A case for Fixed Income ETFs

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Fixed income and asset allocation

Investors are challenged by fixed income allocations. While fixed income still plays its traditional role of partially offsetting equity risk in portfolios, the yield contribution has declined with central bank activity and slow global economic growth impacting interest rates. The probability of extended price appreciation in fixed income markets is low and volatility now has a greater effect due to a decreased buffer from bond coupons. However fixed income portfolios remain a valuable part of a balanced asset allocation strategy; the benefits of this asset class go beyond yield alone. It is for this reason investors have increased their appetite for more bespoke benchmarks, those that capture more yield while at the same time keeping risks under control.

Historically, portfolio construction has been heavily focused on equity asset allocation. In the current environment, investors, while still valuing core fixed income holdings, are repositioning based on three key decisions:

1. Credit Positioning
2. Curve Positioning
3. Regional Diversification

Maximizing the benefits of these decisions, and being able to efficiently reposition portfolios has led investors to look beyond traditional investments and has coincided with the growth of liquid, transparent, and tradeable ETFs.

The rise of ETFs

Fixed income ETFs are one of the most popular and fastest growing segments of the ETF market. They appeal to investors by trading like equities while providing exposure to a diversified basket of bonds. Investors use fixed income ETFs both as a low cost core holding and as precise exposures to reposition their portfolios. Investors recognize that ETFs are easy to use, offer additional liquidity, and help to minimize trading costs. In a low yield environment, investors must increasingly focus on fees and trading efficiency to maximize their returns.

In the current rate environment, investors need more income to cushion their portfolio from market events and volatility. As the industry has transformed, investors are now more equipped than ever to properly position their fixed income sleeve of their portfolio with ETFs that allow them to slice the fixed income spectrum by credit, maturity and geography.

The fixed income market has changed dramatically in the past few years, with the rise of regulations and decreased dealer activity leading to concerns about liquidity in the market. With the recent growth of fixed income ETFs, critics are concerned that these ETFs will suffer a liquidity crisis, if and when interest rates start to rise. We would observe that while the liquidity of ETFs begins with the underlying holdings, the added benefit of exchange trading adds incremental liquidity for investors.

Credit positioning

In the current low yielding environment, yield carry on credit provides investors with an additional buffer if rates increase which is why the distinction between sovereign and corporate credit risk is so important. This decision is primarily driven by the short-term macroeconomic factors.

Leading into a recession, investors would raise sovereign exposure as corporate bond default rates rise and credit spreads widen; at the same time central banks begin their easing process by lowering interest rates, which also may lead to outperformance of sovereign bonds. Typically coming out of a recession, as the economy recovers and growth returns, corporate bonds tend to outperform sovereign debt. For example, if you look at the financial crisis in 2008, the Global Treasury Index outperformed the Global Corporate Bond Index, due to the flight to quality that resulted in flows into sovereign bonds. As the market recovered in 2009, we saw this trade reverse, as the market bottomed and flows went back into corporate debt. During this period we also saw spread tightening which also lead corporate bonds to appreciate in price.

Global Treasury vs. Global Corporate Bonds

Year	Global Treasury	Corporate	Differential
2015	1.80%	0.12%	1.68%
2014	8.49%	7.90%	0.59%
2013	0.26%	0.25%	0.01%
2012	4.74%	11.07%	6.32%
2011	5.98%	4.95%	1.03%
2010	3.87%	7.32%	3.45%
2009	1.35%	16.46%	15.10%
2008	11.45%	-3.80%	15.25%
2007	6.07%	3.57%	2.51%
2006	2.99%	3.23%	0.24%

Source – Barclays POINT (now Bloomberg Barclays Indices). Data as at 31.10.2016

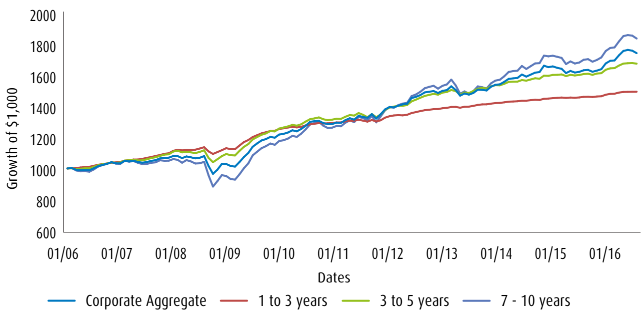
Global Aggregate Corporate option adjusted spread

Source – Barclays POINT (now Bloomberg Barclays Indices). Data as at 31.10.2016

Curve positioning

As the industry has evolved, with more ETFs coming to market, investors now have the flexibility to tactically position the duration of their portfolios based on their risk appetite, investment horizon and their curve expectations.

