ETF Express Fixed Income Special Report – October 2018

The ETF market was born to deliver passive exposure to baskets of assets. The first ETFs tracked broad equity indices. Because these funds could be bought and sold like equities, they were traded by cash equity desks and sold by equity salespeople. Equity indices had existed for a century and the underlying securities were liquid with daily prices and closing auctions. Equity ETFs were simple, efficient, easy to price and easy to trade. The only real question for a provider was which equity indices would be most relevant to investors. However, when providers turned their attention to other asset classes like fixed income, the questions weren't just about which parts of the market were interesting, but also about how best to gain exposure.

In fixed income, ETFs have been a success story with a twist - there are over 400 ETFs but almost half the assets are in only 20. This suggests a lot of unsuccessful experiments as providers tried to work out what investors wanted. However, those large investment grade bond ETFs that *have* captured assets have brought multiple benefits. As well as giving investors access to a broad range of companies, coupons and maturities in one transaction, they have also created pools of bonds that can be traded by creating and redeeming shares in the fund. In a world where bank balance sheets have shrunk, this new source of liquidity is a significant bonus.

When talking about passive investing, however, it's hard to generalise across fixed income. Firstly, we talk about fixed income as a single asset class but, in reality, it is a series of highly disparate sub-asset classes: investment grade bonds, high yield, distressed debt, bank loans, asset backed securities, bank capital, mortgage backed securities and many more. Secondly, even within a sub-asset class, the range of available securities is dizzying. There are nine million fixed income securities and counting. Finally, when you identify the securities you want, it is very difficult to get information on trading activity, availability and pricing.

While there might be challenges, the opportunities for investors are significant. Fixed income securities typically offer more controlled returns than equities and give exposure to different parts of the balance sheet. The age-old assertion that equities outperform fixed income over most timeframes is too simplistic if you adjust for risk. And, increasingly, techniques like factor investing, which have been practised for decades by specialist fixed income managers, can be made available to multi-asset investors via ETFs.

In European credit products, reducing interest rate exposure has been a popular theme. Some funds have limited the duration of the bonds they hold while others have focused on floating rate notes or hedging interest rate risk by selling futures. The fixed income market has created an instrument focused on this risk factor: CDS, which offer credit spreads without interest rate exposure – but this is a relatively new tool to ETF investors.

All these dynamics mean that fixed income ETFs are only beginning to come of age. The next leap forward will come from providers who are focused on the asset class and have the in-depth knowledge to understand and deliver the opportunities. There has never been a better time to be an investor looking for passive fixed income exposure.