EM Corporate Debt: A Potentially Resilient Option in Today's Credit Markets

WisdomTree Emerging Markets Corporate Bond Fund (EMCB)

Emerging markets (EM) corporate bonds offer the mystique of emerging markets with the discipline of investing in the bonds of global corporations, generating potentially attractive income. They are both similar and different from other slices of EM debt as well as U.S. corporate credit, offering a unique complement or substitute within an EM debt portfolio or comprehensive credit portfolio.

Jean-Dominique Butikofer, CFA of Voya Investment Management, has tracked the EM debt market for more than 20 years and has witnessed first-hand the emergence of EM corporates as a tradable asset class. Since August 2017, he and his team have successfully managed the Emerging Markets Corporate Bond Fund (EMCB), generating top decile total return performance among emerging market debt funds over the last three years (as highlighted by Morningstar).[1] In the following pages, he provides his perspective on the EM corporate debt market, the opportunities and risk it offers and how that influences the way he manages EMCB.

IT HAS BEEN A WILD RIDE SINCE THE START OF 2020. HOW DID EM CORPORATES PERFORM, AND WHAT HAVE YOU LEARNED ABOUT THE ASSET CLASS OVER THE LAST 15 MONTHS?

2020 and the first quarter of 2021 have highlighted the resiliency of the asset class and the maturing of EM corporations in recent years. EM corporates[2] posted positive returns of 7.1% in the tough year of 2020. While EM corporates ceded some of those gains in the first quarter, performance since the beginning of 2020 has significantly outpaced EM USD sovereign bonds and U.S. investment-grade (IG) corporate bonds.[3]

Corporate default rates among EM HY issuers have also been moderate and much lower than default rates for U.S. HY issuers.[4] EM corporates had record issuance of $497 billion in 2020, which proves their ability to access external capital markets during times of distress. Companies have used primary markets to increase their liquidity position and extend their maturity profile. Net leverage for EM IG corporate increased from 1.4x in 2019 to 1.9x in the second quarter of 2020 due to a sharp decline in EBITDA during the COVID-19 pandemic. However, the net leverage for EM IG remains low relative to U.S. IG.

WHERE DO EM CORPORATES FIT WITHIN EM DEBT AND THE LARGER CREDIT UNIVERSE?

Hard-currency (HC) EM corporate debt is generally defined as debt issued by EM domiciled corporations and denominated in U.S. dollars that is largely directed to global bond investors. A broad representation of the universe places the aggregate size of the market at $1.3 billion. Relative to other EM debt asset classes, it is smaller than the universe for EM local debt but nearly the same size as or larger than the universe for EM sovereign debt issued in U.S. dollars.

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[1] EMCB generated total returns in the 36th, 6th, and 16th percentiles among fund listed in Morningstar's Emerging Markets Debt category over 1- year, 3-year, and 5-year periods ending March 31, 2021. 271, 241, and 192 funds were incorporated in the Emerging Market debt category for the 1-year, 3-year, and 5-year periods. Voya began managing the fund on August 23, 2017. Prior to that date, the fund was run by Western Asset Management Company.
[2] EM corporates are represented by the performance of the JP Morgan CEMBI Broad Diversified Index.
[3] Performance covers the January 1, 2020 to March 31, 2021 period, and EM USD sovereign bonds and U.S. investment-grade corporate bonds are represented by JP Morgan Emerging Market Bond Index Global Diversified and the Bloomberg Barclays Corporate Bond Index.
[4] "EM Corporate Default Monitor," JP Morgan, 2/17/21.

If you look at the table below, the universe of EM corporate USD (U.S. dollar) denominated debt features much shorter duration instruments than EM USD sovereigns. This characteristic also holds if you extend the comparison to broader core fixed income markets (U.S. aggregate and global aggregate) and the market for U.S. investment-grade corporates. While the duration is higher than U.S. high yield, yields are currently higher despite significantly better credit quality (57% of EM corporates are investment grade).

