Executing Active Strategies: Using Precise Fixed Income ETFs

Fixed income ETFs (exchange traded funds) demonstrate the same speed and precision as a ski racer going through a slalom course, says Mark Webster, Director, Institutional & Advisory, Exchange Traded Funds, at BMO Global Asset Management. He moderated the Benefits and Pensions Monitor Meeting & Events 'Executing Active Strategies: Using Precise Fixed Income ETFs,' sponsored by BMO Global Asset Management, with Matt Montemurro (CFA, MBA) Portfolio Manager, Exchange Traded Funds, at BMO Global Asset Management; and Markus Otema, Executive Director, Automated Market Maker, at CIBC.

With fixed income, "where you are on the yield curve is more important than the bonds that got you there," he said. ETFs can be used, alongside futures and swaps, to make quick forays around different parts of the yield curve.

Webster: *There's an incredible due diligence in deciding what to bring out in an ETF. How do you approach this?*

Montemurro: Anytime we launch a product, there's a thoughtful approach to create portfolio building blocks to solve the potential problems investors may have.

Whether that's liquidity, operational challenges, or access to a specific asset class, when we're looking at building an ETF, we determine how it is going to provide operational benefits to the users because we're going to take on the headache of owning it to get diversified exposure to a specific asset class in a single trade.

Webster: *What's your role in facilitating these trades?*

Montemurro: If a client comes to us, in a normal market, to sell $180 million of high yield, you want to do it without having an impact on the market. Typically, you're going to have to do it over two, three, or four trading days.

What we do is quote the client the entire trade in a single day volume and get them high yield exposure at NAV, which is index mid-point. We can do that because we have the access to buyers willing to transact at mid and both sides make money on the trade.

From that perspective, those are the type of opportunities where using an ETF can get you in and out of the asset class in a very cost-effective way.

Webster: *Can you explain the delivery basket concept?*

Otema: A basket of securities is defined, but it's also negotiable which comes into play when prices move.

However, if there are well over 1,000 securities in the index, how does that translate into a basket of goods? It would be impossible to price 1,000-plus securities in a timely manner, and trading 1,000-plus securities would create serious slippage on your trade. Also, the security trade sizes would be particularly small, which is not the type of flow a typical bond desk likes to see.

So, there's this concept of sampling, where the bond index has a different risk component. This takes bits of the universe to be representative of the whole. The portfolio manager decides what the delivery baskets look like, but the basket really is a sampling.

A delivery basket is set about every 10 days to be representative of what will be accepted from market makers and it changes as the bond market does, so you always have a representative, liquid sample.

Webster: *As we move out on the curve, the attraction of using ETFs becomes more acute. Why is that?*

Otema: The ability to allocate to specific risk factors is definitely appealing for a number of reasons.

There can be idiosyncratic risk that you definitely don't want to have in your portfolio. A fixed income exposure of 40 per cent may really mean the investor wants the characteristics of fixed income and not the idiosyncratic risk.

However, the fixed income should not be a throwaway component of asset allocation. It should be very well thought through and deliberate.

Now, depending on your point of view on inflation, you may be well-justified increasing your duration or increasing your credit exposure. It may be difficult to stomach in the context of potentially taking heavy losses this year on your fixed income, but you should always be looking at your portfolio and seeing the opportunities now and how these can reshape the future.

The big misconception is that rising rates are necessarily bad for fixed income returns. I would argue it is totally dependent on the time variable.

Montemurro: ETFs really open up the toolkit and make these decisions much easier and their execution much faster.

Rather than having to put on long provincial bond exposure with one bond or one of every province or the entire universe, from an ETF perspective, we do that for you. You make one decision and one trade, likely at NAV.

In this environment, where we're all trying to do more with less, ETFs open up the entire toolkit, the entire range of risk and exposures for investors, and allow them to do it in a simple and efficient way. **BPM**

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