UNDER THE SPOTLIGHT:

Investigating the fixed income ETF revolution

It's time to rethink fixed income with ETFs
iShares by BlackRock

What is driving the increasing demand for fixed income ETFs?
Tom Eckett, Deputy Editor of ETF Stream

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It's time to rethink fixed income with ETFs

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed Investors may not get back the amount originally invested.

The role of fixed income in multi-asset portfolios is evolving with the unprecedented levels of market volatility we have seen this year, and it is hard to think of a better time to rethink fixed income.

In today's fixed income markets, investors face increasing pressure to deliver returns, generate yield and maintain diversification. To do so, we believe there is a need to move beyond the outdated 'active first and only' fixed income approach and consider indexing and fixed income ETFs.

Indexing has the power to transform the fragmented bond market into standardised, predictable and efficient exposures, and greatly simplify portfolio construction. Indexing drives cost, risk and time efficiencies. It does so by lowering overall portfolio costs, improving transparency to help control and manage risks, and by minimising the burden of monitoring and reviewing managers.

Fixed income ETFs allow investors to take a holistic approach to portfolio construction, by combining indexing and alpha-seeking strategies rather than exclusively choosing one over the other. By using every tool in the box, investors can focus on the role of fixed income in their multi-asset portfolio and what intended outcomes and goals they are seeking to achieve.

The best way to understand these advantages is to consider how fixed income ETFs can help address the main challenges in today's bond markets. We see four challenges that are compelling investors to rethink how they construct a fixed income allocation.

1. Resilience through diversification

Firstly, the endless search for yield has increased investors' portfolio risks, leaving many with poor portfolio diversification and a lack of resilience in market downturns.

As yield becomes increasingly scarce, investors are allocating to riskier asset classes. Corporates and emerging market debt – a sizeable amount rated high yield – make up 40% of fixed income allocations in multi-asset portfolios. The increase in these exposures exacerbates credit spread risk – our research finds that this now accounts for 58% of fixed income risks in multi-asset portfolios[1].

There is another problem. These greater allocations to corporate and emerging market exposures give bond portfolios higher correlation to equity markets – in particular during market crises. This reduces the diversification benefits that fixed income can bring to multi-asset portfolios.

Indexing and ETFs offer investors greater transparency and clarity on portfolio exposures and risks in fixed income because of their rules-based approach. Moreover, they serve as efficient building blocks that can bring resilience to the core of a fixed income allocation through diversification, in a cost-effective way that also saves time. After all, indexing can offer access to as many as 25,000 bonds with just one trade[2].

These building blocks can be far-reaching, allowing investors to buy broad diversification through a single ETF. However, they can also be offering exposure to more targeted slices of the market, enabling investors to diversify in a very precise way – perhaps to fill a gap in their existing portfolio. All in all, fixed income ETFs reach almost every part of fixed income markets.

Risk: Diversification and asset allocation may not fully protect you from market risk.

2. Help to protect portfolio from currency fluctuations

Another challenge which is particularly pertinent for fixed income allocations is the impact of currency fluctuations on overall performance.

Foreign exchange is the second largest risk in multi-asset portfolios – only equity risk is greater. Many investors have been stung by holding unhedged allocations that were hit by strong currency moves[3].

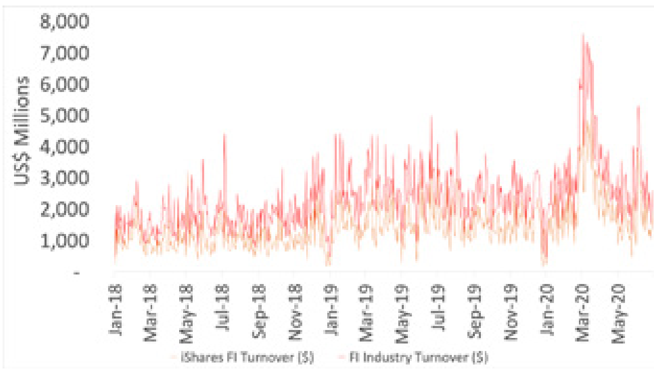
Investors need efficient building blocks which also feature the flexibility to hedge currency risks. iShares fixed income ETFs can help with this, offering various currency hedged share classes across exposures including sterling, dollar, euro, krona and Swiss francs.

3. Flexibility

The third challenge is investors' discovery that their portfolios lack flexibility.

