Accessing fixed income through ETFs

by Dr. Christian Gast, Head of iShares Switzerland

For professional investors, fixed income has always played a role in well-diversified portfolios. Since the financial crisis however, we have entered a new world of investing and fixed income is no longer the asset class it once was. Demand for bonds has increased greatly, driven by the need to de-risk and de-leverage portfolios, which has led many investors to increase their allocations to bonds and away from equities. Monetary policy has created a situation where yields are very low, particularly for government securities, and investors relying on fixed income to generate the stable and steady income streams of the past are facing new challenges.

More fundamentally, fixed income can no longer be considered a homogenous asset class. Many new types of issuer have emerged and in increasing size. For example, issuance by emerging market corporates in US dollars has increased dramatically over the last decade, from $10bn in 2000 to $188bn in 2011 according to JP Morgan. Companies from across the rating spectrum are also using the capital markets to raise financing, and issuing bonds where they may previously have relied on bank funding. This has created a situation where the divergence of returns between different fixed income asset classes has widened, making asset allocation, or being in the right place at the right time, a key driver of returns. Looking at Bloomberg data, since 2007 there has been a 20% to 40% difference in return between the best and worst performing fixed income sector in any given year.

Analysing bonds in a granular fashion

What does this mean for professional investors? Whether they are using fixed income for income, returns or indeed for both purposes, investors are analysing the bond market in a more granular fashion and allocating between bonds as they might do between equities.

There is a clear trend to diversify holdings by issuer and sector, and by region, currency and credit quality, in an effort to secure new sources of income or return and to spread risk. We are finding that many investors are looking beyond the gilt market and considering other sovereigns, and indeed different types of corporate debt. High yield has been a particular beneficiary of this trend, providing investors who are comfortable with the credit risk they are taking on with a way to boost income.

However, small and medium sized investors will find it much more difficult to access bond markets compared with equity markets. In the first instance, fixed income markets are much larger than equity markets by capitalisation, with security-specific analysis less readily available, making it more demanding to evaluate opportunities. Many bonds also have high minimum investment criteria, which makes building and maintaining a diversified portfolio logistically challenging.

Easy access to fixed income markets

Indexed investments, and exchange traded funds (ETFs) in particular, are gaining significant new attention from those who want to diversify their holdings and access new markets in an easy and effective way. ETFs started out offering access to equities, and many professional investors will already use them to get exposure to a basket of stocks in a single, cost-efficient trade.

In the fixed income space, ETFs similarly offer investors a way to express their views and implement asset allocation decisions efficiently and precisely. With no minimum subscription, it is possible to use ETFs to add exposure to an area of the market, such as emerging market corporate bonds, in a more cost-efficient and diversified way than buying individual bonds.

Fixed income is the fastest growing area of the ETF market, and global assets held in bond ETFs grew by 24% in 2011 according to BlackRock ETP Landscape data. This trend shows no sign of abating, as investors respond to the new dynamics and opportunities of the fixed income markets, and consider new tools to help them meet their investment objectives today. According to a new iShares market analysis, the global market for fixed income exchange traded funds (ETFs) will likely grow to more than $2 trillion in assets over the next decade compared with $302 billion today.

New iShares ETFs on the SIX Swiss Exchange

iShares ETF	SIN	SIX ticker	Total expense ratio (TER)	Trading currency	Tracking method
iShares Markit iBoxx $ High Yield Capped Bond	13876308	IHYUSW	0.50%	CHF	Physical
iShares Barclays Capital Euro Corporate Bond ex-Financials	10608422	IEXFSW	0.20%	CHF	Physical
iShares Barclays Capital Emerging Markets Local Govt Bond	13167739	IEMLSW	0.50%	CHF	Physical
iShares MSCI Japan Monthly EUR Hedged	11834409	IJPESW	0.64%	EUR	Physical
iShares MSCI World Monthly EUR Hedged	11834432	IWDESW	0.55%	EUR	Physical
iShares S&P 500 Monthly EUR Hedged	11834662	IUSESW	0.45%	EUR	Physical
iShares Dow Jones Emerging Markets Select Dividend	14423164	IEDYSW	0.65%	CHF	Physical

About the author

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Dr. Christian Gast is a Managing Director at BlackRock and has been head of iShares Switzerland since 1 November 2010. Prior to assuming his current role in 2010, Mr. Gast was with UBS Global Asset management, where he had worked since 1999 heading up the ETF business. Additionally, Christian was also Head Product Development and Management UBS Equity Funds. Prior to this, he worked with the St. Galler Kantonalbank as Senior Portfolio Manager responsible for managing private and institutional assets.

Christian Gast earned a PhD degree from the University of Zurich in 1998 and an M.B.A. from the University of Saarbruecken in 1994.

About iShares

iShares is the global product leader in exchange traded funds with over 500 funds globally across equities, fixed income and commodities, which trade on 20 exchanges worldwide. The iShares Funds are bought and sold like common stocks on securities exchanges. The iShares Funds are attractive to many individual and institutional investors and financial intermediaries because of their relative low cost, tax efficiency and trading flexibility. Investors can purchase and sell shares through any brokerage firm, financial advisor, or online broker, and hold the funds in any type of brokerage account. The iShares customer base consists of the institutional segment of pension plans and fund managers, as well as the retail segment of financial advisors and high net worth individuals. For additional information, please visit the Company's website at www.iShares.ch.