HSBC
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Why invest in fixed income ETFs?

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Since their introduction to the investment landscape back in 2002 in the U.S., there has been a rapid increase in the adoption of bond ETFs by institutional and retail investors due to a recognition of their ability to transform the hard-to-access and opaque global bond market. With assets globally reaching US$1.4tn[1], fixed income ETFs provide liquid, diversified and efficiently priced access to a multitude of fixed income markets.

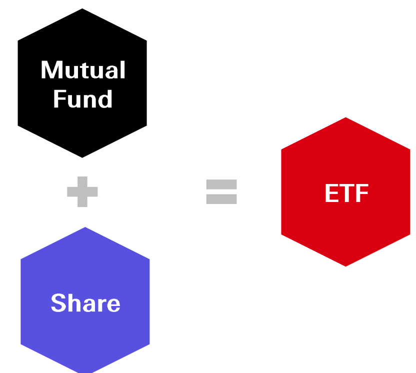
ETFs and fixed income

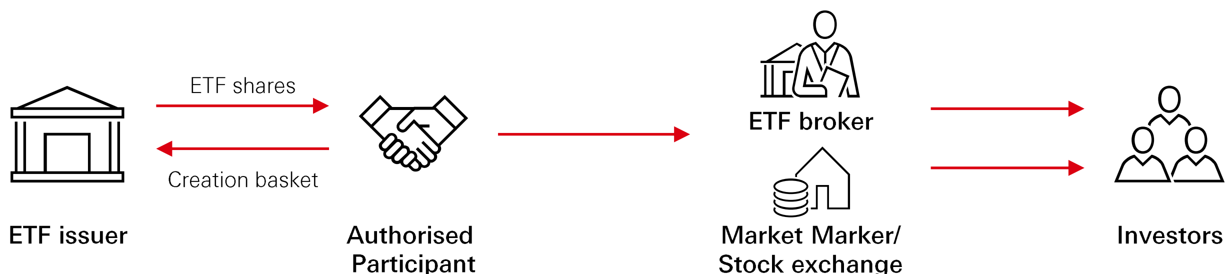
- Fixed income ETFs seek to track the collective performance of the index, through holding a representative sample of the collection of bonds
- Like equity ETFs, fixed income ETFs provide exposure to a collection of securities through a simple, easy-to-use vehicle; investors can access different forms of debt from all areas of the market, adding diversification and a steady rate of income to a portfolio
- Fixed income ETFs go a step further than equity ETFs, however, as they bring the over-the-counter (OTC), opaque nature of the fixed income market into a transparent and exchange-traded wrapper. The unique structure of the ETF vehicle brings specific benefits to navigating investments in the fixed income space, including liquidity, diversification and transparency (more details on page 3)
- Given the depth of debt capital markets and variety of ETFs available, investors are able to get an attractive combination of different grades of credit (sovereign, investment grade, high-yield etc.), geographies and durations

How do ETFs work?

Exchange Traded Funds (ETFs) are investment funds which track an underlying index.

- A **standard mutual fund** that is open-ended creates or redeems shares once a day at the net asset value (NAV) of the fund, with investors directly transacting with the fund. If the fund needs to adjust its shares in issue, this will result in the fund transacting in the underlying market and buying or selling holdings
- **ETFs**, on the other hand, can be bought or sold on exchange intraday at a price determined by the market, but with a creation and redemption mechanism that ensures that the market price is kept within a close range of the NAV of the fund





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1. Source: ETFGI, as at March 2021

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ETF investors buy and sell ETFs on **exchange or OTC** (often via RFQ systems) on the secondary market. A selection of broker dealers and market makers referred to as **Authorised Participants** (APs) are able to trade with the ETF directly, enabling (but not obliging) them to create and redeem ETF units in response to supply and demand for the ETF. As part of the agreement the AP has with the ETF, the AP will only transact with the ETF in large transactional sizes (known as **baskets**), typically in multiple millions of dollars in value. The creation or redemption of ETF units occurs at **NAV** and will often involve the AP exchanging a basket of bonds in return for the ETF units or vice versa when redeeming ETF units. This mechanism of creation or redemption means the ETF price remains closely linked to the NAV of the fund.

How do fixed income ETFs track an index?

