RBC BlueBay Asset Management

Why do Fixed Income ETFs underperform their benchmarks?

For Professional Investors Only | Marketing Communication

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> "Fixed income markets offer significant opportunities for a truly active manager... to generate consistent alpha."

Would you invest in an active fund manager that regularly delivered you sub-benchmark returns?

Most likely not, but this is essentially the reality for investors in passive fixed income exchange traded funds (ETFs).

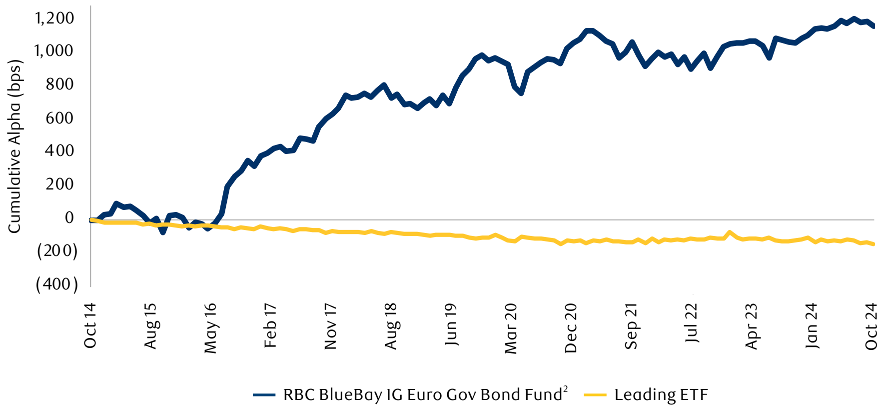
These funds track the benchmark but charge a fee so the actual total return to investors is below that of the benchmark itself. Due to the differences between equity and fixed Income markets, we do not consider ETFs the best solution for investors when allocating to bond markets. Fixed income markets offer significant opportunities for a truly active manager, who can take advantage of the many idiosyncrasies that exist, to generate consistent alpha (outperformance) net of fees.

Passive Fixed Income ETFs Consistently Lag Benchmarks Due to Fees

Over the past decade ETFs have grown rapidly across both the US and Europe. From 2016-2022 their volume increased by 16% p.a. exceeding the 5% p.a. growth of mutual funds[1]. ETFs began in the US in 1993 as an alternative to passive index funds for individual investors, but now their reach is global. ETFs exist across many asset classes and have now been widely adopted by institutional investors. But we do not believe that ETFs are the best solution for investors in fixed income.

As shown in the chart below, over the past ten years, the RBC BlueBay Investment Grade Euro Government Bond Fund has outperformed its benchmark whereas the leading passive ETF has underperformed its benchmark, net of fees. The RBC BlueBay Fund has generated alpha of 110bps per annum, but the leading ETF has lagged by an annualised 14bps.

Alpha Generation of RBC BlueBay IG Euro Gov Bond Fund vs leading ETF



Source Bloomberg, at 31st October 2024. All data is net of fees.

[1] Oliver Wyman
[2] I-EUR share class - ISIN LU0549539178

Why do Passive Fixed Income ETFs deliver sub-benchmark returns?

The first ETF was based on the S&P 500, a large capitalisation equity market. In markets such as these, due to the high liquidity and narrow bid/offer spreads that prevail, providers can offer ETFs at very low costs. However, in fixed income markets spreads are wider and liquidity is lower, so the ETF providers generally charge investors more. Transaction costs and fees mean passive fixed income ETFs lag benchmark returns, this tends to be exacerbated during volatile periods when liquidity decreases.

Fixed income markets are structurally inefficient

The bond markets are mainly traded 'over the counter' (OTC) and are generally less efficient than equities. This means they are more prone to the mispricing of risk, which creates opportunities for active managers. Information inefficiencies also exist within fixed income markets. In equity indices an issuer will only be one member, but in fixed income benchmarks issuers often have multiple securities, with differing maturities and coupons. These often have different features such as callability, subordination or covenant protection which are difficult to value. This can lead to pricing anomalies that can be exploited through an active management strategy.

Passive strategies always replicate the benchmark

This could mean they hold securities even though the fundamentals are deteriorating. A passive ETF will not sell until the issuer is removed from a benchmark, which can happen when the credit rating is downgraded. This can lead to all ETF holders selling their holdings simultaneously, possibly causing sales at depressed prices.

Equities are effectively perpetual securities, but a typical bond has a maturity of five to seven years. Consequently, the turnover of the constituents within fixed income indices is multiple times that of equity indices. Equity indices are often rebalanced quarterly and, due to the methodology, annual index turnover is normally only 1-2%[3] of the index capitalisation. As bonds mature they leave the benchmark, so typically between 15% and 20%[4] is replaced annually. This gives a meaningful advantage for active investors as issuers generally price new issuance at a discount to outstanding bonds, to avoid the reputational risk of them being undersubscribed. Active investors can participate in the new issuance and generate alpha. Passive investors will not purchase bonds until added to the benchmark, when often the discount in pricing has closed.

Are Active ETFs the solution?

More recently 'Active ETFs' have been launched, aiming to combine the value-added skill of active managers with the low costs of ETFs. But observed performance shows there is no evidence to support this is adding value to end investors. In fixed income markets we observe that the data available indicate that many of these funds track their benchmarks closely, indicating that little 'real' active risk is taken.

[3,4] Bloomberg

ETFs – under the hood

It is important to understand some of the key features of ETFs and how they differ from mutual funds.

Tax: In the United States ETFs have a preferential capital gains tax treatment relative to mutual funds, this has been a major driver of their popularity in the US. But the tax regime in Europe is different so this feature adds no value to European purchasers.

Liquidity: ETFs offer investors the ability to trade intraday, so ETF traders can attempt to exploit intraday volatility. However, investors who take a longer-term view do not need intraday liquidity, but they are in effect 'paying' for others to have this facility. ETF providers are required to create or liquidate the balance of orders each day, this generates transaction costs that are borne by the remaining ETF investors.

Index construction methodology in the equity markets generally affords the largest weighting to the companies with the greatest equity capitalisation. In fixed income the largest constituents are those issuers with the highest level of debt. So, in a passive fixed income ETF investors are most heavily exposed to the most indebted companies. These companies are potentially more vulnerable to downgrades or defaults.

Responsible investing: Passive ETFs invest in all issuers in the benchmark so do not distinguish based on ESG criteria. Consequently, they will have exposure to companies with weaker ESG scores, which will lower their overall ESG rating. Many investment-grade passive ETFs are classified SFDR 6, the RBC BlueBay Investment Grade Euro Government Bond Fund has a SFDR 8 classification. Some investors have restrictions on the percentage of their portfolios that can be allocated to SFDR 6 funds, so investing in passive ETFs can use up this allocation. At RBC BlueBay we can integrate responsible investment analysis into our credit evaluations, with an emphasis on forward-looking and qualitative factors.

Actual returns from active ETFs display no evidence of systematic outperformance, and they can still underperform their benchmarks after fees. Active ETFs generally charge higher fees due to additional transaction and management costs.

Summary

Fixed income markets have multiple idiosyncrasies that can allow an active fixed income manager to generate outperformance, after fees, whereas passive ETFs have consistently delivered net returns that lag their benchmarks. It is also important to choose a 'truly active' manager such as RBC BlueBay where we retain the agility and rigorous investment process that enables us to take advantage of these opportunities for the benefit of our clients.

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