Comparison of EM Corporate Debt vs Other Fixed Income Markets, as of March 31, 2021

	EM Corporate	EM USD Sovereigns	EM Local Debt	US High Yield Corporate	US Investment Grade Corporate	US Aggregate	Global Aggregate
Market Size in USD Trillions	1.3	1.3	2.2	1.6	6.6	24.8	65.8
Yield (%)	4.48	5.28	4.99	4.23	2.28	1.61	1.16
Duration	4.90	7.86	5.28	3.87	8.48	6.40	7.39
% Investment Grade	57%	54%	82%	0%	100%	100%	100%
Currency	USD	USD	EM FX	USD	USD	USD	Multi
# of Issuers	771	166	19	900	800	1,042	2,924
# of Countries	60	73	19	27	23	36	71

Source: JP Morgan and Bloomberg, 3/31/2021

Market Value for EM Corporates, EM USD Sovereigns and EM Local Debt is representative of the JP Morgan Corporate EMBI Broad, EMBI Global and GBI-EM Indices. Other statistics for EM Debt are sourced from the diversified versions of the rescpective indices for each asset class.

US High Yield and US Investment Grade Corporate Bonds are represented by the Bloomberg Barclays US Corporate High Yield and US Corporate Bond Indices, while the Bloomberg Barclays Aggregate Index and Global Aggregate Index cover the broader investment grade bond markets in the US and across the world. You can not invest directly in an index.

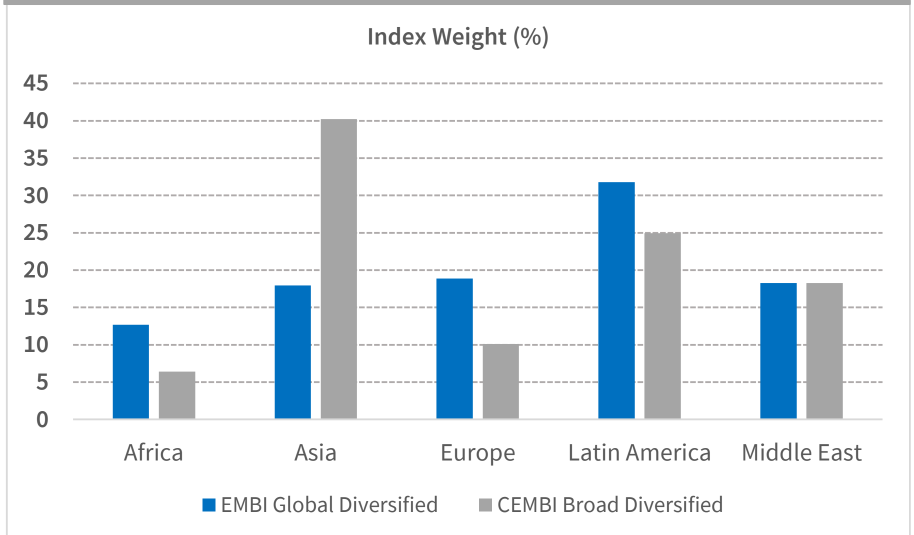
As such, EM corporates could be a valuable source of total returns, incremental income and diversification when blended with an EM hard-currency sovereign strategy. Blending EM corporates with HC sovereigns and quasi-sovereigns expands an investor's EM "credit" toolkit and can improve long-term risk/return metrics.
For diversified fixed income portfolios, EM corporates have evolved into a unique asset class offering competitive total and risk-adjusted returns over the long term. With more than 1,937 issues from more than 771 entities from 60 countries (JP Morgan, as of March 31, 2021), the EM corporate debt market can serve as a well-diversified, risk-adjusted complement in a fixed income portfolio. In addition, investors can select bonds from across the full rating spectrum on the EM corporate debt market.

CAN YOU ELABORATE ON SOME OF THE KEY RISKS TO INVESTING IN HC EMERGING MARKET DEBT AND WHAT DIFFERENTIATES EM CORPORATES?