2020 was a stress test for everyone's portfolio. As volatility soared in March, many investors discovered their fixed income allocations lacked the liquidity, price discovery and flexibility they needed to be able to de-risk as markets sold off. Investors need nimble, liquid fixed income exposures that remain so when markets become volatile in this way.

Figure 1: Secondary trading volumes in UCITS fixed income ETFs testify to strong liquidity

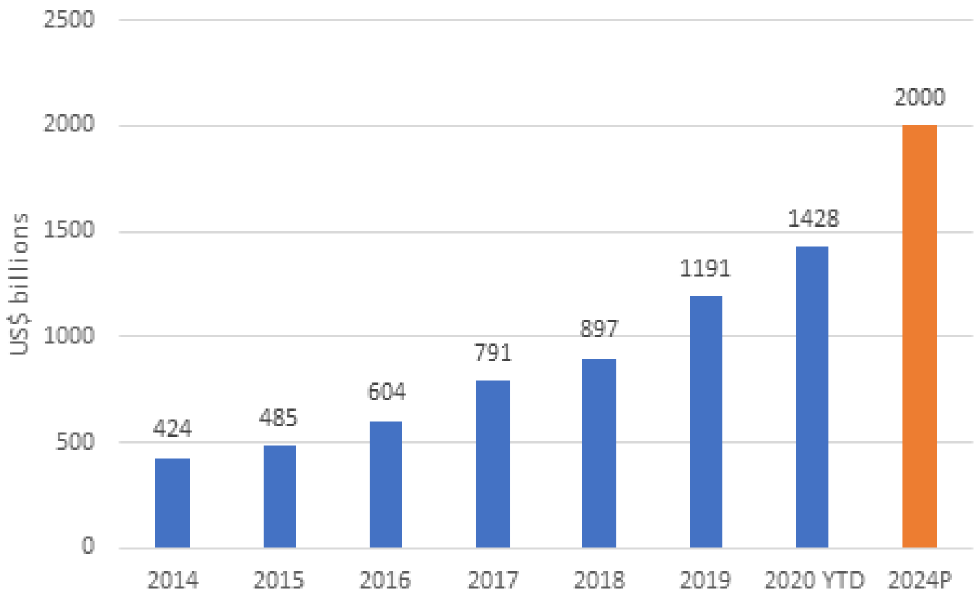


Source: iShares

Fixed income ETFs are certainly nimble. They allow investors to be tactical with asset allocation even in the face of extreme volatility. Through ETFs, investors can quickly price whole sections of the market and make informed decisions in real time.

1 Source: Portfolio Insights (2020 Edition), BlackRock, January 2020.
2 Source: BlackRock, Bloomberg as at 30 September 2020.
3 Source: Portfolio Insights (2020 Edition), BlackRock, January 2020.

Figure 2: AUM in global fixed income ETFs: On track to hit USD$2 trillion by 2024



Source: iShares

Fixed income ETFs are certainly liquid too, regardless of market conditions. In March 2020, flagship iShares fixed income ETFs continued to track their indices tightly, offering liquidity and price discovery.

4. Sustainability

The final challenge is that investors cannot ignore the pressure to become more sustainable. Interest in sustainability has been on the rise in recent years. 2019 saw a 13% increase in allocations to sustainable fixed income.as more and more investors seek ways to navigate the bond market with a sustainable lens[4]. When it comes to sustainable, investors also want a transparent and scalable implementation approach.

An indexed approach to sustainable fixed income allows for full attribution and transparency through a rules-based methodology. With a range of building blocks, investors can use iShares sustainable fixed income ETFs to help achieve similar risk-return characteristics to traditional exposures while improving their sustainability profile.

Fixed income ETFs: Playing a greater role in today's portfolios

To conclude, investors in fixed income today face several challenges. Fixed income ETFs may help investors address these challenges. In June 2019, the global fixed income ETF industry crossed $1 trillion in assets and BlackRock predicted we would see assets cross $2 trillion by 2024[5]. However, the pace of growth to date has been even faster than expected, today global fixed income ETFs stand at over $1.4 trillion fueled by an acceleration in adoption from all investor types[6]. As multi-asset investors rethink the role of fixed income in their portfolios and address today's portfolio construction challenges, we see an even greater role for fixed income ETFs.

Risk: There can be no guarantee that the investment strategy can be successful, and the value of investments may go down as well as up.

