Invesco

This marketing communication is for Professional investors and Qualified clients/ sophisticated investors.

How to take full advantage of ETFs in a bond portfolio

Contents

Overview

The ETF market in Europe has been growing strongly over the past decade and this growth has accelerated in the most recent years as a broader range of investors discover the potential benefits ETFs offer to their portfolios. This trend is arguably most noticeable in fixed income, where ETF flows appear to be gaining momentum, including among pension and insurance funds as well as other traditional bond buyers who are using ETFs for both strategic and tactical allocation requirements.

Yields from traditional sources remain low in historical terms, due largely to central bank policies. A combination of interest rate cuts and sustained asset purchases in response to the Covid-19 crisis have helped support bond prices (and maintained downward pressure on yields). However, yields have risen from the lows seen in the immediate aftermath of the pandemic as these emergency measures draw to an end, therefore it may now may be a good time to review portfolios.

Choosing between ETFs, index trackers, segregated mandates, derivatives and direct investment will often be influenced by a host of factors, including individual circumstances, objectives, timeframe, costs, size of portfolio, frequency of trading and level of expertise in the asset class. Here, we will look at different areas of fixed income and highlight where and how ETFs may be worth considering.

ETF growth has accelerated... as more investors discover the potential benefits ETFs offer.

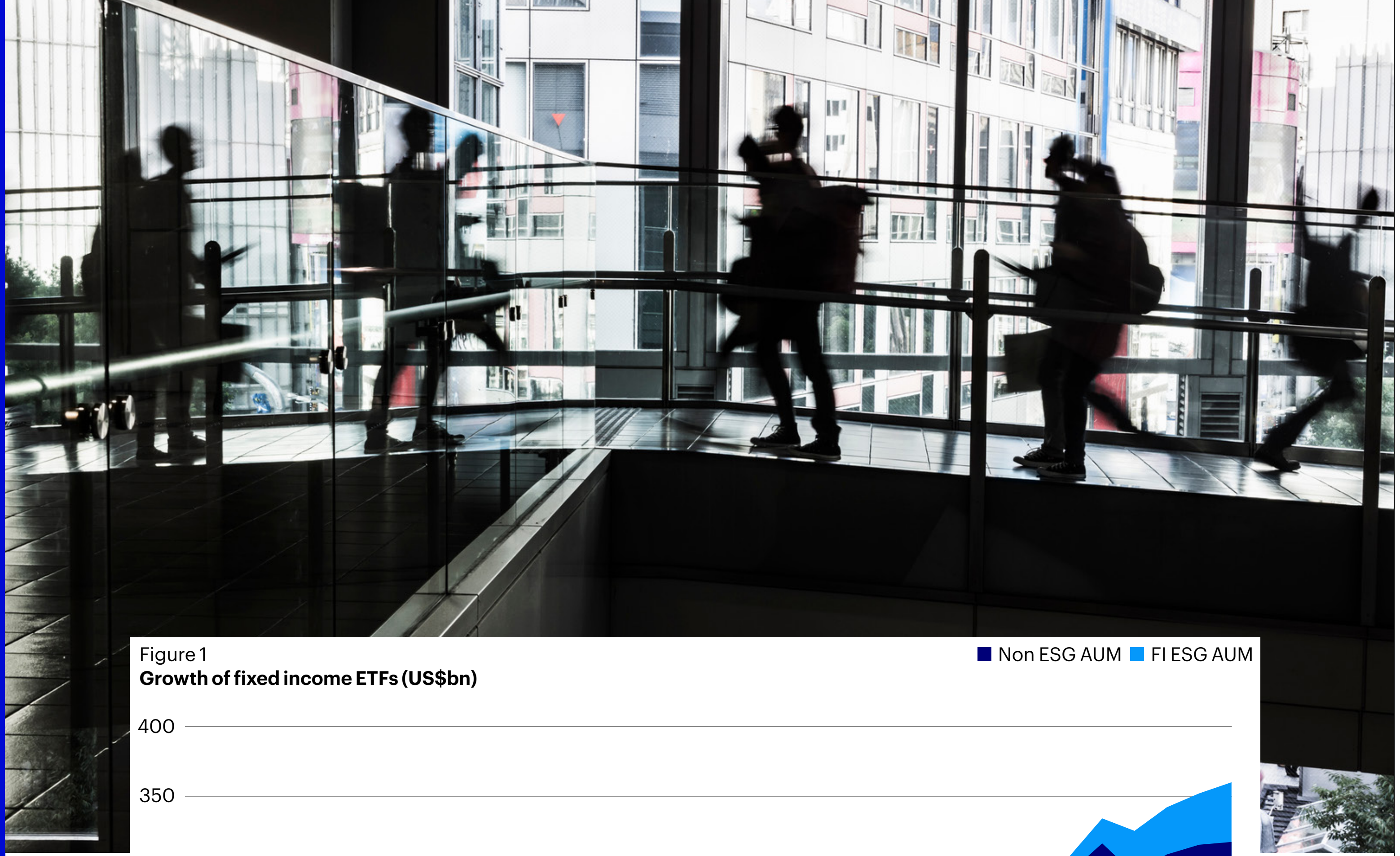
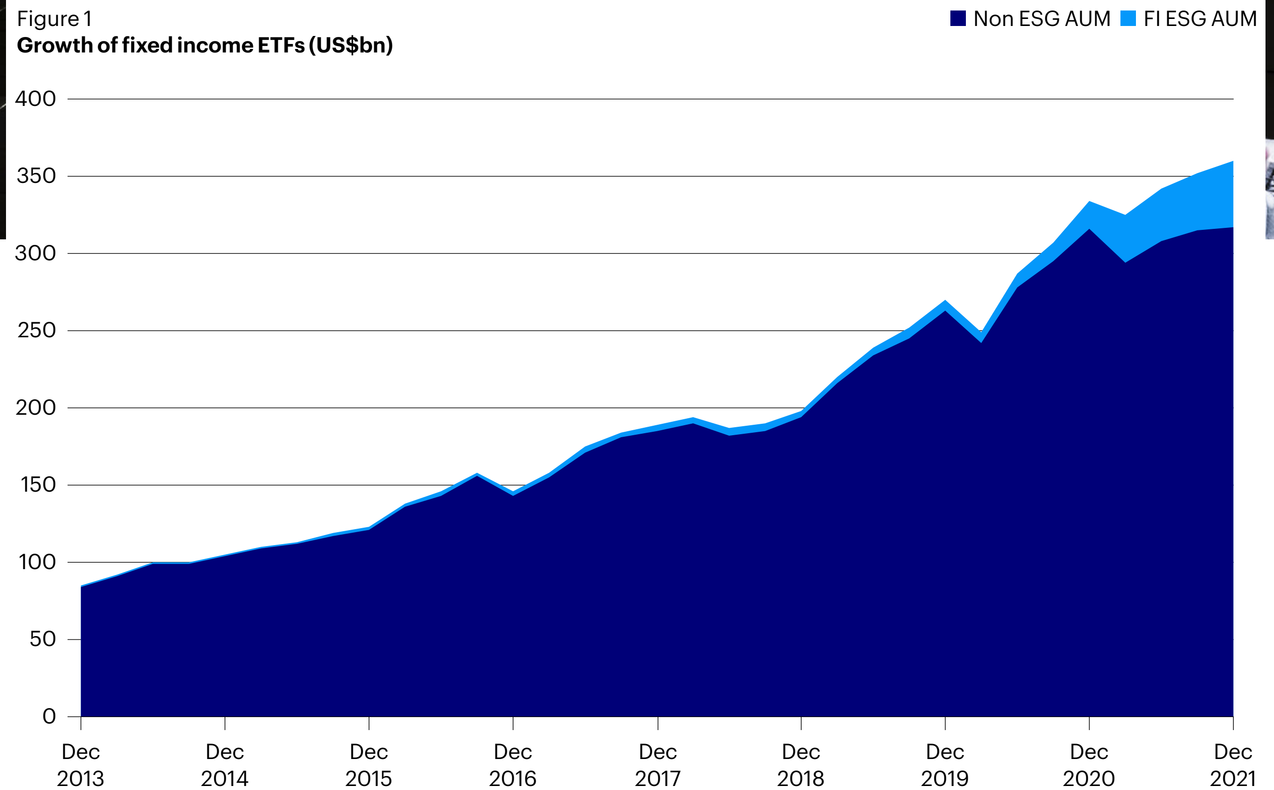


