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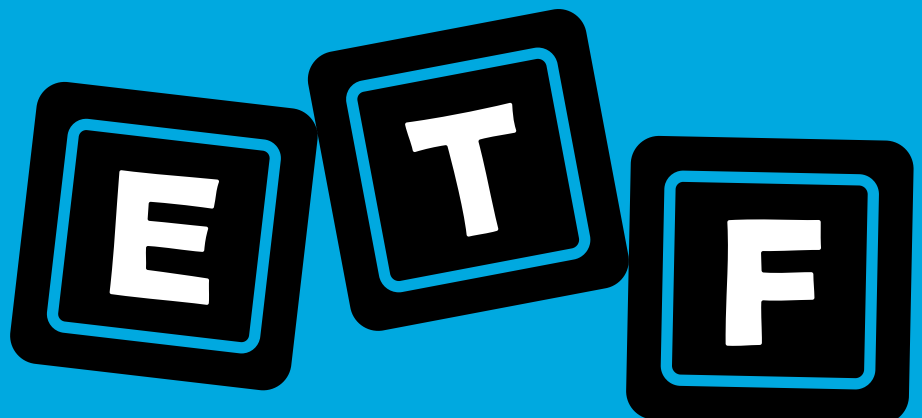
EXPANDING INSTITUTIONAL OPPORTUNITIES

How ETFs are broadening investment avenues for institutional investors



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EXECUTIVE SUMMARY

Exchange traded funds (ETFs) have emerged as one of the most transformative financial innovations of this generation. The advent of ETFs over 30 years ago equipped investors of all types with an efficient way to access a wide range of market exposures, with liquid, transparent execution.[1] Ever since, institutions — including pension funds, insurers, central banks and many other investor types — have found increasingly innovative ways to integrate ETFs into their investment strategies.

Institutions are further embracing ETFs as they have repeatedly demonstrated their utility in challenging markets. Consider that two of the most notable periods for ETF adoption were the onset of the global pandemic in 2020 and markets sell off in 2022. The growing adoption of bond ETFs is illustrated in the surge of trading volumes during periods of volatility. In 2022 for instance, rising inflation and political turmoil have led to higher volatility. In this context, industry-wide UCITS bond ETF trading volumes have averaged USD 3.3B per day, up 21% versus the USD 2.8B seen in both 2021 and 2020.[2]

Asset owners have been persuaded to adopt ETFs (in particular bond ETFs) and find new uses for them after observing the efficiency and the deep liquidity of ETFs in highly stressed market conditions relative to their underlying markets.

In this paper, we examine the ETF market from the perspective of asset owners and discuss common uses of ETFs with a special focus on fixed income.

51% of public pensions surveyed reported either increasing their usage of bond ETFs during recent volatility or that they are likely to increase their usage.[3]

8 OF THE 10 LARGEST U.S. INSURERS use bond ETFs, and 5 of them adopted bond ETFs after the volatile markets of March 2020.[4]

1 Source: BlackRock as of 31/08/2023. **2** Source: Bloomberg as of 31/12/2022. **3** Source: Institutional Investor, Rising to the challenge of a dynamic market: Institutional investors respond to uncertainty in 2022, as of 30/06/2022. Based on 759 respondents. Usage figures come from a global survey of institutional investment decision makers at insurers, endowments, family offices, foundations, pensions, and asset management firms surveyed in Q1, 2022. This study was sponsored by BlackRock. BlackRock is not affiliated with Institutional Investor or any of their affiliates. **4** Source: S&P Global Intelligence, BlackRock analysis of filings with the National Association of Insurance Commissioners (NAIC) and the Securities and Exchange Commission.