Disclaimer

4 Source: Portfolio Insights (2020 Edition), BlackRock, January 2020.
5 Source: BlackRock, "Primed for Growth: Bond ETFs and the Path to $2 Trillion," 30 June 2019.
6 Source: BlackRock, GBI, 30 September 2020.

What is driving the increasing demand for fixed income ETFs?

Demand for fixed income ETFs in Europe has exploded over the past 18 months driven by ongoing ETF innovation, the modernisation of bond markets and the Federal Reserve's decision to purchase ETFs for the first time in its history earlier this year.

According to data from Morningstar, the fixed income segment of the European ETF market has developed rapidly over the last five years with assets jumping from €95bn in 2015 to €257bn, accounting for over a quarter of the entire ETF ecosystem this side of the pond, as at 30 September.

In 2019, in particular, fixed income ETFs saw a record €54bn inflows in 2019, up from the previous high of €25bn positive flows set in 2017, while the segment has seen €27bn inflows so far this year.

Brett Olson, managing director and head of iShares fixed income, EMEA, at BlackRock, said this rapid evolution was driven by a number of factors including a clearer thinking around portfolio construction, the modernisation of the bond market and ongoing ETF innovation.

> "The last two years have been a major turning point for fixed income ETFs as all different investor-types have started to realise the benefits of the structure in their portfolios whether that be for tactical or strategic allocations or as a liquidity management tool"

With investors focusing more on costs as a result of regulation such as MiFID II and the low yield environment, Olson explained bond ETFs have provided the perfect tool for investors to deliver portfolio outcomes.

Furthermore, he argued the ETF ecosystem has developed rapidly in fixed income in recent years with market makers and authorised participants investing in technology which has led to tighter bid-offer spreads making the strategies more attractive for investors from a trading perspective.

Finally, there has been a sharp rise in bond ETF launches in recent years as investor demand for more precise exposures has increased.

ETF issuers such as BlackRock now offer different maturity buckets across the yield curve, for example, so investors can home in on a very specific type of exposure.

Olson added the ability for issuers to create share classes that have different currency hedges instead of creating a whole new ETF has led to an operational efficiency where issuers are managing one larger pool of assets rather than a number of smaller ETFs. This also provides investors with solutions in a much shorter time frame.

"The last two years have been a major turning point for fixed income ETFs as all different investor-types have started to realise the benefits of the structure in their portfolios whether that be for tactical or strategic allocations or as a liquidity management tool," Olson said.

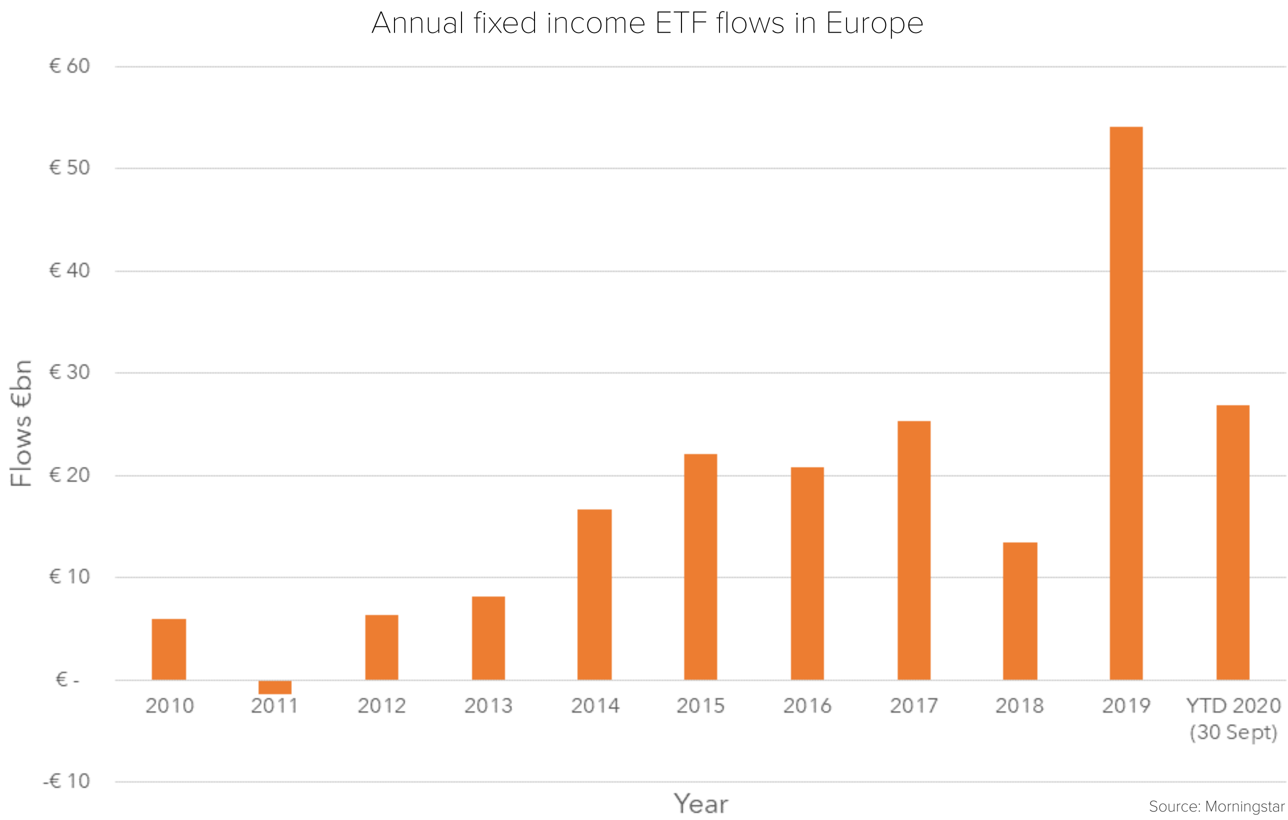
His views were echoed by Jose Garcia-Zarate, associate director, passive strategies, manager research, Europe, at Morningstar, who said the instant access to the asset class investors got without having to engage with individual securities was one of the key drivers in bond ETF adoption.