Figure 1
Growth of fixed income ETFs (US$bn)



Data: Invesco, Bloomberg as at 31 Dec 2021.

Benefits of the ETF structure

The basic structure and the way ETFs trade could provide advantages compared to other investment vehicles.

Low cost of ownership
ETFs generally have low cost of ownership, particularly in fixed income. Headline fees only tell part of the story, however, so you need to compare other less obvious costs to determine which vehicle available to you offers the lowest overall cost of ownership. Variable costs are incurred from transactions and rebalancing, for instance, but you should also consider any revenues earned from securities lending as they will effectively reduce costs. You can compare the total costs of different vehicles tracking the same index by measuring their tracking difference.

Quick and easy access
Unlike some of the other investment alternatives, ETFs can be bought and sold throughout the trading day at continually updated bid and offer prices. Investing in an ETF is as simple as it is with ordinary stocks and shares. You may also be able to place different order types, which can give you more control over the price paid or received.

Transparency
The nature of the ETF structure requires transparency, as they are traded throughout the day rather than having a single valuation point. For this to be workable, investors, market makers and authorised participants (AP) all need to be able to agree on the value of the ETF's assets at any point in time. Therefore, every ETF disseminates to the market a detailed daily statement of its exact holdings. In combination with publicly available index rules, this level of transparency allows an investor to see exactly what they are getting when they buy an ETF, allowing them to anticipate how it should perform in a variety of market conditions.

Portfolio management
Passive portfolio management requires precision and accuracy to efficiently track fixed income indices. Having a dedicated ETF fixed income portfolio management team can offer further potential benefits through the use of sampling techniques, rebalancing procedures, and even through the creation / redemption process.

With an average of over 10 years' experience, our ETF portfolio management team has the experience and expertise to deliver accurate and consistent index performance. We have developed proprietary tools to assess key performance drivers and risks parameters across the entire investment horizon.
As an independent US$1.6 trillion[1] global asset manager, we also have the resources and trading relationships to find additional ways to improve costs and, in turn, performance.

[1] Source: Invesco, as at 31 Dec 2021.

Liquidity
One of the biggest advantages of an ETF is the enhanced liquidity compared to other types of investment. The vast majority of an ETF's trading activity is executed between buyers and sellers on the secondary market (the stock exchange) and with market-makers providing their own bid and offer prices. These matching trades do not involve the buying or selling of the underlying securities. Where orders cannot be filled in this way, shares in the ETF can be either created or redeemed on the primary market, offering an additional source of liquidity for investors.

A further factor is that, due to the requirement for intraday liquidity, indices used for fixed income ETFs are often more liquid versions of broad benchmarks. Fixed income benchmarks are often complex with a high number of constituents. To make them more replicable and therefore suitable for an ETF, the number of constituents may be reduced, often by adding liquidity screens such as minimum issue size or seasoning (limiting the time since issue). As long as this is done intelligently, it should not detract from overall performance and can potentially enhance returns relative to a broad index, thus providing investors with a more liquid exposure to a fixed income asset class.

“

ETFs can provide investors with a more liquid exposure to a fixed income asset class.

