Case Study
Fixed Income

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Why ETFs for Fixed Income

Fixed income ETFs can offer liquid access to otherwise highly illiquid bond markets — a benefit that's driving their growing adoption among active investment managers.

We spoke with Michael Contopoulos, Director of Fixed Income at Richard Bernstein Advisors (RBA), to learn more about the firm's unique investment approach — and why they've chosen ETFs for their fixed income strategies.

A Top-Down Macro Investment Approach

RBA takes a top-down approach to active fixed income investing, seeking to capture macro variables such as duration and credit quality, and tactically over- or underweight them. "All of our research over time suggests that what drives returns — and alpha — are macro variables," explains Contopoulos.

Three pillars comprise the firm's research analysis: profits, liquidity, and sentiment. RBA believes that profit and liquidity cycles are strong determinants of market performance — and that identifying inflection points in these cycles can inform desired credit risk and interest rate risk exposures. They also use sentiment indicators to identify capital scarcities and excesses, as their research shows returns are greatest when capital is scarce.

The outcome of this process is a clear vision on portfolio characteristics and objectives. "The investment committee comes up with a conclusion on what the fixed income portfolio should look like and how we want it to behave over the next 12-24 months," says Contopoulos. "Through an X-Raying process where they take a comprehensive look at ETF underlying holdings, the implementation team then finds the ETF — or multiple ETFs — that best represent those views."

Why ETFs for implementation? "ETFs can offer liquidity many times greater than that of the underlying bonds — giving us the ability to express our investment committee's views in a liquid, low-cost way while retaining the principles of active management," says Contopoulos.

The Dawn of a New Fixed Income Management Era

In RBA's view, we're at a pivotal moment in fixed income investing — and having the ability to nimbly express tactical macro views has never been more important.

For the past 40 years, interest rates were falling 75% of the time and rising just 25% of the time, making for a straightforward fixed income investing process. "Fixed income management was essentially a passive strategy during this time," observes Contopoulos. "All fixed income PMs had to do was strategically overweight interest rate risk to outperform 75% of the time, and overweight high yield bonds to outperform when interest rates were rising."

With this era now likely behind us, the pattern will kick into reverse over the next several years, where interest rates rise the majority of the time. As a result, fixed income investors seeking outperformance will need to take a different approach. "We believe investors will need an active strategy that can turn on a dime with interest rate risk and credit allocations," says Contopoulos.

RBA sees fixed income ETFs as the best match for this strategy, as they can offer the liquidity to quickly implement tactical views.

"With ETFs, we can hedge interest rate risks, express a view on interest rate volatility or the yield curve, or go from a 2-year duration portfolio to one that has 8-year duration in a single day — all because of ETF liquidity," explains Contopoulos.

Fixed Income ETF Liquidity: Dispelling the Myths

While RBA views fixed income ETFs' ability to offer significantly more liquidity than the underlying bonds as a key advantage, some have flagged it as a potential risk. RBA believes more education on ETF structure can address these concerns.

"Walking skeptics through ETF mechanics, and how they offer two layers of liquidity — the primary market creation and redemption process, and the secondary market on-exchange trading — can be enlightening," notes Contopoulos. In essence, ETFs' additional layer of liquidity is a structural innovation that sets them apart from individual bond portfolios and mutual funds, where trading illiquid bonds can be costly and time-consuming.

"I can't overstate the importance of liquidity enough," says Contopoulos. "In our view, there's an opportunity to reimagine fixed income management. The old way of managing fixed income through individual bonds and mutual funds is on its way out — and we'll see the new way of using ETFs for bond exposures take over the space."

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Investing involves risk including the risk of loss of principal.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

International Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns. Investing in high yield fixed income securities, otherwise known as "junk bonds", is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Frequent trading of ETFs could significantly increase commissions and other costs such that they offset any savings from low fees or costs.

There can be no assurance that a liquid market will be retained for ETF shares.

ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

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