Four key risks should be considered when allocating to emerging markets debt: country, credit, duration and currency. As noted above, EM corporates offer an attractive risk/return profile compared to other emerging market and credit asset classes, but certain differences can help investors decide where and how to allocate to EM corporate debt. Regional and rating differences and duration, credit, currency and capital structure risks are some of the most influential in this decision-making.

REGIONAL DIFFERENCES
The EM corporate market skews toward Asia, which makes up 40% of the JP Morgan CEMBI Broad Diversified Index (CEMBIBD) versus only 18% of the market for EM USD sovereigns (as represented by the JP Morgan EMBI Global Diversified Index—EMBIGD). On the other hand, EM sovereigns have been more concentrated in Latin America and Europe. The historical gap in Middle East representation on CEMBIBD and EMBIGD disappeared after sovereign and quasi-sovereign issuers from Saudi Arabia, Qatar, United Arab Emirates, Bahrain and Kuwait became eligible for the EMBIGD in January 2019. In addition, not all sovereigns (e.g., China, India) issue regularly liquid USD-denominated debt. Investors can still get exposure to those countries through corporate bonds.

Regional Composition of EM USD Corporates and EM USD Sovereigns



Source: JP Morgan, 3/31/21. You cannot invest directly in an index.

RATING DIFFERENCES

The EM corporate bond market maintains a higher average rating quality at BBB- than sovereigns at BB+ due to a higher proportion of Asian investment-grade bonds and lower proportion of African high-yield bonds. (In addition, EM corporate indexes have issuers from a variety of ratings under each country. EM corporate indexes also contain quasi-sovereign entities, which are partially government owned. These corporates (e.g., Petrobras, Israel Electric, OCP) could provide an attractive spread compared to their sovereign counterparts.

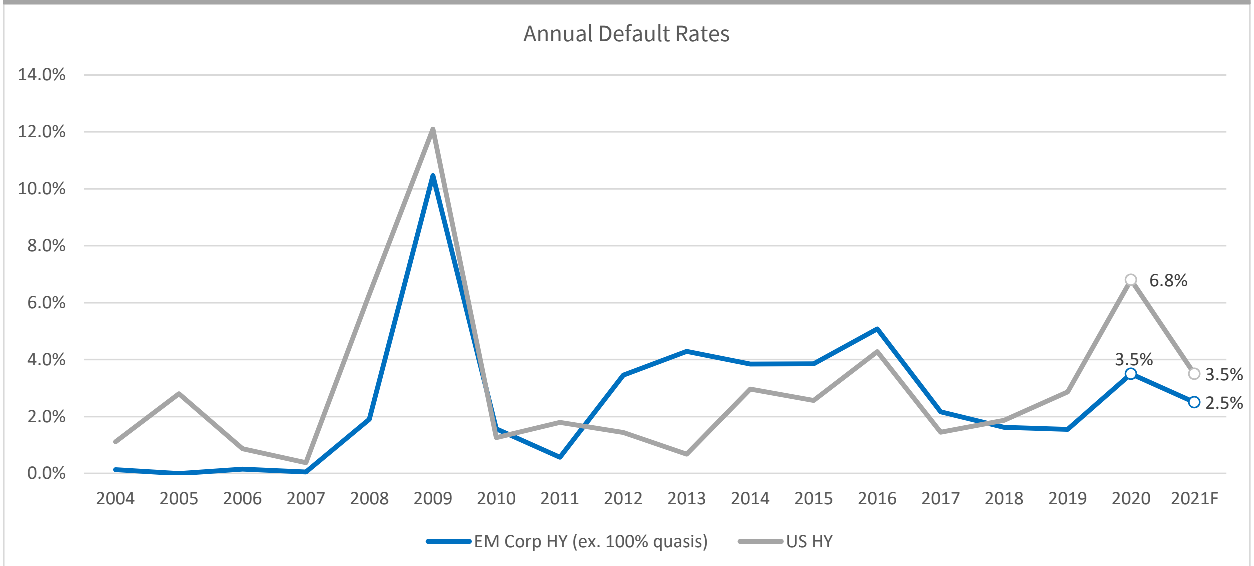
CREDIT RISK (DEFAULT AND RECOVERY RATES)

