level focus. The first part of the process defines the universe, employing a stringent issue- size criterion and including only public issuers domiciled in the U.S. The emphasis then shifts to the balance sheet, where factors that have worked consistently over time, such as free cash flow over debt service, leverage ratio and return on invested capital, are used to screen for [quality](#). The process then tilts the weighting toward bonds with more favorable income characteristics.

Conclusion

The landscape for fixed income investing in the U.S. promises to remain a challenging one as we look ahead. The prospects for rates remaining relatively low, the [Federal Reserve \(Fed\)](#) beginning to normalize policy and uncertainty in the [fiscal policy](#) outlook all combine to create an environment in which bond investors will no doubt be searching for “smarter” fixed income solutions.

Important Risks Related to this Article

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.

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DEFINITIONS

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

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Inflation : Characterized by rising price levels.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Government bonds : A debt securities issued by a government to support fiscal spending.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

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

Micro : Focused on issues impacting individual companies as opposed to those impacting the broader economic landscape.

Securitized : a debt security whose value is backed by an asset or pool of assets such as a mortgage.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.