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Fixed Income

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RISING ASSETS
Transformative year for fixed income ETFs

MARKET RESILIENCE
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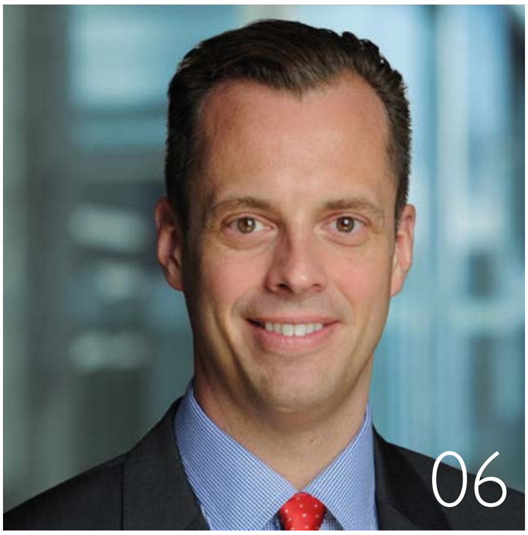

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Fixed income ETFs see assets rise in transformative year

By Beverly Chandler

Extreme volatility in the world's asset classes in early 2020 saw fixed income ETFs emerge covered in glory. Salim Ramji, Global head of iShares and Index Investments at BlackRock published the firm's fixed income report in July saying: "Liquidity, price discovery, usage and transaction costs were severely challenged across multiple asset classes in the bond markets, from high yield and investment grade corporates to emerging markets and even – for a brief period – US Treasuries.

"It was the long-awaited test for fixed income ETFs – they passed. Through the stresses, the largest and most heavily traded fixed income ETFs performed as our institutional clients hoped they would, by providing more liquidity, greater transparency and lower transaction costs than the underlying bond market."

Fixed income ETF trading surged through the volatility partly because investors tend to move to fixed income in times of uncertainty and also because of their trust that fixed income in ETF form would be able to hold up as efficient and effective tools for rebalancing holdings, hedging portfolios and managing risk.

From late February through late March 2020, iShares UCITS fixed income ETF trading surged to USD17.5 billion on average, more than twice the 2019 weekly average of USD7.8 billion. Trading volume in UCITS high yield fixed income ETFs averaged as much as USD620 million per day in March 2020 with USD13.4 billion traded in total over the month.

"For comparison, high yield UCITS ETFs averaged USD290 million per day in 2019. The trend was similar in UCITS investment grade corporate ETFs where trading in March 2020 averaged USD1.67 billion per day, giving a monthly total of USD36.3 billion compared to USD740 million daily average in 2019," Ramji says.

At a recent Morningstar Investment Conference, BlackRock chief executive Larry Fink said: "We're seeing more and more active investors using ETFs for active management. They go in and out of passive exposures through ETFs, and the biggest transformation of that is in fixed income. The fixed income market will be substantially more of an ETF market in the future."

Currently, actively managed bond ETFs represent nearly one-tenth of the USD1trillion market, according to ETF.com. The actively managed bond sector has enjoyed 13.4 per cent, or USD20.4 billion of the USD152 billion that has come into fixed income ETFs.

Back to that market turmoil in March, and the US Federal Reserve put its faith in ETFs, announcing that as part of its measures to steady the financial markets, it would be buying investment grade credit ETFs. This validation and the smooth operation of fixed income ETFs have encouraged assets to rise.

The great search for yield in a near-zero environment and the efficiency of actively managed fixed income ETFs has also attracted investors. The fixed income ETF world is becoming increasingly sophisticated with its offerings, actively picking and choosing among bonds to produce specific returns, aimed at investors who need yield in a low yield world. ■

Fixed income ETFs – proving their worth in troubled times

Interview with Brett Olson

Brett Olson Head of Fixed Income iShares EMEA at BlackRock, believes that the period of volatility in Spring 2020 was a turning point for fixed income ETFs, and that now is the time for investors to rethink their approach to fixed income allocation.

