Amundi ETF
ASSET MANAGEMENT

Focus

Fixed income ETFs: the next frontier

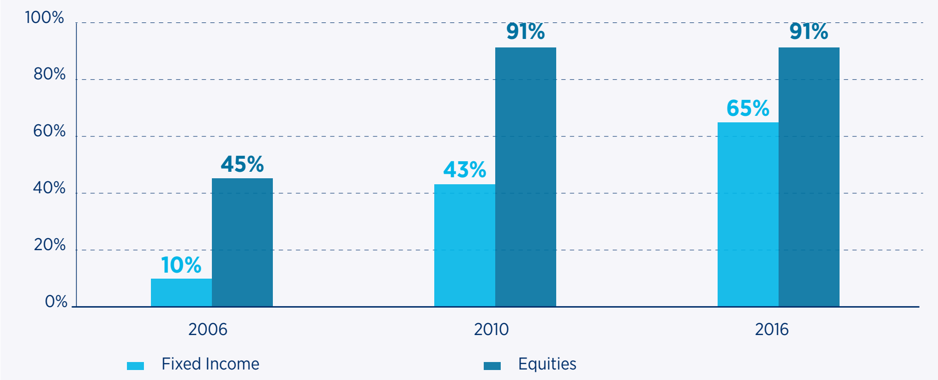
In a fast-growing Exchange-Traded Funds market, Fixed Income products are very successful. After several years of equities incontested domination, the fixed income range offers a new source of diversification allow investors to fine-tune their allocation.

Investors show great interest for fixed income ETFs

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% used the equity equivalents .

Ten years later, equity ETFs are still more popular, but fixed income products have caught up, with usage rates of 91% and 65%, respectively, for the two categories of ETF. And last year, for the first time, flows into fixed income European-listed ETFs were higher than those into equities.

Percentage of institutional european investors using ETF in the portfolio allocation between 2006 and 2016



Source: EDHEC European ETF and Smart Beta Survey, published in April 2017

At first glance this slower rate of adoption of fixed income funds is puzzling, since many of the structural benefits of ETFs are even more helpful in this asset class than in equities. It is also worth investigating why the pace of adoption has suddenly accelerated. ■

ETFs offer easy access to the bond markets

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. As bonds are over-the-counter products, there is no accurate measure of liquidity.

By contrast, a fixed income ETF gives investors access to information on the volumes traded, as well as to transaction costs, in the form of the bid/offer spread of the fund.

Indeed, it is difficult to find an accurate estimate of transaction costs for most OTC products, including bonds. The increasing volume of trading in fixed income ETFs has, however, created the scale required to make this market competitive, as well as improving price transparency.

In addition, ETF issuers work closely with market makers and liquidity providers, who are often committed to providing two-way quotes with minimum volumes and maximum bid-offer spreads. This cooperation provides investors with insights into fund valuations and the possible avenues for trade execution, as well as with an overall improvement in liquidity.

Until recently, despite the easy access provided by fixed-income ETFs to the bond market, investors remained largely immune to their competitive advantages. This may have been due to the available products not meeting in full the needs and expectations of investors. But the situation is now changing. ■

1. Source: Deutsche Bank ETF Monthly Report, August 2017
2. Source: EDHEC European ETF and Smart Beta Survey, 2017

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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 which 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. Both its duration and the potential returns have proved attractive to investors.

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.

Bloomberg Barclays Global Aggregate (500 Million) index

70 countries **23** currencies **11** types of bonds **14,000** constituents

Geographical breakdown of the index	
United States	36%
Japan	18%
France	8%
United Kingdom	6%
Germany	5%
Italy	4%
Canada	3%
Spain	3%
Other	17%

Sector breakdown of the index	
Sovereign	57%
MBS, ABS, CMBS	12%
industrials	10%
Financial Institutions	6%
Agencies	6%
Covered	3%
Local Authorities	3%
Supranational	2%
Utilities	1%

Source: Bloomberg Barclays as of September 2017

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 to investors, this has to be done in a cost-efficient manner.

It would be impossible to meet such cost efficiency requirements by buying each of the 14,000 constituents of the index. Instead, a robust sampling procedure is required to ensure accurate replication, minimising both tracking error and tracking difference.

Emerging market debt ETFs are another example of an asset class that only the largest institutional investors with OTC capabilities could access in the past.

Increasing access to these more complex and expensive parts of the bond market has helped to increase investors' rate of adoption of fixed income ETFs. ■

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 JP 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.

This is because the range of bonds in existence is much broader than for equities. It spans different credit ratings, types of lenders, currencies and maturities. Nor do investors need to access the whole market. Typically, they wish to invest only in those strategies which fit the current macroeconomic environment.

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

3 For more information, please visit www.bloomberg.com

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Fixed income ETFs: the next frontier

For example, a few years ago, the only US credit ETFs available were those tracking indices covering the whole market. Today, providers are building products that offer a more granular solution to the current specific market conditions, as well as access to a specific part of the fixed income market.

An ETF which 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.

An ETF which tracks a US BBB corporate bond one-to-five-year index, rather than one which replicates the entire US corporate bond universe, is arguably a significantly more useful tool for today's investors.

For investors who are not constrained to the investment grade universe, they can use a product which tracks BB corporate bonds, along with BBB instruments. These investors can use the high-yield market to bolster their fixed income returns.

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.

Rating, yield and duration for Barclays US Corporate Bond indices

	Maturity	Rating	Yield	Modified duration	Rate hike to cancel yield
Barclays US Corporate Bond Index	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.

Currency-hedged versions of US dollar-denominated floating rate note (FRN) ETFs are also available, allowing investors outside the US to benefit from higher US interest rates while minimising foreign exchange risk.

As the difference between US and European corporate bond yields is significant, investors can currently achieve a better euro-denominated return by investing in hedged US dollar-denominated FRNs than by investing in equivalent euro-denominated FRNs, even after taking into account the cost of currency hedging.

The increasing range of more solution-focused fixed income ETFs provides investors with a set of tools which 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. ■

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.

To sum up, we think that fixed income trend is expected to accelerate by the easy access offer by ETFs on this asset class. Investors will capitalize on this market trend to fine-tune their allocation and to seek more returns.

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