ETFs vs. individual bonds

There are several possible advantages of gaining exposure to fixed income via ETFs rather than directly investing in underlying bonds.

Diversification
The first, and potentially most obvious, advantage is diversification. Buying a single ETF by trading just one line of stock can provide exposure to the broadest of fixed income asset classes. Fixed income indices are complex, making them difficult to replicate. For example, the Bloomberg Euro Aggregate Corporates Index has over 3,300 constituents from more than 650 issuers[1]. Additionally, while some bonds have minimum trading lot sizes as low as €1,000, most fixed income securities have minimum lot sizes of €100,000, making it impossible for smaller investors to create a truly diversified portfolio through direct investment. Not only that, but the speed and ease of executing a single trade to gain broad asset class exposure relative to calculating a long list of trades, finding counterparties with the right inventory, executing, booking, and settling those trades will be far more time efficient.

Rebalancing
Adding to the efficiency of an ETF relative to direct holdings is the fact that cash flows are automatically reinvested (or paid out on a fixed schedule for distributing asset classes). There's also no need to monitor new issuance or bonds exiting the index as the portfolio is regularly rebalanced in line with index rules.

[1] Source: Bloomberg, as at 31 Dec 2021.
[2] Source: Invesco, as at 31 Dec 2021.

Transaction Costs
Another, but potentially less obvious advantage, concerns trading costs. The cost of investing in fixed income is not just about the fee being paid to access the asset class via a pooled vehicle, but rather the investor's "total cost of ownership", which also includes the cost of trading the underlying bonds. Bonds are traded over the counter (OTC), making pricing less transparent than securities that trade on exchange. Many corporate bonds do not have two-way (bid and offer) prices being quoted on a daily basis, which could make direct investment in underlying bonds *more costly* than investing in them via an ETF and accessing Invesco's top tier status as a $1.6 trillion[2] asset manager.

Liquidity, efficiency, and currency hedging
The breadth of interest in an asset class is generally broader than it is for any individual security within that asset class. That means when it comes to secondary market trading, the ETF capitalises on demands of asset allocators or other "macro-level" investors. The diversified portfolio mitigates idiosyncratic risk and facilitates use of broad-market hedges, which means bid-offer spreads on the ETF can be tighter than the average spreads across its underlying securities. Additionally, the availability of currency hedged share classes can save time for portfolio managers who would otherwise have to value their direct holdings and execute appropriate forward FX trades to hedge currency exposure.

Use Cases

While structural advantages make ETFs inherently useful tools, some fixed income ETFs could be ideally suited to meet specific portfolio objectives.

