

# WisdomTree EUR Aggregate Bond ESG Enhanced Yield UCITS ETF

# YLD

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Given that many investors often follow market-capitalisation<sup>1</sup> (market cap) weighted benchmarks, yields on their holdings of European investment grade bonds have decreased markedly over the years leading to greater exposures to negative yielding bonds. This bias is also prevalent in many Environmental, Social, and Governance (ESG) screened Euro Agg indices which are market cap weighted. By working in close relationship with Bloomberg, WisdomTree helped develop an approach that draws on the same investable universe as the ESG screened Euro Agg Index<sup>2</sup>, seeking ways to boost yield in a risk-controlled manner. This approach gave life to the Bloomberg MSCI Euro Aggregate Sustainability SRI Enhanced Yield Bond Index.

## A bond investors challenge

The Bloomberg MSCI Euro Aggregate Sustainability SRI **Market Index (ESG screened Euro Agg Index)** is a **market cap weighted index** which provides a broad exposure to the investment grade sovereign and corporate bond markets. Due to its market cap weighting, there is a bias to allocate the greatest weights to issuers with the largest amount of debt outstanding. Historically, this has resulted in market cap weighted Euro Agg indices having approximately 50% exposure to Euro Treasuries. For investors seeking income, concentrating positions in this segment of the market appears contrary to their investment objectives given the amount of negative yielding debt within this sector of the bond market. In our view, a more intuitive approach to indexing may focus on the ways an investor can enhance the yield of their portfolio while keeping risk in line with a recognised benchmark.

## Introducing the WisdomTree EUR Aggregate Bond ESG Enhanced Yield strategy

A UCITS compliant exchange traded fund that seeks to increase the income potential of an ESG screened, European investment grade core fixed income universe, while continuing to benefit from the risk mitigation and diversification of a multi-sector portfolio. The investment universe includes investment grade bonds from a broad set of asset classes including corporates, covered, government-related and Treasury bonds. The strategy sources opportunities within the market cap weighted **ESG screened Euro Agg Index** and aims to achieve a higher yield by tilting exposures within the universe meanwhile maintaining predefined risk constraints, turnover constraints and rebalancing monthly to adapt to new market conditions. An approach that incorporates useful features found in both passive and active investment options.

## YLD Quick Facts

- + Structure: Open-end UCITS ETF
- + Exposure: ESG Screened, Euro-denominated, investment grade fixed income.

<sup>1</sup> Market Capitalisation: Price of the bond times number of bonds outstanding from that issue. Issues with the highest values receive the highest weights in approaches designed to weight issues by market capitalization.

<sup>2</sup> ESG screened Euro Agg Index is the Bloomberg MSCI Euro Aggregate Sustainability SRI Market Index which measures investment grade, euro-denominated bonds including Treasuries, government-related, corporate, and securitised issues.

\* Total Expense Ratio (TER): It is a measure of the total costs associated with managing and operating a fund. The TER consists primarily of management fees plus other expenses such as trustee, custody and operating expenses. It is expressed as a percentage of the fund's total net asset value.

FIGURE 1: FUND INFO

| Ticker | Exchange       | ISIN         | Bloomberg Code | Listing Currency | Base Currency | Total Expense Ratio % |
|--------|----------------|--------------|----------------|------------------|---------------|-----------------------|
| YLD    | Borsa Italiana | IE00BD49R912 | YLD IM         | EUR              | EUR           | 0.18                  |
| YLD    | SIX            | IE00BD49R912 | YLD SW         | EUR              | EUR           | 0.18                  |
| WTDP   | Xetra          | IE00BD49R912 | WTDP GY        | EUR              | EUR           | 0.18                  |

**Insight into the index methodology**

The **Bloomberg MSCI Euro Aggregate Sustainability SRI Enhanced Yield Bond Index (Euro Agg ESG Enhanced Yield)** aims to deliver a higher yield than the **ESG screened Euro Agg Index**. To do so, it starts with the basket of the **ESG screened Euro Agg Index** and applies an optimisation method to modify the weights to enhance yields while respecting several constraints.

**I. INITIAL BASKET SELECTION**

The initial basket is the same as the Bloomberg MSCI Euro Aggregate Sustainability SRI Market Index which aims to be a broad representation of the investable Eurozone fixed rate, investment grade sovereign and corporate bond market filtered for three ESG screening cuts. **For illustrative purposes, please refer to the below diagram:**



Source: Bloomberg, WisdomTree

**II. YIELD OPTIMISATION MECHANISM**

The yield enhancement mechanism follows a 3-step process:

- + Divide the ESG screened Euro Agg Index constituents into 36 buckets
- + Determine and apply constraints
- + Run an optimiser to determine new weights for the 36 buckets

**1. Divide the euro agg index constituents into 36 buckets**

In the first step, the **ESG screened Euro Agg Index** is decomposed into 36 buckets across sector, country, maturity<sup>3</sup>, and credit<sup>4</sup> quality, as shown in **Figure 2**. While each bucket retains a suitable size for investability and liquidity<sup>5</sup> purposes, each bucket may present unique opportunities for risk and reward.