Segmenting the Corporate Aggregate market



Source – Barclays POINT (now Bloomberg Barclays Indices). Data as at 31.10.2016

Investors who are willing to take on more risk and are looking for a higher return can increase their duration with longer term bonds, while those who are more risk adverse may choose to shorten their duration. As investors move further out on the yield curve, they gain interest rate exposure but also increased return volatility.

Based on yield curve expectations, investors can manage interest rate risk by adjusting the duration of their bond portfolios using different maturity bands. If investors anticipate a rise in interest rates they can lessen the impact by shortening duration. On the other hand, if an investor wanted to take advantage of a market event such as an interest rate cut, they can increase duration on their bond portfolios. This is further illustrated in the chart below where in 2006 to 2008 the economy started to heat up and the fed raised interest rates. We saw short term bonds outperform the aggregate bond universe because of their lower duration. In 2009 following the great recession we saw the opposite, with long duration bonds outperforming.

By segmenting the market, investors have the ability to be more precise based on their yield curve expectations. As shown in the table below, it is clear that not all bonds are created equal, as the return differential can be significant across maturity bands and further highlights the variance between broad exposure and maturity bands.

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Segmenting the market (Corporate Aggregate Vs. Maturity Banded Corporates)

Year	Full Term	1 – 3	Diff.	7 – 10	Diff.
ytd	7.38%	2.35%	-5.03%	8.85%	1.47%
2015	0.12%	1.32%	1.20%	0.57%	0.44%
2014	7.90%	2.00%	-5.90%	10.77%	2.87%
2013	0.25%	2.24%	2.00%	-1.14%	-1.39%
2012	11.07%	5.48%	-5.59%	14.78%	3.71%
2011	4.95%	1.50%	-3.45%	5.92%	0.97%
2010	7.32%	3.87%	-3.44%	9.41%	2.09%
2009	16.46%	11.23%	-5.23%	20.45%	3.99%
2008	-3.80%	1.77%	5.57%	-8.89%	-5.09%
2007	3.57%	5.68%	2.12%	1.86%	-1.71%
2006	3.23%	4.21%	0.97%	2.76%	-0.47%
2006	2.99%	2.99%	2.99%	3.23%	0.24%

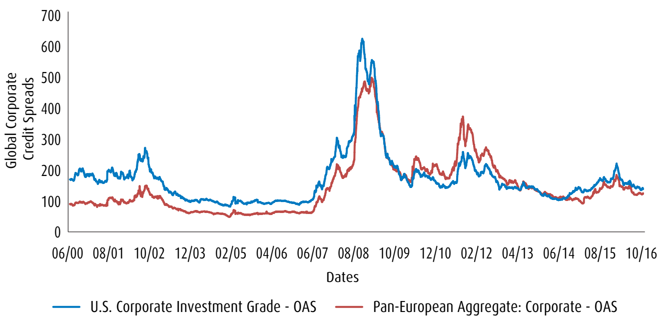
Source: Barclays POINT (now Bloomberg Barclays Indices). Data as at 31.10.2016

Regional diversification

Global bonds have become more accessible as an asset class helping to reduce portfolio volatility similar to the use of international equities. Global bond investors are still faced with multiple sources of risk such as interest rate risk, inflation fluctuations and political challenges from multiple countries; however these risks are mitigated through regional diversification across the portfolio. Through global exposure, investors get access to developing high growth economies and more stable developed countries which can further enhance returns.

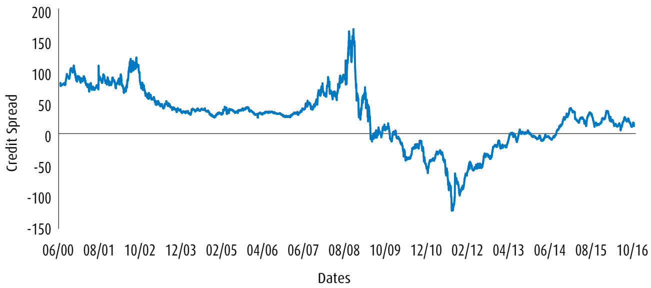
In 2009, U.S. credit spreads widened approximately 150bps more than European credit, while in 2012 European credit widened significantly relative to U.S. credit, further highlighting that through global exposure, investors' portfolios are insulated against country specific market events.