- In contrast to many equity indices, bond indices often have too many constituents to feasibly hold every bond in the index
- It is therefore the objective of the ETF manager to replicate the risk characteristics of the index by sampling, rather than holding every security
- Sampling or optimising means replicating the characteristics of the reference bond index such as duration, issuer credit exposure and term.
- Sampling is an efficient way to replicate fixed income portfolios through keeping the main characteristics of the index without the illiquidity and costs considerations often associated with trying to fully replicate a bond index

Did you know?

The Bloomberg Barclays US Aggregate Index contains over 10,000 bonds from a variety of issuers ranging from the US government to local authorities and corporates.

Sampling in a nutshell

The ETF manager will usually take one of two approaches to constructing a portfolio that replicates the risk characteristics of the portfolio: a top-down approach or a bottom up approach.

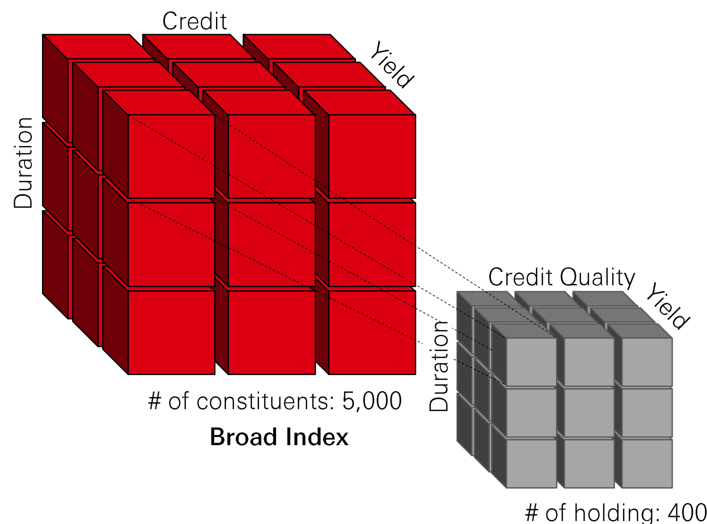
Whichever approach is taken, the ETF manager will screen the securities to maximise liquidity of the index subset while maintaining low tracking error.

Top-down approach

The top-down approach seeks to align the common risk factors of the ETF to the index as these are the key variables. These factors include duration, credit spread, sector exposures and credit rating.

Bottom-up approach

The bottom up approach is used when the ETF manager typically finds more price volatility in the index such as high yield bonds. The ETF manager tries to identify and remove specific idiosyncratic risks from the portfolio.



Sample portfolio with similar risk characteristics

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What are the benefits of fixed income ETFs?

Investors may struggle with a number of complexities when investing in fixed income markets. They are typically fragmented, lacking a centralised exchange and may not be easily accessible to all investors. Fixed income ETFs, however, remove this complexity by offering a simple and transparent vehicle, listed on exchange, which provides easy access to a broad range of fixed income opportunities at low-costs and low barriers to entry.

Below are the key themes for why investors might find fixed income ETFs an attractive proposition:

Liquidity

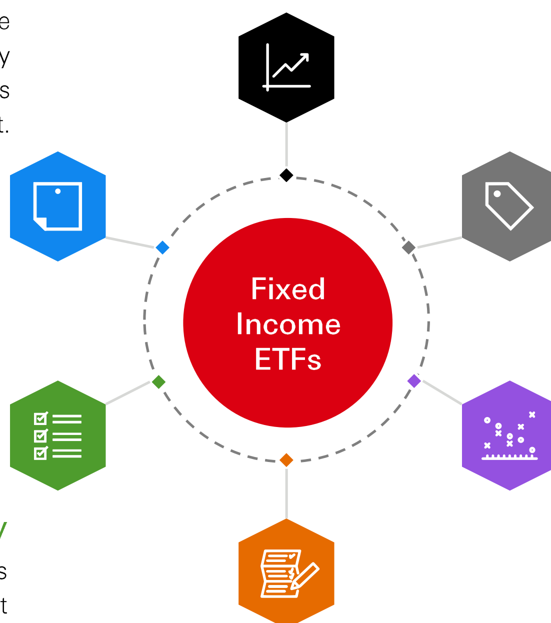
Fixed income ETFs are traded throughout the day on the secondary market giving investors greater liquidity when compared to individual bonds or to a mutual fund.

Cost efficiency

ETFs are usually passive, low cost vehicles designed to track an index. Thanks to economies of scale and operational efficiencies, ETFs are offered with a low TER (all in cost) and will tend to have lower transaction costs than individual bond portfolios.

