

Case Studies in Fixed Income ETF Investing: From Investment Thesis to Execution

Everyone thinks ETFs automatically mean broad or universe index, but fixed income ETFs are available in Short, Mid & Long, Federal, Provincial and Corporate segments. We should look at an ETF “as a mechanism or an access tool,” says Mark Webster, Director, Institutional & Advisory, BMO Global Asset Management. In the *Benefits and Pensions Monitor Meetings & Events* session ‘Case Studies in Fixed Income ETF Investing: From Investment Thesis to Execution’ with Tony Treier, Senior Portfolio Manager, Fixed Income and Currencies, TELUS Corporation Pension Plan; Jimmy Karam, Director, ETF Trading, Capital Markets, BMO Capital Markets; and Greg Walker, Director, ETF Capital Markets & Strategic Partnerships, BMO ETFs; he said, however, still, in meetings with pension plan clients, one of their first questions is whether they need a certain capacity or volume to execute a big trade. A pooled fund manager would not be asked that, he said. Like any Pooled fund, an ETF’s ultimate liquidity is equal to what is available in the underlying asset class. Whatever the amount, they would buy or sell the bonds to create or redeem units in a large portfolio trade. — “we can either create or redeem a very large fashion, just like any pool.”

Karam said fixed income ETFs tend to respond faster than the underlying bond market when there is stress in the market because market makers are always posting Bid-Ask spreads on the Exchange, providing transparency and Price Discovery. So, when an event occurs like the Russian invasion of Ukraine, people gravitate towards ETFs because they get significantly improved liquidity, faster than that from trading the underlying asset classes.

Fully Freezes

On top of that, “sometimes the underlying asset class just fully freezes,” he said. With more participants trading the ETF, “you can fully trade portfolio exposure with a single trade.”

When the market freezes up as it did in March 2020 and the Corporate bond market went no-bid, “we had the tools to deal with that,” said Walker. Clients came into the ETF market to dial down investment grade credit risk. The bond market was not open to them, so they looked at the ETF

which was trading because market making desks trade on an Exchange, providing Price Discovery when none is available on individual issues

For Treier, Senior Portfolio Manager, Fixed Income and Currencies, TELUS Corporation Pension Plan, it is critical his defined benefit plan doesn’t have “any unanticipated liquidity drawdowns.” The ability to seamlessly extending duration from a two-year duration ETF to an 18-year duration ETF shows the true liquidity that sits in ETFs and addresses the threat of unanticipated liquidity drawdowns.



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— JIMMY KARAM

ETFs also solve the market access problem facing smallish to medium sized pension plans with liquidity constraints, he said. If there is a gap in the portfolio, Treier is probably turning to specialty ETFs to plug it. “We haven’t had to do it yet, but we’re getting close,” he said.

Among the biggest users of fixed income ETFs are bond buyers, said Karam, even though they have the ability to hold bonds themselves. In these cases, “we say try to determine what your portfolio looks like under an ETF lens and watch them every day. What you find is that at any given time, the ETF might seem slightly expensive, but they can buy those bonds at any time,” he said.

When there’s some friction in the market, clients who manage bonds, but aren’t in high yield, may use an ETF to fill that gap. “If their exposure gets big enough,

they can redeem the ETF and take the bonds in kind,” said Karam.

Provide Options

The bottom line is ETFs can provide more flexibility. “With all the abilities they have in front of them, if the ETF is adding value over, they are used quickly and often. The minute the ETF becomes too expensive, they switch over to their other tools,” he said.

Walker said, “every tool comes trading opportunities.” With the opportunities after the recent times of stress, “we’re seeing more hedge fund clients and more asset managers participating.” “Everyone needs more tools in their toolbox and ETFs are becoming handier for everyone.”

In areas where the bond market is constrained, there are sample baskets available, said Webster. Sample basket facilitate large trades by executing only the most liquid issues, “so we can get best execution for our clients.” The beautiful thing is, he said, is investors can also open or close a currency hedge at the same time. selling the ETF provides an ability to adjust exposure, in or out, and control currency at the exact same time.”

There is an interesting dynamic, he said, with the way that ETFs are run, especially on the fixed income side, he said. “Most of our funds, and especially the big ones, are used as examples to show how well an index is being tracked, which is the only thing portfolio managers are looking for. Since it’s not as easy as it sounds to get all the bonds needed to track the index, portfolio managers are trying to manage the credit risk and the interest rate risk through duration in the portfolio to make sure it tracks to the index. “We will be interested in any bond that keeps our tracking the same. We’re not interested in anything that hurts our tracking error.”

In a worst-case scenario, the liquidity of the ETF is one to one with the underlying instrument liquidity, said Karam. Setting aside the liquidity of the underlying asset class, somewhere in the middle there’s “what we call fragmented liquidity.” It’s a buyer to seller without the need to touch the underlying bond market transaction. “This is really what makes the ETF so powerful. You are basically talking about second layer of added liquidity.” **BPM**

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