HOW GROWING ADOPTION AND TODAY'S MARKET ENVIRONMENT ARE CREATING MORE OPPORTUNITIES FOR INSTITUTIONAL INVESTORS TO USE BOND ETFs

Institutions that had historically constructed portfolios from the bottom up with single name bonds are now using bond ETFs for transparency, accessibility, liquidity and efficiency. While many have historically used bond ETFs to rapidly dial up or down tactical risk exposures, many are beginning to realize that bond ETFs can also represent 'betas' (long-term strategic, core market exposures) and 'tilts' (a persistent allocation to a specific return exposure, for example, high yield), replacing the cumbersome alternative of a number of individual bonds in portfolios. Investors are also increasingly using bond ETFs as risk management alternatives to futures or swaps, as cash and liquidity management instruments, and also as a tool to reduce the expenses associated with trading individual bonds, helping to reduce the 'total cost of ownership'.

More structurally, bond ETFs are helping institutional investors of all types and sizes adapt to a changing macro environment characterised by high interest rates, sticky inflation, and macro uncertainty. Investors face a variety of unique portfolio construction challenges: managing uncertain liquidity, liability demands, and generating positive real return against the backdrop of high levels of inflation. Against that backdrop, managers are turning to ETFs for six main portfolio construction solutions.

Those are:

