Fad or Forever? Institutions Weigh Pros and Cons of Replacing Single Bonds with ETFs

As the exchange-traded fund industry attracts new institutional investors, WallachBeth Capital is on the leading edge of providing intelligent trading solutions through execution, education and support. We took a moment to speak with Steve Mickle, Director of ETF Trading Solutions, on the evolution of fixed income ETFs and their expanding institutional usage.

Q. What are you seeing from your pension, foundation, endowment and insurance clients regarding the need for fixed income ETFs?

In a recent survey, more than a third of institutional firms indicated they've faced increasing challenges with single bond liquidity in the past two years as stricter regulatory landscape has significantly reduced banks' market making ability and shrunk inventory levels.

It's important to remember, though, that institutions are built to favor single bond exposure, irrespective of transaction expense, in order to strategically match liabilities and payouts. Recently, though, fixed income ETFs are increasingly being used to achieve strategic bond exposure. They also remain a popular tool for short term tactical trades and cash equitization.

Q. How hampering are events like the recent August flash crash to institutions using or considering using ETFs?

There's an interesting dichotomy of opinions on this topic. While it was alarming to see names like SDY, VIG and DVY dislocate from their NAVs as they did, this event was largely the result of panic selling by retail via things like "stop-loss" orders.

Ironically, chaotic events tend to portend ETF liquidity in certain fixed income sectors. On Aug 24th, the liquidity of the high-yield single bond market declined nearly 20% to $5.1B. Simultaneously, HYG saw traded volumes increase to an all-time high of $1.6B, or roughly 32% of the underlying high yield market[1]. And we've seen this before – albeit in smaller proportions – during the 2008 financial crisis, the 2011 treasury downgrade, the 2013 taper tantrum and the 2014 oil price decline. These occurrences remind us that fixed income ETFs can offer ample liquidity during traumatic times and present an efficient vehicle even when the market itself is stubborn.

Q. What other big challenges do you see in institutional adoption of fixed income ETFs?

ETFs certainly have their place in institutional portfolios and their usage is gaining momentum, but some continue to have reservations. Why? A fixed income PM's job is to manage bonds that earn return and match liabilities or fund payouts. Replacing individual bonds with ETFs can be a tough value proposition. Concern about job security, internal investment restrictions, the belief that all-in expenses are high and the perception of limited trading volume still deter some from embracing fixed income ETFs.

Q. Are there particular fixed income sectors that are more attractive for institutional ETF exposure?

Short term corporate credit is one ETF sector that offers advantages and is one we've seen recent interest in from the insurance community. Compare a short-dated corporate bond ETF versus an actual corporate bond portfolio—the predominant advantage for the former is the ability to easily gain exposure to a portfolio with sufficient diversification and yield spread (versus cash equivalents). Furthermore, implementation costs and annualized expense ratios for the ETF are generally favorable, especially in the wake of declining single bond liquidity. Municipal bond, mortgage, and U.S. real estate ETFs are also interesting. ETFs like MUB, SHM, MBB, VMBS and IYR have reasonable bid/offer spreads and block liquidity of up to $25mm notional can be sourced within levels close to NAV.

Q. What advice would you give institutions looking to implement fixed income ETFs?

The proliferation of ETFs now allows easy access to diverse market segments. But with more product options comes more complexity and risk. We recommend carefully choosing a trusted partner to guide you through the investment process, from product diligence through implementation.

At WallachBeth, we pride ourselves on doing just that and consulting with clients on alpha generation, portfolio construction and optimal trading strategies. For execution, we can anonymously access liquidity through various avenues—be it risk markets from our extensive liquidity network, basket trading, creations/redemptions, NAVs, etc.—and provide unbiased guidance on the best avenue given a client's objectives and the ETF's particular constraints. Perhaps most importantly, our agency-only model allows us to provide full transparency throughout the process— a consideration our clients value and one that in turn allows us to build a true relationship of trust.

[1] *Source: Bloomberg*

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Prior to joining WallachBeth in 2013, Steve covered insurance companies for four years at Barclays Global Investors which was acquired by BlackRock in 2009. There he focused on positioning iShares fixed income ETFs within insurers' general account portfolios. Prior to BGI, Steve covered hedge funds and mutual funds for Merriman Capital, a boutique investment bank and broker dealer in San Francisco. Steve received his BA in mathematics and Spanish from Hamilton College.