"This has democratised access to all sorts of investors, and it is probably the greatest thing that ETFs have brought about when it comes to fixed income," he added.

Liquidity test

Many critics of the ETF structure have claimed the wrapper created an "illusion of liquidity" by offering access to illiquid parts of the market.

The litmus test came during the sharp sell-off in March when the rapid spread of the coronavirus created a liquidity crunch leading to wide discounts on many bond ETFs. According to analysis conducted by Citi, some 80% of investment-grade



bond ETFs traded at all-time high discounts to their net asset values (NAVs) during this period.

Instead of highlighting structural issues within ETFs, however, the wide discounts and subsequent premiums following the Fed's decision to step into the market highlighted the "price discovery" role ETFs play.

As Garcia-Zarate said: "Many critics of bond ETFs expected that at a time of crisis and constrained liquidity conditions the ETF structure would collapse.

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"The opposite happened and suddenly many investors understood the real benefits of the ETF structure when used to accessing bond markets."

Olson added he saw a big uptick in interest for bond ETFs following the liquidity test especially from institutional clients who had not previously realised the benefits of the ETF structure especially during periods of market stress.

"The market disruption in March has led to investors using ETFs more," he noted.

Federal Reserve

Along with passing a liquidity test, fixed income ETFs have also been bolstered by the Fed's move into corporate bond ETF market for the first time in its history.

Through its Secondary Market Corporate Credit Facility (SMCCF) and executed by BlackRock, the Fed has poured $6.8bn assets into US-listed ETFs since it started purchases on 12 May, as at 17 June.

John Leiper, CIO at Tavistock Wealth, said the ongoing support from the US central bank has provided a strong tailwind for fixed income ETFs.

"A large part of the story is the increasing propensity for central banks to implement quantitative easing, or other supportive measures, via ETF purchases," he added.

Another angle to the purchases as highlighted by Jordan Sriharan, head of MPS and passive and Canaccord Genuity Wealth Management (CGWM), is it shows investors the Fed believes that ETFs are "robust and efficient enough funnel significantly large investment through".

"Up until now, many doomsayers had predicted the demise of bond ETFs on the grounds that when everyone headed for the exit door in a relatively illiquid and opaque asset class, ETFs would struggle to meet redemptions and might even have to 'gate' like a commercial real estate fund.

"In fact, ETFs provided better transparency around pricing as they moved from discounts, at the height of the panic, up to premium, as risk sentiment improved into Q2," Sriharan continued. "This has improved the credibility of bond ETFs and woken multi-asset investors up to the prospect of finding a home for them in portfolios."

Tom Eckett
Deputy Editor
ETF Stream