EM corporates have proven resilient during recent financial crises. Contrary to common perception, EM corporates had much lower default rates than U.S. HY bonds during both the global financial crisis of 2008 and the uncertainty created by COVID-19 and lower oil prices in 2020. In 2020, EM HY corporates had a much lower default rate of 3.5% versus a U.S. HY default rate of 6.8%.[5] Similarly, in 2021 JP Morgan forecasts a lower default rate of 2.5% for CEMBI HY versus 3.5% for U.S. HY. Most CEMBI corporates are national champions with easy access to local and foreign markets capital. Further, national oil companies (NOCs) dominate the oil and gas sector in emerging markets. NOCs are significant contributors to local economies and government budgets, which increases the likelihood of sovereign support during times of distress. This characteristic also helps the EM oil and gas sector handle liquidity crunches when oil prices are low. In addition, several EM corporates have stronger credit fundamentals (lower leverage and higher profitability) than implied by their credit ratings because their ratings are capped as a result of lower sovereign ratings (e.g., Brazil and Turkey).

EM corporates also have higher recovery rates versus advanced market corporates. The average recovery rate for senior unsecured bonds in EM (40%) is slightly higher than in developed markets (36%). The higher recovery rates help investors reduce their losses during default events.

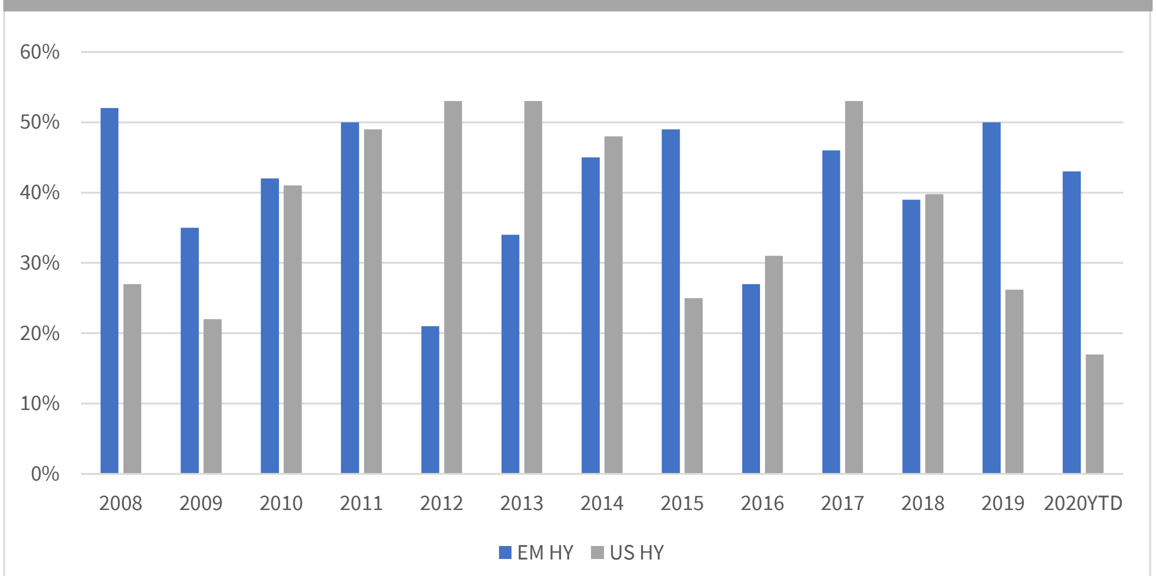
[5] "EM Corporate Default Monitor," JP Morgan, 2/17/21.

Comparison of Annual Default Rates of EM and US High Yield Corporates



Source: "EM Corporate Default Monitor," JP Morgan, as of 2/17/21. You cannot invest directly in an index.

Comparison of Recovery Rates between EM and US High Yield Corporates



Source: Moody's, as of 12/31/20. You cannot invest directly in an index.

