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FIXED INCOME ETFs

FUND COUSINS BRING ON A EUROPEAN BOND REVOLUTION

Following the runaway success of equity exchange-traded funds comes the fixed income version. iShares describes how fixed income ETFs work and how to derive the best possible benefits

Europe's first equity exchange-traded funds (ETFs) were launched in 2000. They have been received positively by investors, despite the severe bear market which has stacked the odds against them.

At a time when some European stock markets have witnessed historical falls in equity values, this revolutionary product has bucked the trend and gathered US$11bn (€10bn) in new assets across the Continent.

Despite only being available in Europe for three years, European providers have launched 118 products. This compares very favourably with the US market, which boasts just 113 products after 10 years.

While assets under management in Europe still lag significantly behind the US's $102bn invested in ETFs, the 91 per cent asset growth in Europe during 2002 proves they are becoming noticed as a viable investment product and have a growing audience.

Investors from widely different backgrounds are continuing to learn about ETFs, recognising them as efficient tools and using them in lieu of other products.

While most ETFs conceived to date have been equity-based, last year saw the launch in the US of iShares fixed income ETFs by Barclays Global Investors.

More recently, the first European product (tracking German government bonds) was launched by Indexchange, and iShares has just announced the launch of Europe's first corporate bond ETF linked to the iBoxx € Liquids Corporates index. The question on everybody's lips is: can fixed income ETFs repeat the runaway success of equity ETFs?

EARLY GROWTH

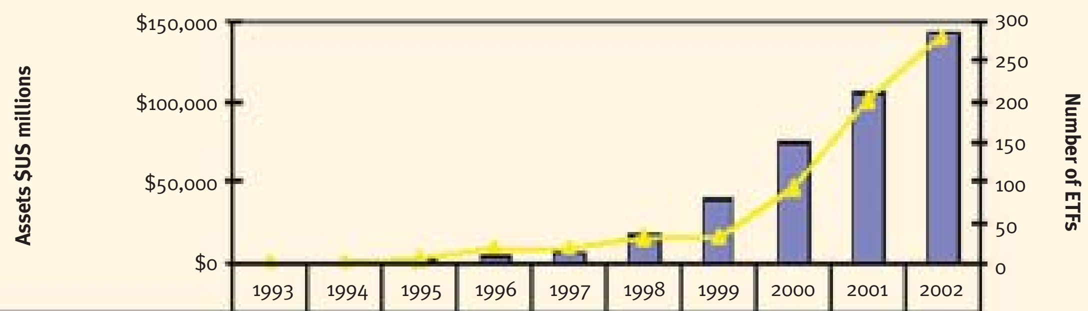
If the US is anything to go by, fixed income products are off to a solid start. With the US bond ETF market barely seven months old, there are already eight listed funds with assets under management of $3.85bn.

Trading volumes are robust and growing, with an average of more than $50m traded on exchanges each day, and at least the same amount again traded over the counter.

Part of their success is linked to the considerable cost benefits compared with buying individual bonds or traditional bond mutual funds.

Of the US fixed income products, the iShares

Worldwide ETF Growth



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Assets $USm	811	1121	2302	5258	8234	17,596	39,605	74,337	104,800	141,621
Number of ETFs	3	3	4	21	21	31	33	92	202	280

Source: SsgA, Bloomberg, Morgan Stanley Research

Goldman Sachs $Investop, which provides access to the US investment-grade corporate bond market, has been the most successful in attracting assets. This is primarily due to its appeal to both institutional as well as retail investors. It is fair to say the biggest and most flourishing ETFs have been those that interest both types of investor.

Fixed income ETFs will offer the same benefits and applications to bond investors as equity ETFs brought to equity investors. And in some areas, including pricing transparency, bond index-based derivatives and futures on credit markets, fixed income ETFs are likely to revolutionise how bond investors do business.