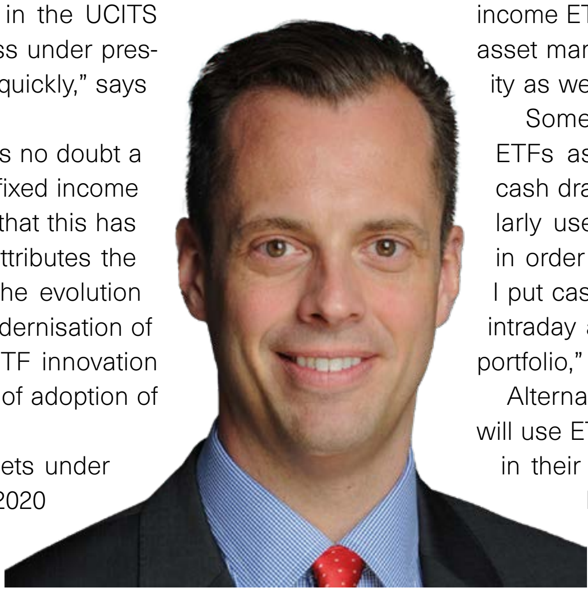
"The crisis earlier this year showed that the ETF structure is resilient to market shocks, while the dramatic rise in secondary market trading volume proved that in times of stress, more money turns to ETFs to trade, either to add risk or de-risk," says Olson.

According to Bloomberg, as of 20 March 2020, the average weekly iShares fixed income ETF trading volume was just under USD18 billion per week, whereas the 2019 average weekly trading was around USD8 billion. The iShares' flagship Core Euro Corp Bond UCITS ETF (IEAC) fund traded EUR1.2 billion on 6 March. This was over 6.5 times the 12-month average daily volume.

"We had not seen the secondary market tested in this way, particularly in the UCITS space and with every asset class under pressure at the same time and very quickly," says Olson.

The volatility in early 2020 was no doubt a turning point in the evolution of fixed income ETFs. However, Olson believes that this has been a long time coming. He attributes the growth to four main drivers – the evolution of portfolio construction, the modernisation of the bond market, continuous ETF innovation and the proliferation (or growth) of adoption of ETFs themselves.

Global fixed income ETF assets under management as of 26 June 2020 were USD1.4 trillion and of that, BlackRock manages around 48 per cent, according to Bloomberg. In EMEA BlackRock has a 60 per cent market share.



"Investors have learnt that they can use index products at the core of their holdings. By combining these lower cost ETF exposures with high conviction active strategies, investors can create more diversification and flexibility to their fixed income allocation. This is certainly more of a "barbell" approach than we have seen historically," says Olson.

He explains that BlackRock's clients – asset owners, asset managers and wealth managers – are becoming ever more innovative in their use of fixed income ETFs.

Essentially there are six primary use cases for fixed income ETFs, continues Olson. For tactical asset allocation (TAA) or strategic asset allocation (SAA), as a liquidity sleeve, a derivative complement, for cash continuum or as a transition tool.

No client will use all six. For example, a wealth client will probably not use fixed income ETFs as a liquidity sleeve, however, an asset manager is likely to use them for liquidity as well as for TAA.

Some investors might use fixed income ETFs as a liquidity sleeve to manage the cash drag in their portfolios. "This is particularly useful for an active portfolio manager in order to ensure they are fully invested. If I put cash in a fixed income ETF, I can trade intraday and I can have a beta return on my portfolio," says Olson.

Alternatively, some active bond managers will use ETFs to manage inflows and outflows in their own funds. For inflows, they might buy an ETF in a secondary market and only sell it when they find the bonds that they want to hold.

Banks or hedge funds might use fixed income ETFs as a derivative complement. "We see investors who may want to hedge their portfolios by borrowing ETF units on secondary markets – just like stock lending.

"On the corporate side, we are finding that in a negative rate environment, investors might look at fixed income ETFs for cash continuum via an ultra-short duration ETF – a one to three year government bond ETF – or an ultra-short investment grade product that has less than a half year of duration, to minimise the negative return that a cash deposit would create."

Olson is also seeing multi-asset funds or asset owners using fixed income ETFs as a transition tool. If a manager is looking to transition from one active strategy to another, perhaps for performance reasons, they may not want to be out of the market.

Inevitably, currency hedging plays an increasingly important role in BlackRock's fixed income ETFs, which is why a few years ago, it evolved its fixed income ETF platform to offer share classes of its funds.

