Education

Fixed Income indices: From benchmark to investment solution

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Introduction

Fixed income indices are transitioning from performance measures or reference benchmarks to being regarded as an investment solution, given the steady growth of passive funds and ETFs. In a low yield environment, the combination of the downward pressure on fees and a lack of performance differential for active funds means that passive AUM is growing faster than active AUM. Investors are increasingly aware that passive solutions can achieve similar returns and non-financial objectives, such as ESG, as actively managed funds (especially after fees are taken into consideration).

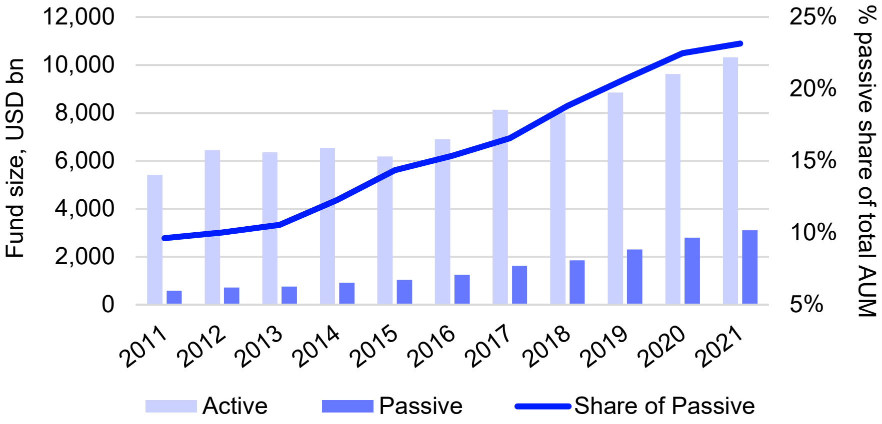
We think this goes beyond fees and returns. While investors require indices that are transparent and objective[1], demand is increasingly pointing to ever more innovative fixed income benchmarking – to indices that achieve complex and challenging goals, while maintaining replicability for passive strategies.

Rise of passive investing

Passive fixed income ETFs and mutual funds reached a total of USD $3.1 trillion AUM as of December 2021, making up 23% of the total pie[2], steadily rising from 17% at the end of 2017. Figure 1 shows the growth in AUM over the last 10 years, representing a 10-year CAGR (Compound Annual Growth Rate) of 18.4% for passive fixed income, versus 6.7% for active fixed income.

[1] Building a better fixed income benchmark, March 2022.
[2] Lipper. Total active and passive AUM as of 31 December 2021, global fixed income ETFs + Mutual Funds.

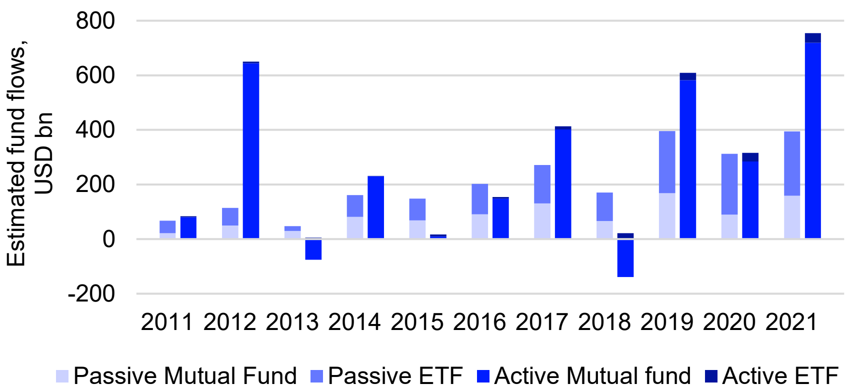
Figure 1: Growth in passive fixed income AUM



Source: Lipper, Global Fixed Income AUM, ETFs and mutual funds. Annual data as of December 2021 year end.