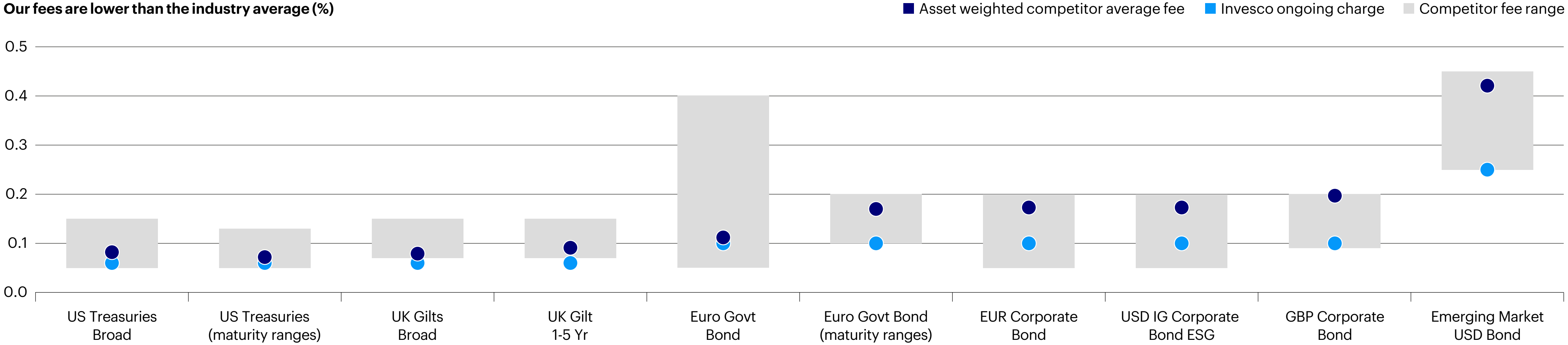
Core Allocation

ETFs could be particularly attractive to investors looking for low-cost targeted exposure to specific segments of an asset class. Investors can construct the core, long-term, strategic elements of their diversified portfolios with a choice of government, agency and corporate debt exposures, with maturity buckets and currencies to match their requirements and objectives.

Taking a simplistic example of a 50/50 allocation between US Treasuries and US Investment Grade Credit, with no specific maturity target, an investor could gain total exposure in two trades for an average OCF of under ten basis points.

Most investors will have more diverse and targeted strategic allocations than this, but the precision and variety of ETFs and their generally low cost compared to most other competing vehicles enables investors to construct well-diversified portfolios where each of the components follows a predictable, rules-based methodology.

Figure 2
Our fees are lower than the industry average (%)



Source: Invesco, Bloomberg, 1 Mar 2022. Fee range is for ongoing charges, excluding Invesco products. Average is weighted by AUM. Competitor range is defined by all ETFs listed on a European exchange tracking the same or similar index.

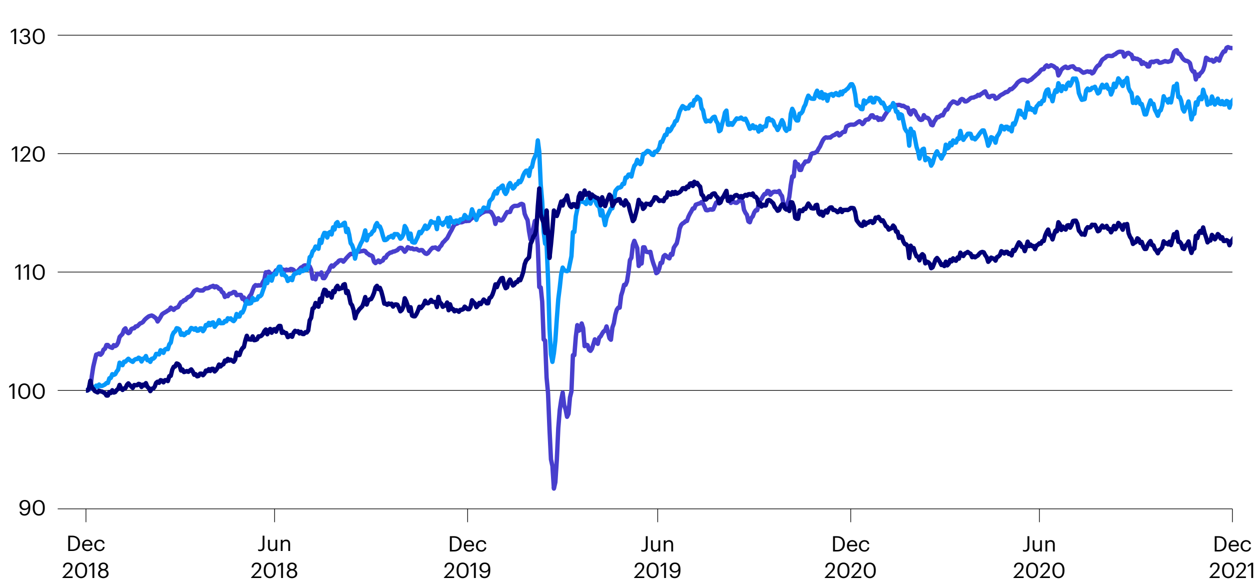
Tactical allocation

Given the targeted nature of ETFs, they provide an ideal vehicle to implement tactical asset allocation decisions compared to traditional actively managed mutual funds. Take, for example, an actively managed strategic bond fund. It would likely include allocations to sovereign, investment grade credit and potentially some high yield debt with the portfolio manager allocating to each asset class based on their views while remaining within their risk limits. The investor in that fund is relying on the portfolio manager to identify opportunities and to implement relevant allocations in the fund. However, an ETF can provide an end investor with the tools to be able to implement an asset allocation decision based on their own market views and risk appetite.