01 **Strategic portfolio rebalancing and the implementation of tactical views**

02 **Efficient market access**

03 **Reduce the total cost of ownership**

04 **Liquidity management**

05 **Complement private markets allocations**

06 **An alternative to derivatives**

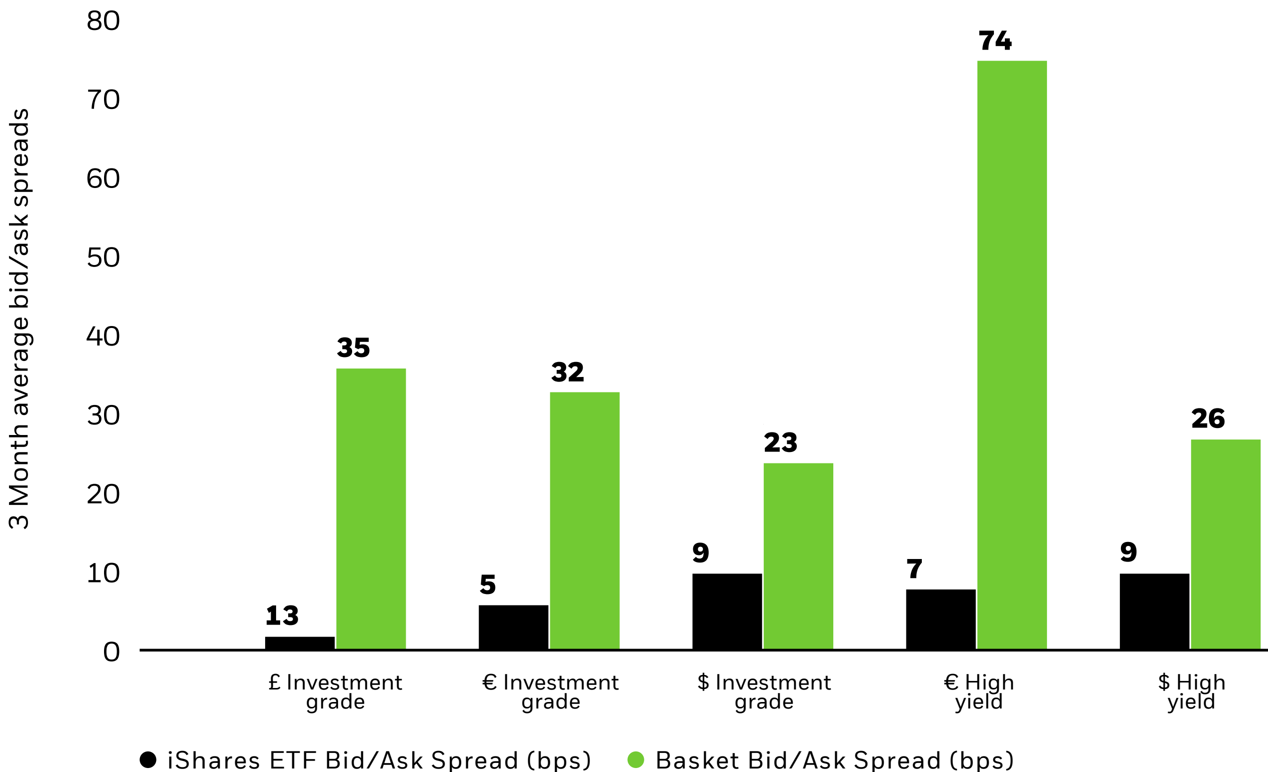
1

STRATEGIC PORTFOLIO REBALANCING AND THE IMPLEMENTATION OF TACTICAL VIEWS

Institutions tasked with incorporating strategic allocation changes or rebalancing portfolios often face implementation challenges, whether they involve constructing internal portfolios or evaluating external managers. Such processes can be time-consuming, and any prolonged market delay may result in performance setbacks. For example, the increase in yields over 2022 and 2023 created new opportunities in fixed income markets after a decade of low income levels.[5] This surge in yields is calling for a rethink of strategic asset allocations as investors can benefit from higher levels of income while investing in low-risk assets such as government bonds or high-quality corporate bonds. In this context, bond ETFs are cost effective, efficient ways for investors to gain easy access to a diversified, broad bond market, saving the need and money of sourcing hundreds (if not thousands!) of individual bonds.

For managers looking for tactical exposures, an ETF can be an appropriate vehicle for its immediate access, cost effectiveness and efficiency. For example, take institutions looking to expand allocations to investment grade (IG) or high yield (HY) exposures. Particularly if this is a new asset class for the organization or outside the area of expertise, it may take several days or even weeks to invest, while a similar exposure in an ETF can typically be executed within one or two days, at a significantly lower trading cost as represented by tighter bid/ask spreads (Figure 1).

Figure 1 **Average bid/ask spreads of UCITS iShares ETFs vs underlying markets**



Source: BlackRock, One Tick, as of 31/08/2023. Average spreads are for the 3-month period ending August 2023. The ETF selection was based on biggest funds with the asset class in terms of assets under management (AUM).

5 Source: BlackRock and Bloomberg as of 31/08/2023.

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2 EFFICIENT MARKET ACCESS

With their launch 21 years ago, bond ETFs connected the fragmented fixed income markets with transparent and liquid on-exchange trading, creating an entirely new class of efficient building blocks for assembling fixed income portfolios. A movement that started with four bond ETFs has now grown to USD 2T in AUM and more than 1,500 products around the world.[6]

Today, bond ETFs break the bond market down into more precise exposures across credit, sectors, duration and other risk factors. Many strategies featured in more recently launched bond ETFs were previously available only to large investors at high cost and great difficulty, if at all. This increasing granularity enables investors to efficiently access their desired market exposure, build increasingly customisable portfolios, hedge risks and capture opportunities.

Today, bond ETFs provide innovative avenues to access diversified sources of yield such as Asia investment grade credit, China, or India bonds. More recently investors managing fixed maturity funds or liability-driven solutions are turning to fixed maturity ETFs to maintain diversification and liquidity yet retain their target maturity profile. Additionally, investors looking to integrate sustainability into portfolios may use ETFs to do so, benefitting from the transparency and the rules-based approach offered by index solutions.

6 Source: BlackRock, Bloomberg and Morningstar as of 31/08/2023.

> **WE HAVE USED ETFS FOR MANY YEARS FOR STRATEGIC, TACTICAL AND TEMPORARY EXPOSURES TO SELECT ASSET CLASSES. WE RECOGNISE THAT IN SOME ASSET CLASSES THEY CAN AT CERTAIN TIMES BE A FAR MORE EFFICIENT INSTRUMENT TO TRADE AND HOLD THAN EQUIVALENT EXPOSURES IN POOLED FUNDS OR DERIVATIVES, DUE TO THEIR DIVERSIFICATION, EASE OF EXECUTION AND LIQUIDITY.**

Arif Saad, CFA
Executive Director, Fiduciary Management & Institutional Solutions
- Van Lanschot Kempen Investment Management

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REDUCE THE TOTAL COST OF OWNERSHIP

Investors evaluating buying a bond ETF versus a portfolio of individual bonds, assuming similar risk characteristics, may want to consider the total cost of ownership. The total cost of ownership considers both the costs of holding an investment over a period and the costs associated with trading into and out of the investment.