The rise in passive flows has been driven largely by passive ETF growth. Passive ETFs have seen consistent positive net flows over the last 10 years, as shown in figure 2. The passive ETF channel is growing increasingly significant out of the four channels represented.

Figure 2: Flows to global fixed income funds



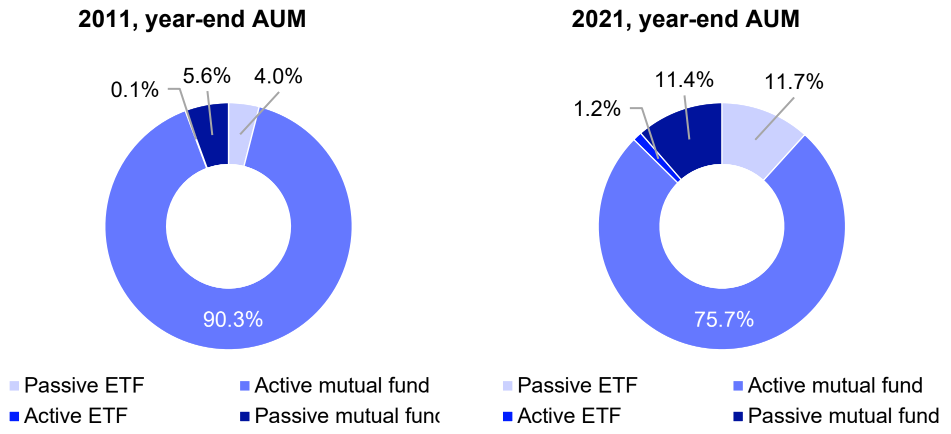
Source: Lipper, Annual Estimated Net Flows in USD billions, global fixed income, as of December 2021 year end.

While traditional, passive mutual funds have historically held a greater share of AUM, passive ETFs grew to 50% of total passive AUM at the end of 2021, with a 10-year CAGR of 21% versus 16% for mutual funds[3]. As of 2021 year-end, passive ETF AUM has grown alongside passive mutual fund AUM to become a more significant piece of the overall pie, as shown by figure 3. BlackRock estimates that the global bond ETF industry could reach $2 trillion in 2023 and $5 trillion in 2030[4], as ETFs become further entrenched in modern fixed income investment strategies.

[3] Lipper, Global fixed income passive funds, as of December 31, 2021.

[4] BlackRock, All systems go.

Figure 3: Global fixed income fund landscape 10 years on



Source: Lipper, AUM share of global fixed income, as of 31 December 2011 and 31 December 2021.

What's driving this preference for ETFs?

Key trend 1 – Rise of the institutional fixed income ETF investor

Regulatory changes have been making ETFs more acceptable to a wider set of investors. For instance, rule changes mean that ETFs can receive bond-like capital treatment if they meet certain criteria, making it easier for insurance companies to invest in fixed income ETFs. As a result, US life, property, and casualty insurers increased their bond ETF holdings to $10 billion in 2020, up from $3 billion in 2016[5]. This opens up passive investment to an entire new client segment that can benefit from lower costs, management requirements and liquidity.

Moreover, fixed income ETFs can be used within multi-asset active strategies to target fixed income exposures more efficiently, blurring the traditional dichotomy between active and passive investment. For example, investors could incorporate a short-duration sovereign ETF to protect against rising interest rates or to execute a flight to safety strategy in periods of market volatility. According to ESMA, during the first quarter of 2020, just over half of European active funds underperformed their benchmarks, by an average of 6.6% (annualized)[6]. Not only does this demonstrate that active funds do not guarantee the outperformance they are associated with (for higher fees), but they may also benefit from using ETFs to more efficiently exit positions in stressed market conditions, during which selling a portfolio of securities becomes more challenging.

Therefore, it is not surprising that, according to an Institutional Investor survey conducted in Q3, 2020, 51% of pensions and 50% of insurance institutions increased their use of bond ETFs due to difficulties associated with transacting in individual bonds in periods of market volatility[7].