As an example, the COVID pandemic caused financial market volatility to increase substantially in February-March 2020, when government bonds rallied while credit spreads widened dramatically. However, central banks acted swiftly and aggressively to both support the global economy and to stabilise financial markets. This provided a perfect opportunity to take on more credit risk, switching from government debt to investment grade credit and, for those with a higher risk tolerance, to allocate to riskier areas such as high yield, including fallen angels and subordinated debt. As the timing of the asset allocation decision (rather than the individual stock selection) would be the main driver of future returns, the ability to switch between asset classes with one sell and one buy trade is key. Trades being executed on same day allowed the end investor to quickly react to breaking news. There would have been no delay from deciding which holdings to sell, which to buy and having to seek liquidity and axed counterparties for potentially hundreds of lines of stock. ETFs would also ensure the investor gained broad asset class exposure, avoiding unwanted idiosyncratic risk. Over time, once the asset allocation had been changed, then some or all the new allocation could be unwound into an active fund or into individual bonds, depending on the investor's view.

Figure 3
Index performance

Past performance does not predict future returns.



Source: Bloomberg, Invesco, as at 31 Dec 2021. Indices shown are Bloomberg US Treasury Index, Bloomberg US Corporate Bond Index, and Bloomberg US Corporate High Yield Bond Index. Returns may increase or decrease as a result of currency fluctuations.

Core-satellite approach

ETFs can also be employed in a core-satellite approach, enhancing returns by adding higher performing asset classes in which the investor may lack expertise to be able to select individual holdings.

Over the long term, fallen angels have outperformed the broad high yield market, but they tend to be more volatile, particularly during economic downturns when there are a higher number of downgrades. A high yield investor is unlikely to fully switch their high yield exposure to a fallen angel strategy because they have different characteristics, but they may wish to boost exposure to that sector, particularly at certain points in the economic cycle, in which case an ETF using a systematic approach to investing in fallen angels would be the ideal vehicle. It avoids the need for the investor to monitor downgrades and source bonds, which can be time-consuming, as that is taken care of by the index methodology and the ETF manager.

This core-satellite approach can be applied to EUR-denominated investment grade credit, or USD-denominated credit, with the addition of a relevant ETF, to either diversify risk, enhance returns, or in some cases, do both.

Either way, the principle is that that fixed income ETFs give the end investor the ability to make the asset allocation decision themselves, based on their views and risk tolerance without having to rely on an active manager to identify opportunities and implement new allocations whilst remaining within their own risk limits.

“

ETFs provide an ideal vehicle in which to implement tactical asset allocation decisions

ETFs can provide investors with the ability to choose the right balance between improvement in ESG score and similarity to a broad non-ESG index.

Liquidity sleeve
Fixed income ETFs can be used as a liquidity sleeve in the strategic asset allocation of a multi-asset portfolio. Holding a small percentage of each asset class in an ETF could enable creations and redemptions to be handled efficiently, requiring only a single order per asset class rather than trading several lines of underlying bonds and seeking appropriate secondary market liquidity to execute the required orders.

An ETF could also be an efficient means for an active manager to remain fully invested with broad market exposure while waiting on primary market issuance to enter more concentrated positions and pick up some new issue premium. They also allow a higher level of precision for multi-asset portfolio rebalancing as trades will be executed on the same day as orders are placed.