So, who can use them? There is by no means a shortage of potential investors:

- portfolio managers
- asset allocation managers
- hedge funds
- insurance companies
- private banks
- proprietary traders
- transition managers
- market makers
- derivative/structured product traders
- individual investors

Trading fixed income ETFs can be done in two ways, either directly with a market maker in over-the-counter transactions or on exchange, through a broker.

Larger investors are likely to continue to trade over-the-counter, through their usual dealers, at least in the initial stages. Retail-focused smaller institutions, and individuals familiar with exchange dealing, can go on exchange to deal.

Best ETF features

The following points summarise the advantages of using ETFs:

- **Intra-day trading – because an ETF is listed on an exchange, investors can buy and sell whenever the market is open**
- **Diversification – by accessing an index of stocks with just one transaction, the investor is reducing single issuer risk**
- **Benchmark performance – reduces active risk for the investor**
- **Low cost – low internal management fees**
- **Transparency – investors can see daily disclosure of holdings**
- **Liquidity – the ETF is as liquid as the underlying bonds and does not suffer from premium or discount issues**
- **Simplicity – ETFs traded and settled like ordinary bonds**
- **Dividends – index yield minus fund expenses**

APPLICATION

As a portfolio tool, fixed income ETFs have a number of possible uses although some are more suited to institutional investors:

- instant market exposure for cash flows
- hedging
- sector rotating/asset allocation
- long/short strategies – spread trades
- buy and hold positions
- transitional tool
- core/satellite investment strategies

The real benefit for investors is the ability to adopt diversified positions in entire indices or sub-indices with just one or several trades. Rather than buying 100 stocks or bonds and administering dividend or coupon payments, and so on, investors can make one purchase and administer one asset.

One of the fundamental uses for ETFs among institutions and retail investors is the establishment of core-diversified investments in core satellite portfolios. The largest users of these indexed products in the US are,

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Mark Roberts, iShares

in fact, active investors looking to create diversified core positions around which they can add value.

ETFs are designed to be used for long or short positions in a way that is much easier to understand and manage than derivatives. Macro hedge fund managers, for example, whose main source of outperformance is anticipating macroeconomic changes in economies, can implement their views through a series of ETFs covering countries, regions, economic sectors and – with fixed income ETFs – yield curve plays.

By virtue of their high liquidity, intra-day pricing and ability to cover subsets of indices, ETFs can also cater for short-term, sector-specific views used, for example, by non-systematic trend managers.

Aside from the cost benefits described earlier, fixed income ETFs also have the potential to offer a viable and efficient alternative to futures, over the counter (OTC) derivatives and notes.

IDENTITY CRISIS

While fixed income ETFs offer the same benefits as their equity-based siblings, there has been some question as to whether a fixed income ETF is a bond or an equity, and concern as to whether packaging bonds as ETFs might confuse the issue.

Can ETFs provide a product that satisfies bond and equity cultures? We believe that as fixed income investors recognise the benefits of fixed income ETFs, we will see at least as much demand as we have seen for equity ETFs. In some cases demand for fixed income ETFs could outstrip equity ETFs because of the potential to use fixed income ETFs in place of the derivative products that are currently available to bond investors.

Under the skin, all ETFs are funds, used by investors for one-trade access to a basket of securities, whether that basket consists of equities or bonds.

Current market conditions are ripe for fixed income ETFs. Last year, corporate bond markets globally experienced an exceptional number of disasters. According to Standard & Poor's, the credit-rating agency, the proportion of issuers defaulting last year was the highest since 1991. In addition, given the enormous size of some of the companies that failed last year, the total value of bonds defaulted upon reached a record $157bn globally.

While S&P has observed that default rates are already declining from their peak and are expected to fall further, diversification of an investor's bond portfolio through fixed income ETFs could be a key diver to reducing risk levels.

The positive reception of fixed income ETFs in the US demonstrates that there is strong demand for these products.

Initial research suggests that uptake could be even stronger in Europe as a result of the benefits that iBoxx indices will bring to European bond ETFs.

Mark Roberts, head of iShares Product Strategy. Barclays Global Investors Ltd (BGI) is regulated and authorised by the FSA