Price discovery

Fixed Income ETFs are a vital source of bond price discovery, particularly in times of volatility when this information matters the most.



Transparency

ETF holders can verify their positions on a daily basis, providing great transparency. They are priced continuously throughout the day allowing investors to accurately mark-to-market.

Diversification

ETFs provide access to a diversified portfolio of bonds in a simple and easy-to-use wrapper. In one single security, an investor can access hundreds of bonds that are diversified across term structure, credit quality and issuers.

Market access

For investors, the main benefit of ETFs is the immediate exposure to a broad range of bonds, traditionally reserved for institutions. Accessing multiple grades of credit to date has been extremely challenging for the majority of investors, due to minimum trading sizes and a lack of liquidity. This, combined with lower transaction costs, tax advantages, and good intraday liquidity due to being listed and continuously quoted, make fixed income ETFs an attractive alternative to buying a portfolio of individual bonds.

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Market access and diversification

- Bond indices are more complex than equity indices, making them more challenging to replicate or track effectively. Not only do many bond indices contain thousands of issuers, but each issuer can have multiple securities with varying coupons and maturities each with their own price.
- Through ETFs, investors are able to access "core" broad segments of the market or more specialised niche or specifics areas. Areas that were previously difficult to trade or too expensive to access can now be invested in through a single product. This has lifted restrictions on traditionally difficult to access market segments such as emerging market debt (hard currency or local currency), high yield bonds or green bonds.
- Diversification among issuers, credit qualities and term structures is particularly beneficial, as it provides better protection against losses than more concentrated holdings owing to the broad universe of exposure they offer. Investors looking at short duration are able to invest quickly and efficiently without the need to frequently reinvest the cash flows typically associated with this segment of the market.

ETFs vs direct bond investing

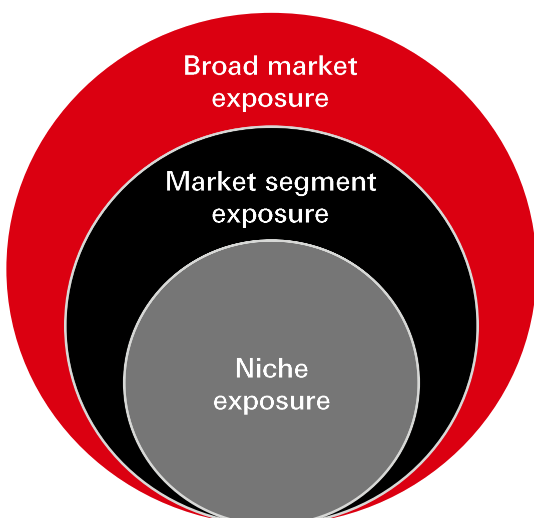
ETFs provide exposure to a large market of fixed income securities in a single wrapper. Trying to achieve this level of diversity investing directly into bonds is not typically possible or straightforward for most investors, as bonds trade in quite large minimum lot sizes (typically tens/hundreds of thousands of dollars per issue). Furthermore, bonds trade over-the-counter (OTC), meaning there is no single exchange on which they trade and no official agreed-upon price. The market is difficult to navigate, and investors may find they receive widely different prices from different brokers for the same bond. Conversely, ETFs allow a diversified exposure from a single unit size upwards allowing efficient and accurate portfolio construction and asset allocation.

ETFs for your fixed income allocation

- An ETF can be a very versatile vehicle and is used by investors in several ways, from core strategic allocation to tactical adjustments purposes.
- ETFs can be used as core and satellite building blocks across asset classes that are easy to access and create accurate exposure.
- There are also a variety of ETFs which provide exposure to difficult-to-reach asset classes (e.g. alternatives) and market segments (e.g. emerging market debt).
- Fixed income ETFs can also provide an efficient means to tweak the duration and credit exposure to meet specified targets.

How are ETFs used?