ETFs may exhibit a lower cost of ownership relative to replicating a portfolio of bonds due to their secondary market liquidity and potential trading efficiencies. As we show in figure 2, for a hypothetical $50m investment grade portfolio with a one-year holding period, holding an iShares UCITS investment grade € ETF could provide a benefit, relative to the hypothetical portfolio. Further revenues can be accrued when incorporating additional operations such security lending (a transaction entails an ETF lending out securities/units held in the fund to an interested party, such as a broker/dealer or hedge fund, for a fee).

Figure 2 Comparison of a hypothetical €IG portfolio trade vs. an iShares investment grade € ETF

Costs (bps)	Cost/revenue item	Hypothetical replicating €IG portfolio	An iShares UCITS IG € ETF
Entry & exit trade	Bid-ask cost, round trip	31	5
	Total round trip transaction costs	**31**	**5**
Holding cost	ETF management fee	-	20
	Securities lending (within portfolio/ETF)	**-6**	-6
	Total	**-6**	**14**
Total cost		**25**	**19**
Securities Lending	ETF unit lending revenue	-	-10
Net cost (incl Sec Lend)		**25**	**9**

The hypothetical replicating bond portfolio results shown are hypothetical and for illustrative purposes only and do not represent any specific investment product or any client account. Past performance does not guarantee future results. Source: BlackRock, Bloomberg, as of 31/08/2023. The table shows the cost of trading a hypothetical € IG cash bond portfolio and an iShares UCITS IG € ETF. This example shows a $50m investment for a 1-year holding period with no rebalancing during the year for the cash bond portfolio. All costs are round trip and in bps; assumes that any ETF premium or discount at trade inception remains constant over the horizon. With securities lending there is a risk of loss should the borrower default before the securities are returned, and due to market movements, the value of collateral held has fallen and/or the value of the securities loan has risen.

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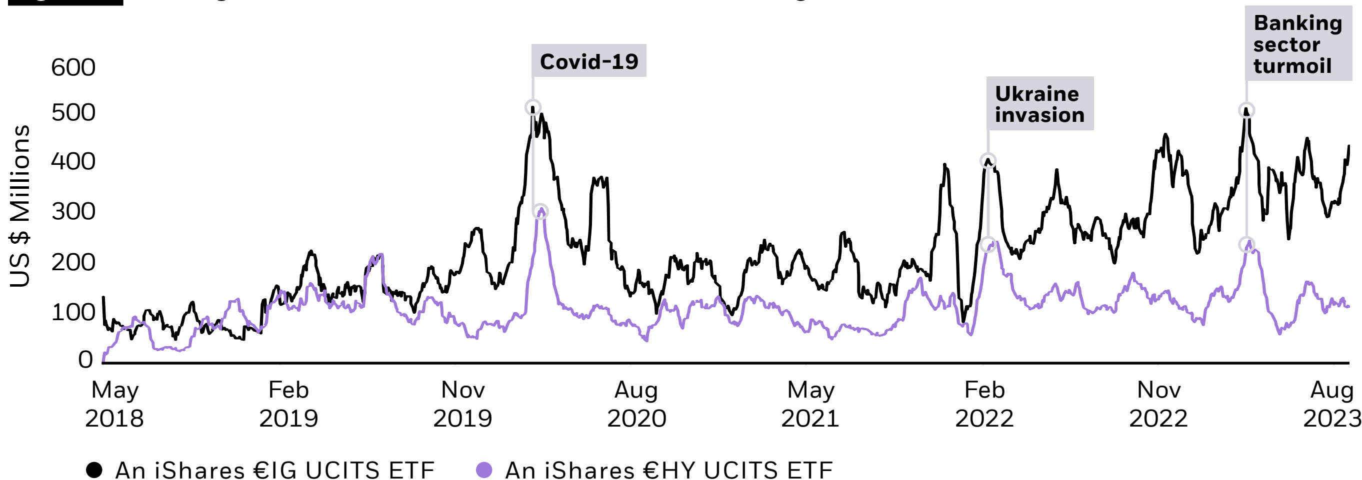
LIQUIDITY MANAGEMENT