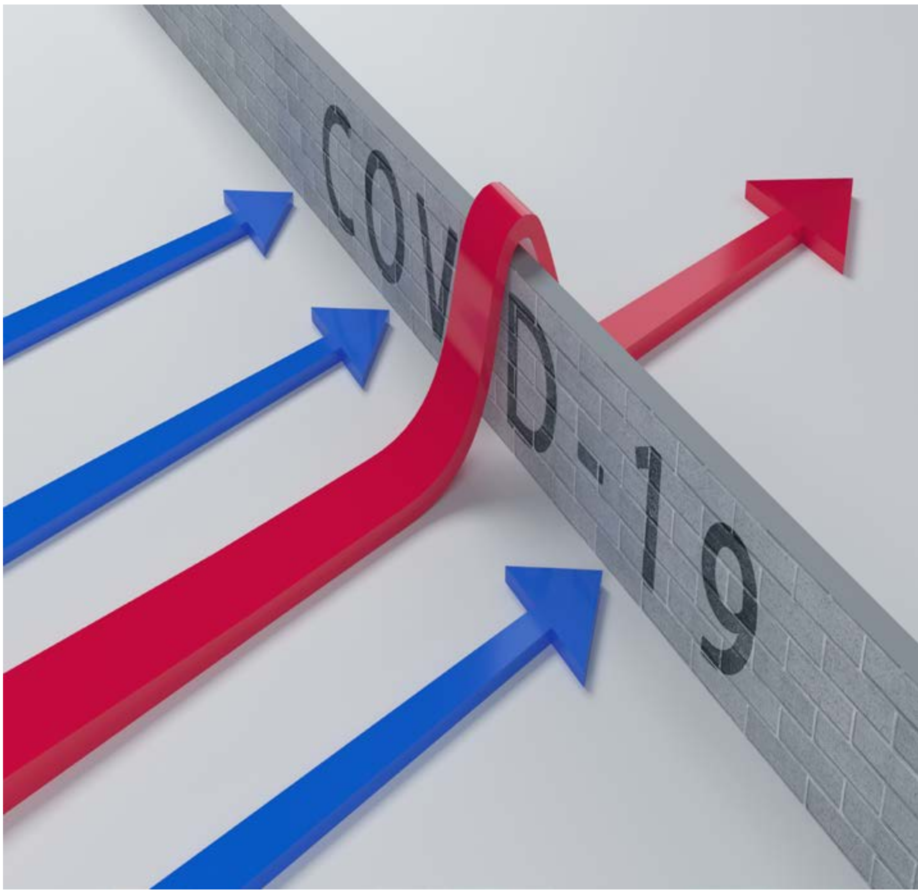
"We found that it was easier to launch a new FX share class than a new ETF. The investors benefit from the overall size of the whole ETF and not just their share class, while we maintain operational efficiency."

But perhaps one of the main illustrations that fixed income ETFs have come of age is from the fact that investors found more accurate price discovery in fixed income ETFs than in the traditional bond market during the crisis.

Unlike the equity markets where shares trade continuously, many bonds do not trade regularly, and companies can have many different bonds outstanding.

"This year, investors trading in fixed income ETFs found a clearer picture of where risk was trading. Some multi-asset investors were using the secondary market as much as they could to benefit from the tighter bid-ask spread. And we had also been hearing from investors that not only was it difficult to sell bonds, it was difficult to buy them too," says Olson.

Now, underpinning all this is the growing demand for climate focus index products. Olson believes that sustainable index offering will play a key role in bringing sustainable investing into the heart of portfolios. A survey conducted by Greenwich Associates in March 2020 found that almost 60 per cent of institutional funds and insurance companies expect



that 50 per cent of their assets are managed with an ESG criteria within 5 years.

It is also about better data being available which is leading to increased ESG coverage of indexable fixed income markets as well as because of the great wealth transfer to millennials which Olson foresees will gain traction in the coming years.

"BlackRock has sustainable fixed income solutions in many parts of the market, across EUR Govies, EUR & USD IG & HY as well as hard currency EM," says Olson. The most recent launch is the iShares EUR Govt Bond Climate UCITS ETF (SECD).

"What is interesting is that throughout the volatile period, the flows in the sustainable range remained resilient, reflecting clients' views of the products as a strategic holding. I would also argue that because of the volatility that we saw in the market, as people re-risked, more money went into ESG than we had anticipated.

"If this year has shown us anything," adds Olson, "it is that fixed income ETFs proved their resiliency, are transforming the bond market and investors are placing indexing at the core of their fixed income allocation." ■

Re-engineering fixed income ETFs

Interview with Michael John Lytle

Assets in fixed income ETFs are growing fast. Do they really need reinventing?
Growth in fixed income ETFs was inevitable, given the huge shift towards passive products and the success of ETFs in equities. It was also natural that the first bond ETFs would use existing bond indices as their benchmarks. But, with hindsight, these indices are only the first step in terms of efficient ETF construction or in their alignment with how investors actually construct and manage portfolios.

What is different about Tabula's approach? Is the name a clue?
People often ask why we're called 'Tabula' and the answer is that our philosophy is to start with a blank slate, a 'tabula rasa'. If you set out with no preconceptions, what would passive fixed income exposure look like? Evolution in financial services is often rushed or driven by vested interests, so it's often worth questioning the status quo. And, of course, new instruments can emerge that do the job better than the old ones.