[5] VettaFi.com, New Rule Could Up Insurer Fixed Income ETF Demand, February 2022.
[6] 'Active funds underperformed during Covid market stress, watchdog finds', Financial Times, April 5, 2022.
[7] Fixed Income ETFs: Investors' Ticket to Flexibility, Institutional Investor, January 2022 sponsored by BlackRock.

Key trend 2 – Increased variety of precise, targeted fixed income ETFs

The increased diversity of ETF investors and use-case applications means there is a need for more precise, sophisticated approaches to investments.

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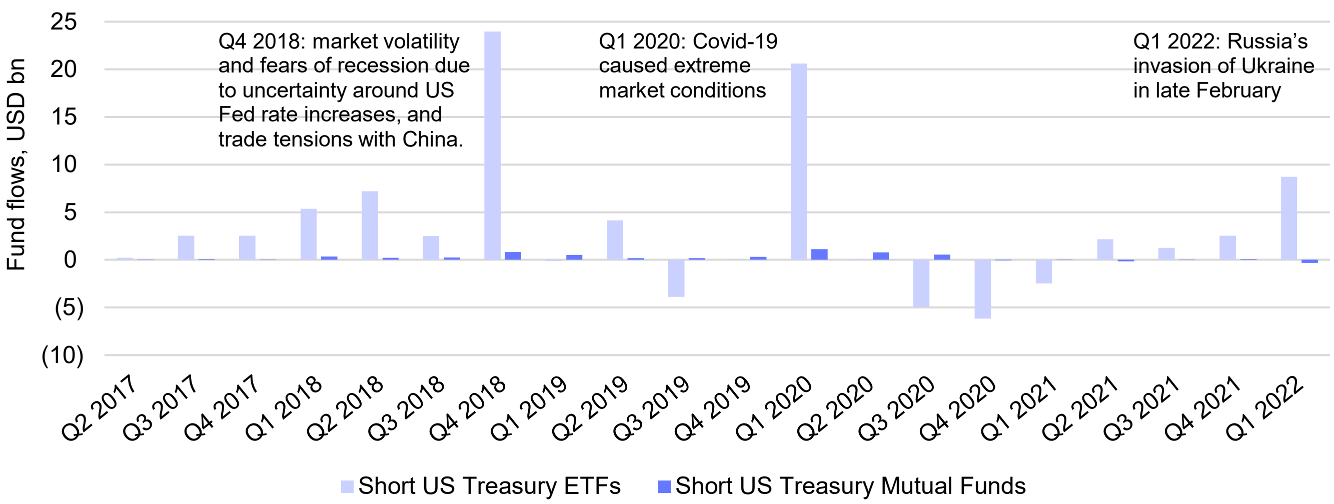
– Use case 1 – institutional investors are using **short-term fixed income ETFs for liquidity management**, to park funds while waiting for alternative opportunities. Short-dated ETFs have also benefitted from a flight-to-safety during recent periods of market uncertainty and volatility. Figure 4 illustrates that US short treasury ETFs absorbed flows over mutual funds in the wake of recent periods of market volatility.
– Use case 2 – ETFs are being used for **transition management**, facilitating the transition from traditional strategies to alternative strategies, such as sustainable investment or smart beta overlays. For portfolio managers and sell-side traders, ETFs create the potential to turn massive portfolios very quickly without the costs associated with selling hundreds of assets. This will become more important as investors are increasingly required to integrate ESG risks or climate risks into their portfolio strategies, for which ETFs provide a practical solution.
– Use case 3 – **ETFs are preferred versus individual bonds**, and can provide diversified, targeted exposure. For example, the US Municipal bond market is large and cumbersome, with 37,508 individual bonds ($1.3 trillion in market value) in the ***FTSE US Municipal Tax-Exempt Investment-Grade Bond Index*** as of June 2022[8]. For the first time, retail investors can access hitherto inaccessible markets without the need for big fees, and through vehicles that are less prone to idiosyncratic risk than individual bonds.