ESG implementation
As ESG reporting becomes increasingly important, the ability to identify transparent methodologies and characteristics for those who do not have internal capabilities is vital. A passive and systematic approach where the same rules are applied across a broad investment universe can ensure high data quality where there is no scope for subjective interpretation. ETFs can provide investors with the ability to choose the right balance between improvement in ESG score and similarity to a broad non-ESG index.

Cash management
The granularity of ETF offerings can provide a solution for longer-term cash holdings by providing exposure that fits somewhere between money market and short-dated bond funds. This "ultra-short" sector is the first step out of cash along the yield curve and may offer higher returns than money market funds and lower volatility that short-term bond portfolios. They are not true substitutes for money market funds and are only suitable for longer-term cash holdings but can help in reducing cash drag in a multi-asset portfolio and may be used as a cash buffer to help absorb regular cash flows.

Transition management
ETFs provide targeted exposure to many different sectors of the fixed income market, enabling investors to remain fully invested in the asset class of their choice, with the appropriate characteristics such as duration, and at low cost, while they are going through the due diligence process of selecting a new active manager.

For example, if an active investment grade credit manager has been underperforming or has moved firms, the decision to move assets out of the active fund may occur before a new manager has been selected. In this case, it's most important to move the allocation away from the incumbent quickly but without changing the overall asset allocation. ETFs can allow the vehicle to remain fully invested in line with the desired asset allocation until the new manager has been chosen and avoiding the consequences of the portfolio being mismatched to that allocation until the new manager has been selected.

When an asset class is better as beta
One of the determining factors when deciding between an actively managed or passive approach is the potential to outperform the broad benchmark through security selection. This case is often illustrated by the US large-cap equity market, which has been notoriously difficult for most active managers to beat with any consistency.

The same can be observed in fixed income, with some segments more suitable for an active approach and others for passive exposure. The AT1 Capital Bond market is an example of the latter. When these instruments were first introduced, after the global financial crisis, active managers could use the newness and relatively small number of participants to their advantage. However, as the market has grown and investors have gained confidence and understanding, the AT1 market has become quite homogenous, with less distinction between issues. As a result, returns from actively managed AT1 funds and (lower cost) passive AT1 ETFs are now highly correlated. If you want exposure to the AT1 asset class, beta exposure makes the most sense.

Summary

Using ETFs to gain exposure to fixed income may have several advantages over other investment vehicles.

There are numerous ways that ETFs can be employed within a fixed income portfolio. From acting as a low cost core holding, to efficient means of implementing tactical asset allocations, and to simply avoid paying for active management in areas where opportunities for alpha generation are limited.

Fixed income ETFs have seen rapid growth in recent years – both in total assets under management and also in the number of products available with the market now offering a solution for (almost) every need of a fixed income investor.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Important information

This document is for Professional Clients only and is not for consumer use.

Data as at 31 Dec 2021, unless otherwise stated.

By accepting this marketing communication, you consent to communicating with us in English, unless you inform us otherwise.

This presentation is marketing material and is not intended as a recommendation to buy or sell any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication.

This presentation should not be considered financial advice. Persons interested in acquiring the fund should inform themselves as to (i) the legal requirements in the countries of their nationality, residence, ordinary residence or domicile; (ii) any foreign exchange controls and (iii) any relevant tax consequences.

Any calculations and charts set out herein are indicative only, make certain assumptions and no guarantee is given that future performance or results will reflect the information herein.

Issued in Dubai by Invesco Asset Management Limited. PO Box 506599, DIFC Precinct Building No 4, Level 3, Office 305, Dubai, UAE. Regulated by the Dubai Financial Services Authority.

Issued in the UK by Invesco Asset Management Limited, Perpetual Park,Perpetual Park Drive, Henley-on-Thames, Oxfordshire, RG9 1HH, United Kingdom. Authorised and regulated by the Financial Conduct Authority.

REDOAK 2127936/2022

Invesco