Our expertise in deconstructing portfolio exposure has given us an interesting perspective too. For example, many portfolio managers think about credit risk and interest rate risk very differently. In the majority of bond ETFs, these two risks are interwoven in a way that the manager cannot control without introducing a hedging strategy. Wouldn't it be simpler to use different instruments for different risks? This was the rationale behind our first ETFs,

using CDS indices to provide precise credit exposure, without the interest rate component.

The important thing is to have an open mind and listen to investors. In some market segments we're making small tweaks to existing approaches. In other areas, we see the need for a more serious rethink.

Does the market need another Euro IG bond ETF?

This is another common question. Clearly, the Euro investment grade bond market is well-served by a handful of large ETFs. However, as we've discussed, the traditional indices may not always deliver optimal exposure for investors, or the most efficient ETF. Again, our credit background helped us find a solution. In the past decade, credit default swap (CDS) indices have become the default instruments for credit trading. For example, trading volume in iTraxx Europe, a basket of 125 investment grade European issuers, averages over EUR4 billion a day. Why not launch a bond ETF that closely matches this liquid instrument? Our Euro IG bond ETF tracks an index designed to provide corporate bond exposure that closely reflects iTraxx Europe.

There are multiple benefits to this approach, including a highly liquid ETF, with more balanced sector exposure and without the additional complexity of US issuer risk. Another plus is that this ETF has a AA ESG rating from MSCI.

I strongly believe that you don't need 3,000 bonds to track a market. During the stressed markets of March 2020, this ETF traded much closer to its Net Asset Value than its competitors.

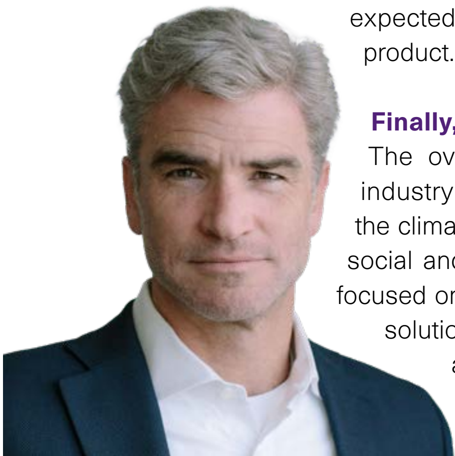
As we approach year end, and the sell side prepares to slim balance sheets while the buy side closes its books, a more liquid approach to EUR IG credit may once again prove beneficial. The current slew of negative factors could also lead markets to experience more than just a seasonal liquidity slump.

You've just launched a US inflation ETF. What was your approach there?

It's becoming ever more likely that the era of stable developed market inflation is coming to an end. Our newest ETF is, again, the result of stepping back and asking what investors really want. Currently, the ETF market offers a choice between traditional inflation-linked bonds, delivering realised inflation, and more sophisticated products offering exposure to inflation expectations but with no real yield. Our conversations with investors revealed that most want exposure to both realised and expected inflation, ideally in the same product.

Finally, what's next for Tabula?

The overriding issue for the whole industry is sustainability, particularly the climate change emergency, but also social and governance concerns. We're focused on finding efficient and impactful solutions that suit the specific characteristics of the fixed income asset class. ■



Michael John Lytle
CEO, Tabula Investment Management

Michael John ("MJ") Lytle is CEO of Tabula Investment Management. Previously MJ was a founding partner in Source, an investment manager focused on the creation and distribution of ETFs, including a partnership with PIMCO to create and distribute a range of fixed income ETFs. Source was purchased by Invesco in 2017. Prior to Source, MJ spent 18 years at Morgan Stanley with a variety of roles across corporate finance, capital markets origination, trading, sales, equity, fixed income, private wealth and technology strategy. Most of these roles revolved around fixed income and evolving and expanding investors' access to the asset class. MJ has a BA in Economics and Government from Dartmouth College with further studies at the London School of Economics.

ABOUT iSHARES

iShares unlocks opportunity across markets to meet the evolving needs of investors. With more than 20 years of experience, a global line-up of 900+ exchange traded funds (ETFs) and USD1.85 trillion in assets under management as of March 31, 2020, iShares continues to drive progress for the financial industry. iShares funds are powered by the expert portfolio and risk management of BlackRock, trusted to manage more money than any other investment firm.

www.ishares.com/uk

TABULA INVESTMENT MANAGEMENT

Tabula is a London-based asset manager focused on fixed income. We offer a growing range of differentiated UCITS ETFs and funds to institutional investors. Our ETFs provide unique solutions in the fixed income space, and help investors achieve greater control of the risks and rewards inherent in institutional investing.

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