Figure 4: Quarterly net flows to US short treasury passive funds in periods of volatility



Sources: Lipper, US domiciled passive funds, as of 31 March 2022.
Oppenheimer Asset Management, Market Observations Fourth Quarter 2018 Recap

[8] FTSE Russell, FTSE US Municipal Tax-Exempt Investment-Grade Bond Index, as of 31 May, 2022.

Key trend 3 – Providing accessibility through data-driven, accurate solutions across asset classes

As the demand for granular exposure through passive investment vehicles is seen across all asset classes, and within fixed income, the scope for granularity is even more important; term buckets, quality segments, sectors and sub-sectors can be easily targeted with accurate and granular terms and reference data. Today, there is a wide range of precise solutions across asset classes, bringing more markets to more investors.

For example, ETFs can be used to provide efficient access to granular segments of the market for tactical asset allocations. An interesting case study is the use of an ETF that has exposure to a single sovereign issuer, which is positioned for potential future inclusion in a major flagship index.

As a case study, consider the recent September 2022 FTSE Fixed Income Country Classification Review announcement[9]. India's place on the Watch List was re-affirmed, with potential re-classification of foreign accessibility to level 1 being re-assessed in March 2023 (at which point, India's eligibility for the FTSE EMGBI would be considered). An ETF targeting the FTSE Indian Government Bond FAR Index could reap rewards should the Indian government bonds, issued through the Fully Accessible Route (FAR), enter the flagship FTSE EMGBI in the future. This type of strategy is facilitated via the forward-looking, transparent, rules-based country inclusion framework, but also the modular approach to fixed income indices taken by FTSE Russell.

Key trend 4 – Complex ESG solutions becoming more prevalent in passive ETF AUM

At the same time, there is rising demand for sophisticated index solutions that allow investors to balance multiple objectives; new indices need to be sustainable, without substantial tracking error and without additional turnover. We demonstrated that while this often can only be achieved by sacrificing performance or increasing volatility, in the case of EM ESG indices this can be achieved with improved returns.

Independent, transparent benchmarking has been a critical ingredient for ESG probity. An example of this is the ***FTSE Global Impact Bond Index Series***, which facilitates investment into bonds funding projects that have a positive environmental and/or social impact. While just over 80% of green bonds are CBI Aligned Green Bonds or CBS Certified, almost 20% (~US$230 billion) of green bonds are 'self-labelled' only[10]. FTSE requires green bonds to be CBI aligned to be index eligible, providing investors with a more robust solution for green bond ETFs.

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While the percentage of AUM behind ESG funds versus non-ESG for US domiciled funds is still small at 2.9% at the end of 2021, the trend is picking up pace. Globally, it is much larger – in 2020, $542 billion flowed into ESG funds worldwide, up from $285 billion in 2019, with ESG funds accounting for 10% of worldwide fund assets towards the end of 2021[11].

[9] FTSE Fixed Income Country Classification Review, September 2022.
[10] Benchmarking the green bond market, FTSE Russell, July 2021.
[11] Reuters, Analysis: How 2021 became the year of ESG investing, December 23, 2021.

FTSE has seen growing demand for ESG or climate risk-adjusted indices for the basis of ETFs that are highly customizable to meet a wide range of client goals, while leveraging the robust methodology constructs of the underlying benchmarks.

Trend for passive solutions to become more entrenched

Indices have a variety of use cases. However, the key trends illustrated here point towards a growing demand for passive solutions that are more sophisticated, granular and targeted. These require indices that are not only objective, modular, and replicable, but also innovative and customizable. High fees are no longer an option in the current climate, and without significant outperformance, passive investing will continue to win out. Smart indices provide a hybrid solution, achieving complex goals of performance or specific ESG requirements, without the need for expensive active strategies.

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