- Asset allocation
- Tactical adjustments
- Transitions
- Cash equitisation
- Rebalancing
- Asset class exposure
- Liquidity management
- Portfolio completion



- Aggregate or universal bonds

- Government bonds
- Corporate bonds
- Municipal bonds
- EM bonds

- Long / short duration
- IG bonds
- HY bonds

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Liquidity and price discovery

- ETF liquidity is underpinned by the primary market where APs transact directly with the ETF issuer to create or redeem ETF units in exchange for baskets of the underlying security.
- ETFs are essentially baskets of stocks or bonds, therefore it follows that their liquidity is derived from the underlying securities they track, as such an ETF tracking an index of high yield corporate bonds for example would usually be less liquid than a basket containing liquid government bonds.
- However, in addition to the underlying liquidity of the basket of bonds and unlike a mutual fund, liquidity in ETFs is enhanced by the secondary market where continuous trading of ETF shares takes place both on exchange and OTC by investors and liquidity providers throughout the day.
- The benefit of the secondary market is that buyers and sellers can exchange ETF units between themselves, and as a result not impact the underlying market. This creates a secondary layer of liquidity, which can be particularly beneficial where the underlying may be less liquid in certain bonds, but also in more liquid securities it can still produces efficiencies as no underlying trading results and associated transaction costs can be avoided.

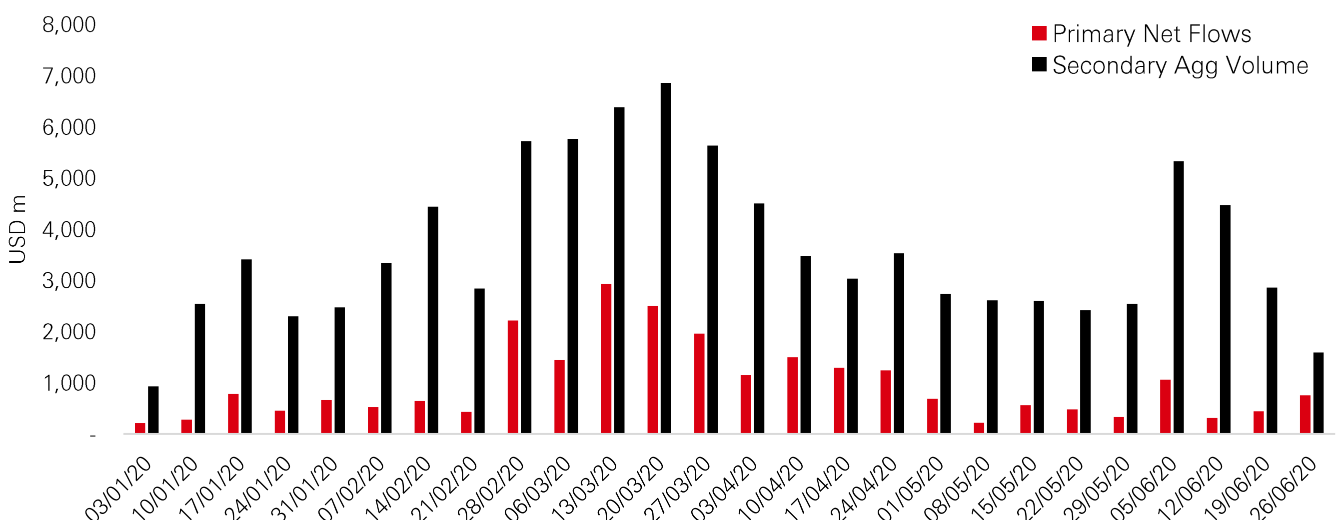
Bond ETFs in stressed markets

During the COVID-19 related volatility in the beginning of 2020, investors may have found it easier to trade ETF shares than the underlying assets held by the ETF, and trading volumes in ETF shares rose significantly. The chart below shows the five largest UCITS fixed income ETFs and how they reacted during the recent COVID-19 volatility. In March 2020, as the sell-off accelerated, it is clear the secondary market of the ETFs grew in size and worked as a shock absorber to redemptions in the primary market. It was also clear that bond ETFs reacted more quickly to news than the underlying bond prices. A Bank of England report[1] confirmed that what may have appeared to be the ETF trading at a discount to NAV was in fact ETFs leading bond prices. The report confirmed that ETF prices provide information about future changes in bond prices more quickly than NAVs and hence these are not discounts but price discovery.

- Market makers and liquidity providers such as banks are also participants in the ETF secondary market and further enhance liquidity through their balance sheets and managing inventory of ETF units from buyers and sellers.
- Instead of trading many individual bonds, an ETF offers focused liquidity in a single vehicle. At the same time, when trading does occur in the underlying securities, liquidity is more prevalent in the creation or redemption baskets of those ETFs.
- As a result, bond ETFs often trade with a tighter bid-ask spread than the underlying basket of securities, hence creating further efficiencies for the investor.
- Secondary market volumes are becoming more transparent thanks to MiFID II where all trades have to be reported in Europe. Unfortunately, European ETFs lack a "consolidated tape" at this stage, however the ETF Issuers Capital Markets team can help to give an overview of secondary market liquidity.

