Navigating Credit Cycles with Actively Managed ETFs

Published December 1, 2014

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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. **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)
AAA	57	67	10
AA	64	74	10
A	91	106	15
BBB	150	161	11
BB	269	304	35
B	316	373	57
CCC	591	734	143

EM Corporate Credit Spreads (bp)	12/31/2013	11/19/2014	YTD Change (bp)
AAA	105	63	-42
AA	147	137	-10
A	167	168	1
BBB	289	299	10
BB	444	519	75
B	678	732	54
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.