Underlying bond market liquidity has been challenged for a number of years, driven in part by the reduction in dealer corporate bond inventory levels since the global financial crisis 'GFC' in 2008.[7] Rising interest rates and wider credit spreads have increased the cost of funding for corporates, leading to reductions in new bond issuance volumes – often an important source of liquidity for investors - in 2022.[8] This dynamic creates additional hurdles for institutions looking to quickly adjust bond portfolios, particularly at points in the year when liquidity is challenged, such as holidays or the summer months.

51% **of institutions invest in bond ETFs for their liquidity.[9]**

Having a liquid sleeve in portfolios made up of cash or a liquid subset of bonds is crucial to manage inflows and outflows. However, a challenge has been how to avoid cash drag of uninvested assets, or how to deal with a sudden drop in even the most liquid bonds in stressed markets. Investors can use bond ETFs, in both stressed and less volatile market environments, to replicate a liquid version of the broader portfolio to achieve low-cost exposure without incurring the cash drag of uninvested assets. Indeed, trading volumes in UCITS-listed iShares bond ETFs have followed an upward trend over the past few years, with volumes spiking during periods of elevated market volatility (see Figure 3).

Figure 3 **Trading volumes in iShares UCITS €IG and €HY largest ETFs**



Source: BlackRock and Bloomberg as of 31/08/2023. Volumes are based on 20 days average daily volumes (ADV). There can be no assurance that an active trading market for shares of an ETF will develop or be maintained.

7 Source: Federal Reserve Bank of New York. Data as of 31/08/2022. Calculation based on primary dealer inventory for USD IG and USD HY bonds issued in the US. **8** Source: BlackRock and Bloomberg as of 31/12/2022. **9** Source: Institutional Investor, Rising to the challenge of a dynamic market: Institutional investors respond to uncertainty in 2022, June 2022. Based on 677 respondents. Usage figures come from a global survey of institutional investment decision makers at asset management firms surveyed in Q1, 2022. This study was sponsored by BlackRock. BlackRock is not affiliated with Institutional Investor or any of their affiliates.

5 COMPLEMENT PRIVATE MARKETS ALLOCATIONS

Private markets play an important role within institutional portfolios, offering the potential for enhanced returns by capitalizing on illiquidity premiums, protection against inflation, and diversifying overall investment holdings. Nevertheless, it's important to acknowledge that investing in private markets may also present liquidity management challenges, particularly during periods of uncertainty. These challenges can manifest in various ways, including maintaining exposures, reducing cash drag, meeting capital calls to fulfil investment commitments, and adhering to predefined asset allocation targets. ETFs can provide a liquid solution to help asset owners better utilise cash during and following the funding of private market allocations. A customised ETF basket can be created, that can range from a simple cash plus exposure, all the way to mimicking an exposure best aligned to the macro and style factors of the underling private market strategy. Leveraging the liquidity, low cost and transparency of ETFs, can reduce the effects of cash drag by staying closer to a desired exposure during the drawdown period.