Fixed income UCITS ETFs during the pandemic

Primary market vs secondary market trading[2]



1. Source: BOE Interim Financial Stability Report – May 2020
2. Source: Bloomberg, HSBC Global Asset Management. 5 Largest UCITS Fixed Income ETFs by AUM. Data as at end of June 2020

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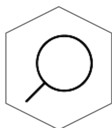
Cost efficiency and transparency

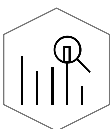
Low TER

- The costs of investing are more in focus than ever before, particularly in fixed income investing in the current low yield environment.
- An ETF is a pooled vehicle meaning that investors benefit from economies of scale. Bond ETFs are growing rapidly with global assets growing from USD 350bn in December 2013 to USD 1.4tn[1] currently, meaning that economies of scale continue to grow. Bond ETFs on the whole are designed to be index tracking vehicles, aiming to deliver the performance of the index minus fees. Generally ETF managers do not take fees with the intention of trying to deliver alpha or outperform meaning that ETFs often have the lowest total expense ratio (TER) for getting exposure to the given market segment.
- Many mutual funds, both active and passive, also add to costs through distribution agreements with platforms and brokers. ETFs don't have this type of costly intermediation involved in the transactions. The entire cost the investor is charged is encapsulated in the TER, an annual all-in fee that includes the management fee as well as all administrative costs.



Price transparency

- The cost of buying or selling an ETF and the price at which the transaction takes place is transparent and immediate when transacting in an ETF.
- The quotes are available throughout the day on exchange, allowing investors to compare costs and see immediately the price impact of any moves in the underlying market which may effect their investment decision.
- This means that particularly in times of volatility or market turbulence, investors tend to use ETFs more because they make it simple to manage risk in portfolios. This is even more valuable in Bond ETFs where establishing a price and finding liquidity in the underlying securities can be more challenging.



What you see is what you get

- Typically, mutual funds are only required to disclose their portfolios on a quarterly basis – alongside that there is often a 30-day lag. During that period, it is not possible for an investor to verify the holdings of the fund and to ascertain if the fund is subject to deviations or "style drift" from its specified objectives. ETFs, however, are far more transparent.
- Most ETFs disclose their full portfolios holdings on a daily basis on public websites. This allows investors to know what they are invested in, what sectors they are exposed to and what geographies they are currently tracking.
- The ETF publishes a portfolio composition file (PCF) daily to the market. This discloses the holdings of the ETF and also details of the basket the AP must deliver to the ETF to create or redeem shares. This – combined with the ability to see the full holdings of the index an ETF is aiming to track – provides an extremely high level of disclosure.

1. Source: ETFGI, as at March 2021.

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Key risks

The value of an investment in the portfolios and any income from them can go down as well as up and as with any investment you may not receive back the amount originally invested.

- **Concentration Risk:** The Fund may be concentrated in a limited number of securities, economic sectors and/or countries. As a result, it may be more volatile and have a greater risk of loss than more broadly diversified funds
- **Counterparty Risk:** The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations
- **Credit Risk:** A bond or money market security could lose value if the issuer's financial health deteriorates.
- **Derivatives Risk:** Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset
- **Emerging Markets Risk:** Emerging markets are less established, and often more volatile, than developed markets and involve higher risks, particularly market, liquidity and currency risks
- **Exchange Rate Risk:** Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly
- **Index Tracking Risk:** To the extent that the Fund seeks to replicate index performance by holding individual securities, there is no guarantee that its composition or performance will exactly match that of the target index at any given time ("tracking error")
- **Investment Fund Risk:** Investing in other funds involves certain risks an investor would not face if investing in markets directly. Governance of underlying assets can be the responsibility of third-party managers
- **Investment Leverage Risk:** Investment Leverage occurs when the economic exposure is greater than the amount invested, such as when derivatives are used. A Fund that employs leverage may experience greater gains and/or losses due to the amplification effect from a movement in the price of the reference source
- **Liquidity Risk:** Liquidity Risk is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors
- **Operational Risk:** Operational risks may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things
- **Real Estate Investments Risk:** Real estate and related investments can be negatively impacted by any factor that makes an area or individual property less valuable

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