Exploring the world of fixed income ETFs

Recent events in the market have highlighted the need to have a properly diversified portfolio and, importantly, the need to be able to change your strategic asset allocation in a fast and efficient way. The classic flight-to-quality approach driven by the market volatility has not been bad news for all segments of the market. It is without doubt that by adding an allocation to fixed income to your fund you can improve your efficient frontier. However, many investors now appreciate that further diversification can occur within a fixed income allocation. Investors who traditionally hold just government bonds should consider whether it's appropriate to add inflation-linked bonds and, despite all the headlines, the notion of considering corporate bonds – the question is how to get the best exposure.

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Why index?

All fund managers have a niche, something that sets them apart from the rest. Therefore, it is important to concentrate on this individual skill to extract as much value as possible. It is also important that this skill is not wasted by making poor choices in the rest of your fund.

Whilst correlations in the bonds universe can be higher than in other asset classes, the traditional arguments for a well balanced diversified portfolio of bonds still hold true. If the allocation to bonds is filled with a laddered portfolio of single name bonds, without rigorous research done, then it's probable that the true risk in the fund may not be known.

It is important for any investor allocating money to an active fixed income product to appreciate what the "fees breakeven" is. By that we mean that the active return (alpha) must be at least the difference in the fees between the two styles of similar benchmarked products for it to be considered a sensible investment choice. You also need to be confident that your active manager will continue to produce the returns in the future – which made them look so compelling today.

If you have neither the time to research or the general belief that the fees charged by some active funds are not providing value for money, then the sensible approach is probably to invest in a low-cost pooled investment index fund.

Why ETFs?

As with the variety of active funds to choose from there are also a variety of indexed pooled products. One such product becoming increasingly important in the market are exchange traded funds (ETFs); these are pooled index funds which trade on national stock exchanges in real time. It is important to note that in the current markets, one of the real benefits of ETFs is the intraday trading versus the traditional once-a-day trading with most mutual funds. This implies you can trade when you want to – not when your fund allows you to.

With a broad, comprehensive suite of ETF offerings currently available, it is possible to implement nearly all fixed income views. Funds available to track include government bonds, inflation-linked government bonds and high-grade credit bonds. These are available not only in the UK market but on the similar European and U.S. markets as well. These low-cost investment vehicles open up new avenues to fund managers and plan sponsors. Thus ensuring they can implement their optimal asset allocation position depending on their view of the market. One

final point to realize on ETFs is that the volume on exchanges does not drive its liquidity; this is solely a function of what the ETF invests in. Therefore, in the case of an ETF tracking UK government bonds, the liquidity of the ETF is the same as the liquidity of the gilt market. All things considered – this makes it a very attractive proposition which should be investigated further.

How can I use fixed income ETFs to add value to my clients' portfolios?

From a portfolio manager's perspective, fixed income ETFs allows them to trade and hedge bond market exposure more efficiently. This is especially true in credit markets, where no futures contracts exist. Bond ETFs offer several features and benefits to investors and are being applied in a variety of ways.

Instant corporate bond market exposure: ETFs are frequently used as a means to gain immediate exposure to a market. Instead of investing new cash flows in money market funds or government bond futures while making investment decisions or waiting for new issuance, a portfolio manager can buy diversified exposure to the credit market through an ETF.

Express macro views on markets and sectors without the need for stock selection: ETFs are a useful tool for expressing positive or negative views on credit markets without having to translate this macro view into individual credit issues. For example, ETFs can be held in a government bond portfolio to gain a diversified credit market tilt or can be sold to hedge a portfolio's exposure to credit markets. Similarly, many investors use ETFs in long-short strategies or spread trades to express macro views – for example euro credit versus government bond futures.

A diversified core for a core/satellite investment strategy: In smaller portfolios, ETFs are held as a core holding, giving the portfolio diversified exposure to a market index. The portfolio manager can then add value by managing active positions in individual securities around this diversified core.

Hedging and asset allocation: As ETFs are extremely liquid and inexpensive to hold and trade, they make efficient hedging and asset allocation tools. For example, if a portfolio manager takes a short-term negative view on credit markets or needs to hedge a portfolio against the impact of a specific event, he can sell an ETF to reduce credit exposure. This is far simpler and less expensive than deconstructing a carefully planned corporate bond portfolio and then buying all the bonds back when the hedge is lifted. In portfolios where no short selling is permitted and you have to own a stock to sell it, then a partial allocation to ETFs can result in long-term transaction cost and time savings for the portfolio manager.

How do ETFs compare to directly holding corporate bonds?

Fixed income ETFs provide several benefits over and above holding the underlying securities directly. ETFs offer simplicity and they are also cost-effective. For example, an investor seeking to invest 10 million euro over a diversified list of bond issues would end up trading in very small amounts. This would result in higher transaction costs. Using an ETF would avoid this, as the investors would be trading in a single security.

Equally, investors trying to gain a large exposure can not always find the liquidity to facilitate this need, especially if there is no new issuance in the market. ETFs are able to facilitate very large transactions quickly, easily, efficiently and consistently.

Furthermore the ETF portfolio is managed to track the return of the index and therefore continues to be representative of the market in terms of duration, credit rating and industry exposure. Depending on the size of the holding, replicating the ETF could be expensive with respect to the time it takes to manage the portfolio, as well as the wider bid/ask spread that one would likely incur.

How do ETFs compare to traditional bond funds?

Many portfolio managers oversee a fund-of-funds strategy, adding value through selecting funds which give the client exposure to specific markets and sectors. ETFs give investors the return on a specific market, for example the FTSE 100. Investors in traditional funds have no control over what the fund invests in or whether an investment style is consistently followed. They can underperform a market index and they can sometimes not even give the investor the exposure to the market that they think they are getting. This can erode the impact of any fund-of-funds manager's sector or asset allocation strategy.

It's also important to note that ETFs are open-ended funds. Unlike closed-end funds or investment trusts they do not trade at significant discounts or premiums to the true value of the underlying portfolio of securities. More shares in an ETF can be created or redeemed to match market demand by directly trading the underlying portfolio of securities in exchange for shares in the fund. This has two important implications. First, the liquidity of an ETF is determined by the liquidity of the underlying bonds in the ETF portfolio and not secondary market trading volumes in the ETF itself. Second, as ETFs are directly exchangeable for the underlying portfolio of securities, any premium or discount in an ETF's secondary market price creates an arbitrage opportunity. Evidence from fixed income ETF trading to date, as well as from equity ETF trading over the past decade, indicates that this arbitrage relationship does hold ETF prices close to their fair value or net asset value (NAV).

As we continue into 2008 the volatility we have witnessed in the market has shown little sign of calming down. We have seen some significant market movements coupled with very big headlines hitting the news. In these times it's almost inevitable that for some investors it's important to reduce the risk in their portfolio, often described as a flight to quality. ETFs fixed income offer a smart, low-cost solution to take some bond exposure and alter your asset mix. Alternatively for those looking to boost their income generation during times of turmoil and liquidity issues, combining fixed income and high dividend equity through ETFs could well be the smart move.

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