Global Corporate credit spreads – U.S. vs. EU



Source – Barclays POINT (now Bloomberg Barclays Indices). Data as at 31.10.2016

Spread – U.S. over Pan-Europe



Source – Barclays POINT (now Bloomberg Barclays Indices). Data as at 31.10.2016

Looking forward

As employment and inflation appear to be near the U.S. Federal Reserve's target, the case for a rate hike in the U.S. has strengthened. Economic activity continues to pick up, the unemployment rate is hovering between 4.5-5% while inflation is around 1-2%. Both metrics point to a gradual tightening of monetary policy, with careful consideration of not excessively slowing the economy or impacting asset prices.

Meanwhile the rest of the world's central banks continue easing monetary policy through negative interest rates and quantitative easing. In Europe, aggregate unemployment is above 8% and inflation continues to bounce around 0%. The ECB has stated that the "key rate will remain at present or lower levels for an extended period of time".

While short-term rates may diverge from time to time, historically the U.S. and German rates (as a proxy for Europe) have moved together. Economic dynamics anchor the two; if the U.S. raised interest rates dramatically relative to the Eurozone, then the U.S. Dollar would rise and the combined effect of both higher rates and a stronger dollar would pull long-term growth down and lead to a weaker dollar and lower rates, thus binding the two rates.

At the short end of the curve, the current spread between the U.S. and German 2-year bond is near 150 BPs, with the market expecting it to widen further to about 250 bps, in anticipation of further U.S. rate hikes. The move should have limited effect on prices due to the short duration of the bonds. As well, any hikes from the U.S. would be due to stronger growth which should narrow credit spreads.

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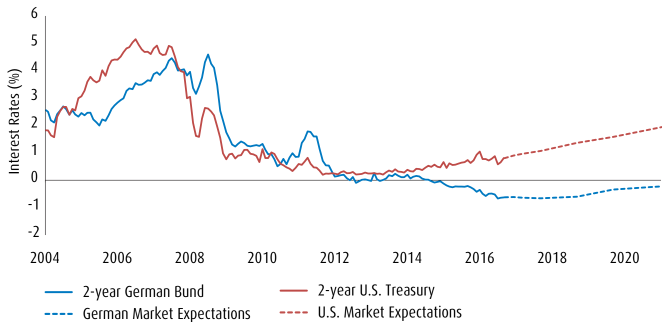
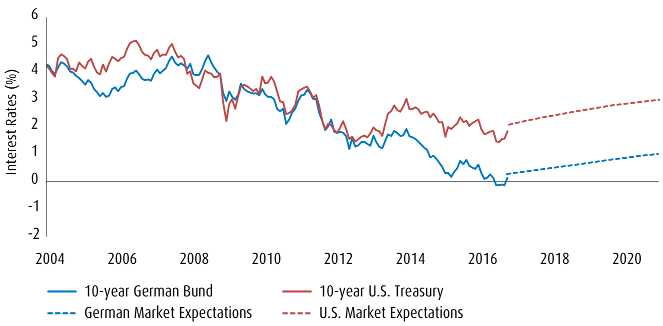
2 year forward looking expectations



Source – Bloomberg. Data as at 31.10.2016

At the long-end of the curve, the U.S. and Eurozone 10-year bonds should maintain their close proximity to each other as they are bounded, not by central bank policy but by long term growth prospects. Rates should remain low for an extended period of time as secular forces such as aging demographics, slow global growth, and global deleveraging will take time to play out. As can be seen in 10-year spread between the U.S. and Germany below, the range is a lot smaller over time and is expected to remain constant over the next few years, around 200 bps.

10 year forward looking expectations



Source: Bloomberg. Data as at 31.10.2016

Currency

When investing in global bonds, currency fluctuations can have a meaningful impact on portfolio returns. Investors are implicitly taking bets on currency movements. Hedging currency risk can significantly reduce the return volatility of global bond investments, giving a better risk control; by removing currency volatility, returns can be attributed solely to performance of the credit exposure.

Conclusion

As investors look to position their portfolios, there are 3 critical decision they must consider when allocation fixed income; credit positioning as corporate bonds and treasury bonds has led to an average annual return differential of 4.93%, secondly curve positioning as short corporate bonds and full term bonds have seen an average return differential of 3.77% and lastly, regional exposure as European corporate and global corporates have seen an average return differential of 1.70%. By effectively allocating to these 3 variables, investors can take advantage of the greater opportunity set in fixed income and higher return potential.

BMO Global Asset Management provides investors with an innovative approach to position their portfolios over the maturity spectrum. This gives investors the ability to implement a precise positioning strategy within the corporate universe. Investors can now benefit by using ETFs as lower cost vehicles to navigate this typically hard to access and illiquid market.

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