DURATION RISK

EM corporates exhibit less interest-rate sensitivity with a duration of 4.9 years. Their duration is significantly shorter than EM sovereigns (7.9 years) and U.S. investment-grade corporates (8.5 years) and only modestly longer than U.S. high-yield corporates (3.9 years).

CURRENCY RISK

Finally, the EM corporate market consists only of U.S. dollar-denominated debt and thus has not historically exhibited the EM currency volatility experienced when allocating to local sovereign debt markets and EM equities. However, fluctuations in an EM corporate issuer's base currency can affect that issuer's ability to pay back their dollar-denominated debt, particularly in domestically oriented industries like telecommunications and consumer goods. Investors could mitigate foreign exchange (FX) risk by investing in exporters (e.g., pulp and paper, gold producers), which benefit from currency depreciation. In deciding upon sectors in which to invest, active managers consider whether companies are domestic- or export-oriented. Some corporates hedge their FX risk exposure through currency swaps or by keeping cash in hard currencies.

CAPITAL STRUCTURE RISK

Investing in EM corporations across asset classes presents interesting capital structure considerations for U.S. investors. In addition to having seniority over equity within the capital structure, EM corporate debt investments are USD-based, while equity investments are largely based in the local currency. By contrast, investing in European bonds and equities usually involves currency risk for U.S. investors, unless they hedge the exposures back to dollars.

With EM currencies losing value over the last 10 years, EM corporate bonds[6] have provided higher total and risk-adjusted returns relative to EM equities[7].

AS SOMEONE WHO HAS BEEN INVESTING IN EM DEBT FOR 25 YEARS, WHAT ARE YOUR REFLECTIONS ON THE EVOLUTION AND GROWTH OF THE ASSET CLASS?

In their 19-year life span, EM corporates have evolved and expanded across countries and regions, industries, credit qualities and maturity profiles, offering one of the most diverse asset classes available to investors. The universe now consists of 58 countries, up from 13 in 2001, with China and Russia as two of the top five countries that were not represented at inception. Much of the growth in regional diversification has come from Middle Eastern and African issuers, which now account now for 24% of the Index versus less than 3% in 2001. Meanwhile, growth in the number of regions and countries has led to a more diverse set of industries, with 12 now represented, allowing investors to capture global market themes and sector trends. Many EM countries have matured into more consumption- and services-driven economies, reducing cyclical risks and dependency on exports or commodities and making the asset class more attractive as a long-term allocation. While Oil & Gas and Metals & Mining, once dominant, are still well represented, and financials are the largest industry, both are declining as the market continues to evolve and become less dependent on banks and commodity prices.

Increasing investor confidence in the asset class has enabled more below-investment-grade corporations to enter the market and more established issuers to secure longer-term financing. More than a third of issuances are longer than seven years, highlighting investor confidence in the sustainability of issuers. In addition, not all issuers are unrecognizable: EM corporate issuers include many household names, such as Lenovo, Alibaba, Aramco, Petrobras, BBVA Mexico, Gazprom, Coca Cola Bottlers and Teva Pharmaceuticals. The opportunities to invest across the credit spectrum and the curve in recognizable global brands highlight not only how far the asset class has come, but hint at its resilience going forward.

[6] Returns represented by the JP Morgan Corporate EMBI Broad Diversified Index.
[7] Returns represented by the MSCI Emerging Markets Net Total Return Index.

HOW DOES THE EVOLUTION OF THE ASSET CLASS FEED INTO YOUR INVESTMENT APPROACH WITH EMCB?

Our considerable experience researching and underwriting EM debt informs our understanding of the various risks involved. This hindsight also stresses the importance of maintaining a broadly diversified portfolio across countries, sectors and single issuers. Prudent and consistent management of the portfolio's topline risks, coupled with in-depth analysis on corporate issuers as well as macro conditions in each country, is key to repeatable solid performance. We believe a risk-aware mindset is essential in successfully navigating the complexities of emerging markets, and risk calibration is integrated through each step in our investment process.

