Investment Managers

For professional clients only

Do ETFs deliver on all their promises? Three questions to ask your provider

In an environment where investor appetite for cost-effective access to financial markets shows no sign of abating, it's easy to see why Exchange Traded Funds (ETF) have become the 'go-to' investment vehicle. In fixed income markets, as a short term tactical asset allocator ETFs provide an efficient and liquid wrapper. However, for investors looking for exposure to long term credit market returns, here are three questions you should ask of your fixed income ETF.

1 Is there a trade-off between high liquidity and balanced market exposure?

The size and scale required to maintain appropriate liquidity levels essential to ETF strategies means that they tend to gravitate towards the largest, most liquid issuers in the universe. In this respect ETFs can end up mirroring market-cap indices.

The concerns associated with fixed income indices are well documented. In short, overall index exposure tends to be concentrated in the most indebted sections of the market. For example the top 10 issuers in the ICE BofA Global Corporate Bond index make up 25% of the total index. Concentrating exposure in a few large names leaves investors exposed to systemic risk and investment bubbles.

You should ask how your ETF manages over-concentration risk, to regions, sectors and issuers.

2 Do ETFs provide a genuine low-cost solution?

ETFs that track an index are forced to follow illogical index rules and are consequently subject to unnecessary transaction costs. These include automatic selling on downgrades and or selling when a bond comes within 12 months of maturity. Forced selling not only creates additional turnover costs but in the case of downgraded bonds, trades are made at precisely the worst moment. Generally, a bond's price will fall as soon as it drops out of an index, but thereafter it tends to rise as the investor base shifts from investment grade to those investing in high yield bonds. Barclay's research suggests that forced-selling due to downgrades costs on average 25bps[1] of performance per year.

You should ask whether your ETF is delivering sub-optimal performance through unnecessary transaction costs.

[1] Source: Barclays research as at January 2017 based on the US Corp IG Index, January 1990 – March 2016.

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Do ETFs deliver long-term, compounded market returns?

General practice among fixed income ETFs is to distribute income from coupon payments. While this may provide an income stream in the short term, it does mean that ETF investors are missing out on the significant compounding benefits generated from re-investing income.

You should ask whether your ETF is re-investing income to produce long-term compounded market returns.

Is there a low-cost solution that has the potential to avoid these pitfalls?

Buy and Maintain strategies focus on conservatively constructed portfolios that are designed to mitigate downside risk by diversifying across regions, sectors and issuers. Using a distinct, 'active' portfolio construction process, constantly monitoring the portfolio for credit quality and reinvesting where there is current value, investors can potentially gain efficient exposure to long term credit market returns, at similar fees to passive strategies.

Investments involve risks, including the loss of capital.

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