INVESTMENT

Fixed-income ETFs: The next frontier

Fannie Wurtz **investigates the rapid rise of fixed-income ETFs and its main catalysts**

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European investors have enthusiastically embraced exchange-traded funds. Over the last decade the number of products has ballooned from 400 to over 1,500, while assets under management have reached €580 billion.

Until recently, however, the popularity of equity products had outstripped that of fixed-income ETFs. The EDHEC *European ETF and Smart Beta Survey* published this year shows that in 2006 only a tenth of investors used fixed-income ETFs, whilst 45 per cent used the equity equivalents.

Ten years later fixed-income products have caught up. And last year, for the first time, flows into fixed-income European-listed ETFs were higher than those into equities.

It is worth investigating why the pace of adoption has suddenly accelerated.

ETFs offer an easy access to the bond markets

Many investors would like to be able to purchase individual bond issues as easily as they can buy company shares. This, however, is often not possible in fixed-income markets: while equities are most often traded on an exchange, bonds are primarily traded over the counter (OTC).

Fixed-income ETFs offer investors an alternative to this constraint: they can gain exposure to a basket of bonds as easily as they can purchase shares in a company. As ETFs are traded on an exchange, this is as straightforward as placing an order with their broker.

NOT ONLY ARE FIXED-INCOME ETFS EASIER TO TRADE THAN THE UNDERLYING BONDS, THEY ALSO OFFER INVESTORS A USEFUL LIQUIDITY PROXY

Not only are fixed-income ETFs easier to trade than the underlying bonds, they also offer investors a useful liquidity proxy. As bonds are over-the-counter products, there is no accurate measure of liquidity. Moreover a fixed-income ETF gives investors access to information on the volumes traded and transaction costs.

Until recently, despite the easy access provided by fixed-income ETFs to the bond market, investors remained immune to their points of attraction. That is due to the available products not meeting the needs and expectations of investors. But the situation is now changing.

Fixed-income ETFs have opened up access to bond markets

Via an increasingly diverse range of products, ETF providers now offer straightforward access to parts of the fixed-income market in which smaller institutional investors have historically found it relatively complex and expensive to gain exposure.

There are now, for example, strategies that track indices with very large number of underlying markets and constituents, such as global aggregate indices. The scope of these indices is so broad that even larger institutional investors struggle to replicate them in full.

The Bloomberg Barclays Global Aggregate Index, for instance, provides investors with a well-diversified investment-grade bond exposure. The index gives a liquid source of fixed-income market returns, cutting across countries, sectors, currencies and issuers.

The geographical diversification of the index's constituents also helps to improve the yield and to mitigate the impact of potential rate hikes on the value of the portfolio.

While its diversification appeals to investors, it represents a real challenge for ETF providers. Constructing a fund to replicate this index is far from simple.

The provider needs to know how to trade different types of bonds from a variety of issuers in a broad range of currencies. To ensure the price of the ETF is attractive, this has to be done in a cost-efficient manner.

Thus, a robust sampling procedure

is required to ensure accurate replication, minimising both tracking error and tracking difference.

New products allow investors to fine-tune their allocations

The first equity and bond ETFs to reach the market were relatively simple: they tracked well-recognised indices such as the S&P 500 or the J.P. Morgan Global Government Bond Index. Over time the product range has become broader.

Investors have now been offered greater granularity. Equity investors can now select from individual country, sector and factor ETFs, while bond investors can choose from ETFs with specified credit rating, currency, issuer type or maturity profiles.

In equities, investors can easily construct an entire global allocation from a relatively small number of the available funds. Nevertheless, the fixed-income ETF market has different characteristics to the equity universe. In particular, replicating the whole fixed-income universe would not make sense for either the provider or the investor since the range of bonds in existence is much broader than for equities.

Rather than developing products which offer access to the full bond universe, providers of fixed-income ETFs have tended to take a more tactical approach, developing products that match a concrete investment need.

An ETF that tracks BBB corporate bonds, for instance, offers a good risk-return profile in the current context. These bonds offer investors the highest possible yields whilst remaining in the investment-grade universe.

If interest rates start to rise, however, the value of these bonds would fall. To mitigate against the negative impact of increases in the cost of borrowing, investors can select those bonds with a shorter duration.

The popularity of floating-rate-note ETFs is another example of the trend towards specialisation in fixed-income ETFs. These are of particular utility to those investors who expect further interest rate increases, since their coupons move in tandem with central bank base rates.

The increasing range of more solution-focused fixed-income ETFs provides investors with a set of tools that gives access to the fixed-income markets while also responding to the current interest-rate environment.

The rise in market flows into European fixed-income ETFs shows that investors have welcomed this aspect of product development and are now more willing to implement their allocation to fixed-income through an ETF, rather than building it for themselves.

Rating, yield and duration profiles: Barclays US Corporate Bond indices

	Maturity	Rating	Yield	Modified duration	Rate hike to cancel yield
Barclays US Corporate Bond indexes	10+ years	A	4.23%	13.70	0.31%
	5-10 years	A	3.14%	6.28	0.50%
	1-5 years	A	2.24%	2.76	0.81%
	1-5 years	BBB	2.45%	2.95	0.83%

Source: Bloomberg, Amundi ETF, Indexing & Smart Beta, September 2017. Past performance is no indication of current or future performance, and the performance data do not take account of the commissions and costs incurred on the issue and redemption of units.

These trends have improved the popularity of fixed income ETFs

The combination of these trends has led to the popularity of fixed income ETFs increasing rapidly in recent years.

All investors can now access those areas of the markets that were previously too expensive or complex to gain exposure to. More sophisticated products offer not only access to fixed-income markets but are also tailored to meet investors' needs in the current interest rate environment.

We expect these two trends to develop further and for the use of fixed-income ETFs in Europe to keep rising. ■

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