| FIGURE 2: BLOOMBERG MSCI EURO AGGREGATE SUSTAINABILITY SRI MARKET INDEX DECOMPOSITION |                             |                     |                      |                     |
|---|-----------------------------|---------------------|----------------------|---------------------|
| Risk Dimension  | Sector                      | Years to Maturity   |                      |                     |
|   |                             | 1-5 Years           | 5-10 Years           | 10+ Years           |
| Rates   | Treasury (Sustain*)         | German Govt 1-5     | German Govt 5-10     | German Govt 10+     |
|   |                             | France 1-5          | France 5-10          | France 10+          |
|   |                             | Belgium 1-5         | Belgium 5-10         | Belgium 10+         |
|   |                             | Italy Govt 1-5      | Italy Govt 5-10      | Italy Govt 10+      |
|   |                             | Dutch Govt 1-5      | Dutch Govt 5-10      | Dutch Govt 10+      |
|   |                             | Spain Govt 1-5      | Spain Govt 5-10      | Spain Govt 10+      |
|   |                             | Other Govt 1-5      | Other Govt 5-10      | Other Govt 10+      |
| Spread  | Govt Related (SRI/Sustain*) | Govt Related 1-5    | Govt Related 5-10    | Govt Related 10+    |
|   | Credit (SRI/Sustain*)       | Aa / Aaa Credit 1-5 | Aa / Aaa Credit 5-10 | Aa / Aaa Credit 10+ |
|   |                             | A Credit 1-5        | A Credit 5-10        | A Credit 10+        |
|   |                             | Baa Credit 1-5      | Baa Credit 5-10      | Baa Credit 10+      |
| Covered (SRI/Sustain*)  | Covered 1-5                 | Covered 5-10        | Covered 10+          |                     |

Source: Bloomberg, WisdomTree

<sup>3</sup> Maturity: The amount of time until a loan is repaid.

<sup>4</sup> Credit: A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

<sup>5</sup> 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.

**2. Determine and apply constraints**

The following constraints are added, which serve to control risk and concentration while limiting turnover:

- + **Tracking error constraints:** the expected Tracking Error Volatility (TEV)<sup>6</sup> of the **Euro Agg ESG Enhanced Yield** index relative to the **ESG screened Euro Agg Index** should be less than 35 basis points each month.
- + **Duration<sup>7</sup> constraints:** The duration constraint is symmetrical to allow for +/- 1 year versus the Bloomberg MSCI Euro Aggregate Sustainability SRI Market Bond Index (**ESG screened Euro Agg Index**).
- + **Sector and sub-component constraints:** The weight of major sectors (Treasuries, Government-Related and Credit) cannot deviate by more than 20% from their weights in the **ESG screened Euro Agg Index** and the weight of minor sectors (Covered Bonds) cannot deviate by more than 10% from their weights in the **ESG screened Euro Agg Index**. Each individual bucket (German Govt 1-5, German Gov 5-10, etc.) cannot deviate by more than 5%.
- + **Bucket size constraint:** To be eligible for selection on any given monthly weight determination date, a bucket's market value must be at least EUR10bn, or its weight has to be at least 0.15% of the **ESG screened Euro Agg Index**.
- + **Turnover constraints:** Portfolio turnover due to monthly rebalancing is capped at 5%. When this condition cannot be met, the turnover limit is increased incrementally by 1% until a solution is found.

FIGURE 3: SUMMARY OF THE CONSTRAINTS ON THE BLOOMBERG MSCI EURO AGGREGATE SUSTAINABILITY SRI ENHANCED YIELD BOND INDEX

|   |
|---|
| <b>Tracking Error Volatility</b>        |
| < 35 bps / month                        |
| <b>Duration Cap</b>                     |
| +/- 1 Year                              |
| <b>Weight Deviation</b>                 |
| Major Sector +/- 20%                    |
| Minor Sector +/- 10%                    |
| Individual Buckets +/- 5%               |
| <b>Bucket Eligibility</b>               |
| At least 10Bn Euro or                   |
| At least 0.15% of Euro Agg ESG universe |
| <b>Turnover</b>                         |
| Less than 5% each month                 |

<sup>6</sup> Tracking Error Volatility: The volatility of the difference between the performance of a portfolio and its benchmark. In this case, the portfolio is the Euro Agg ESG Enhanced .

<sup>7</sup> 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.

**3. Determine bucket weights**

Each month, weights of the Index are reallocated across the 36 buckets to maximise yield, while adhering to the five constraints. It is important to note that the optimisation is done at the bucket level, not the security level. Consequently, they keep the same relative weight within a bucket.

Example:

| Initial Weights in ESG screened Euro Agg Index |     |   | Optimised Weights in Euro Agg ESG Enhanced Yield Index |      |
|--|-----|---|--|------|
| Aa / Aaa Credit 5-10                           | 12% |   | Aa / Aaa Credit 5-10                                   | 5%   |
| Security A                                     | 6%  | ➔ | Security A   | 2.5% |
| Security B                                     | 6%  |   | Security B   | 2.5% |

Source: Source: WisdomTree.

In this hypothetical example, the ESG screened Euro Agg Index has 12% allocated to the Aa / Aaa Credit 5-10 Year bucket. This bucket consists of two bonds, Security A and B, which represent 6% of the index each. The optimiser assigns a new weight of 5% for this bucket. Security A and B are consequently adjusted, keeping the same relative weight with each other, to 2.5% each of the index.

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