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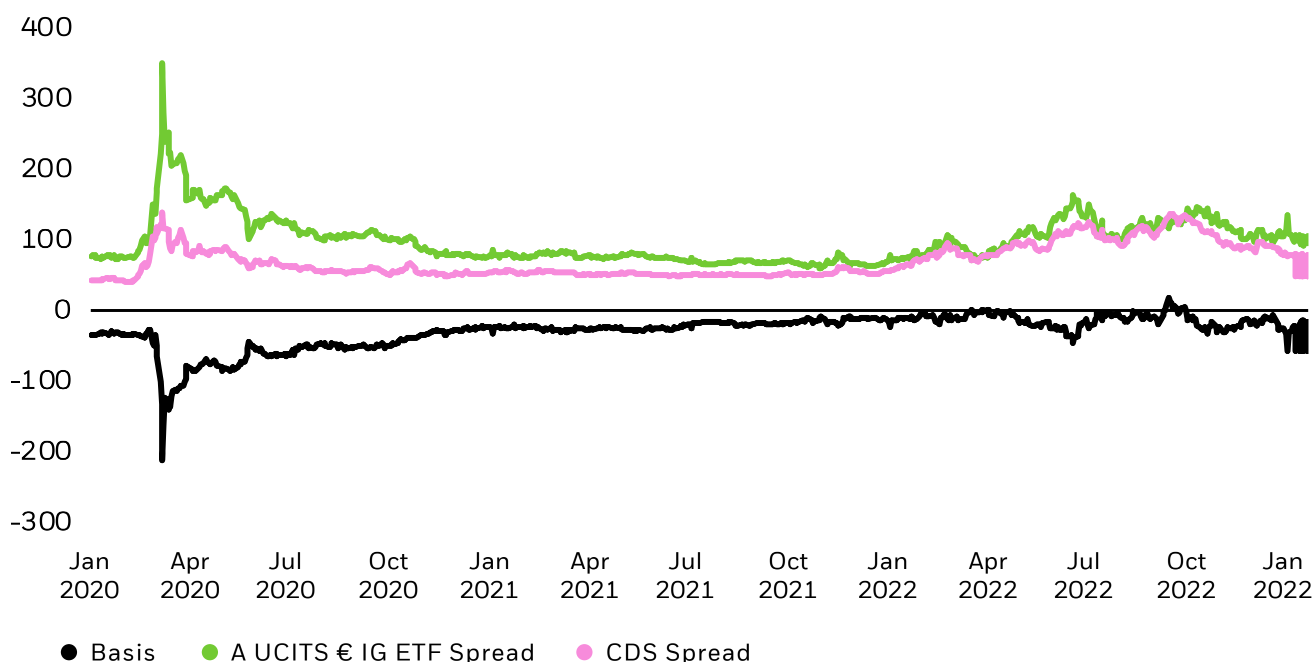
AN ALTERNATIVE TO DERIVATIVES

Institutions have many choices for adding or hedging credit risk in portfolios. The choices for investment grade and high yield portfolios include credit default index swaps (CDS), credit index futures, credit index total return swaps, credit ETFs or individual bonds. The relative merits of using one investment versus another are driven by the portfolio objectives and market dynamics. Regarding derivatives instruments, the liquidity provided by CDS allows investors to rapidly add and reduce risk at scale. However, the basis risk in CDS (the difference between the spread an investor receives when owning a physical corporate bond and the CDS) can be substantial during times of volatility as outlined in Figure 4 during 2020.

Credit index total return swaps (such as iBoxx TRS) typically offer improvement in basis risk and correlation, but do not yet enjoy the same liquidity and transaction cost advantages of CDS indices or credit ETFs.[10] Credit index futures (such CBOE $HY and $IG index futures) may also see increased interest over time as additional volumes develop in these contracts.

Figure 4 **Spread moves comparison: € IG ETF spread vs CDS spread**



Source: Bloomberg as of 31/12/2022.

10 Source: BlackRock, Bloomberg and Morningstar as of 31/12/2022.

CONCLUSION

Bond ETFs' transparency, accessibility, liquidity and efficiency have helped them gain widespread adoption as instruments for fixed income investment exposure and portfolio risk management. We believe institutional investors will continue to adopt and embrace this powerful technology and bond ETF innovation will bring to market more precision for portfolio construction and risk management.

More than ever, we believe institutional investors will continue turning to bond ETFs to navigate rapidly changing market dynamics. This reinforces our belief that bond ETFs will continue to grow, reaching $6T in assets globally by 2030,[11] while further cementing their role as a central and important part of the bond market itself.

11 Source: BlackRock. Projection as of May 1, 2022. Subject to change. The figures are for illustrative purposes only and there is no guarantee the projections will come to pass.

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