Risk-aware does not mean risk averse; we often take on more aggregate spread risk[8] than the Index, but it is risk that we feel confident in taking. We avoid investing in distressed situations, and our focus is investing in liquid corporates that offer long-term attractive credit-adjusted value. Beside our credit analytical framework, we aim to ensure EMCB portfolio liquidity and control risks by investing in more recently issued bonds and then using U.S. Treasury futures to reign in incremental duration exposure relative to the Index. The diversified approach has delivered higher performance for EMCB with lower volatility than its peers within the Morningstar Emerging Market Debt category—the category that covers funds investing in EM USD corporates or sovereigns—or both—over the last three years. EMCB delivered a return of 6.05%[9] and a standard deviation of 9.15% versus the 3.10% return and 11.92% standard for the Morningstar category average.

EM corporate bonds may offer investors an attractive risk/return profile for an asset class that we believe is only going to continue to grow and evolve as EM countries continue to develop and benefit from globalization. The market offers attractive yield potential in a low-yield environment. Diversification is key when allocating to EM corporates to seek to minimize concentration and default risk.

We believe that EMCB's consistent investment approach as well as current positioning will allow clients to take advantage of the opportunities currently offered by this evolving asset class.

Link to Standardized EMCB Performance

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[8] Spread risk is often represented as a measure of a portfolio's sensitivity to changes in the relative yields or spreads between EM corporate bonds and similar maturity risk-free securities.

[9] **Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at wisdomtree.com.** WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, please call 866.909.9473, or visit WisdomTree.com to view or download a prospectus. Investors should read the prospectus carefully before investing.

Important Risk Information

There are risks associated with investing, including possible loss of principal. 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 the Fund attempts to track or replicate. Thus, the ability of the Fund to achieve its objective will depend on the effectiveness of the portfolio manager. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. References to specific securities and their issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

JPMorgan CEMBI Broad Diversified Index: Represents the broadest universe of debt issued by emerging market corporations and quasi-sovereigns, subject to a diversification scheme ensuring more evenly distributed weights across countries. JP Morgan EMBI Diversified Index: Represents a smaller subset of the CEMBI Broad with higher minimum par amounts for issues and less concentration in issuers. It provides investors with a benchmark that is more selective and liquid. JP Morgan EMBI Global Index: Represents market cap-weighted universe of debt denominated in U.S. dollars issued by EM sovereigns. JP Morgan EMBI Global Diversified Index: Represents the universe of EM USD sovereign debt once the diversification scheme is applied. JP Morgan GBI-EM Global Diversified Index: Represents the local government debt of emerging market sovereigns, subject to a diversification scheme ensuring more evenly distributed weights across countries.
Bloomberg Barclays U.S. Corporate Bond Index: Represents the market of investment-grade corporate debt issued in U.S. dollars. Bloomberg Barclays U.S. Aggregate Bond Index: Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage- and asset-backed securities. Bloomberg Barclays Global Aggregate Bond Index: Represents the global, investment-grade, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage- and asset-backed securities. Bloomberg Barclays U.S. Corporate High Yield Bond Index: Measures the USD-denominated, high-yield, fixed-rate corporate bond market. MSCI Emerging Market Net Total Return USD Index: Represents the market cap-weighted universe of selected stocks from 24 emerging countries. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Earnings before interest, taxes, depreciation and amortization (EBITDA): The net income of a company with interest, taxes, depreciation and amortization added back to it. 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. Spread risk: A measure of a portfolio's sensitivity to changes in the relative yields or spreads between EM corporate bonds and similar-maturity risk-free securities. Spread risk is the risk investors assume when investing in bonds that contain risks beyond those of similar-maturity risk-free securities. For example, the overall risk of a corporate bond can be divided into interest rate risk and spread risk.
Standard deviation: A measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk" in that there is more of a chance the actual return observed

is farther away from the average return.

Morningstar rankings are based on a fund's average annual total return relative to all funds in the same Morningstar category. Fund performance used within the rankings, reflects certain fee waivers, without which, returns and Morningstar rankings would have been lower. The highest (or most favorable) percentile rank is 1 and the lowest (or least favorable) percentile rank is 100.

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