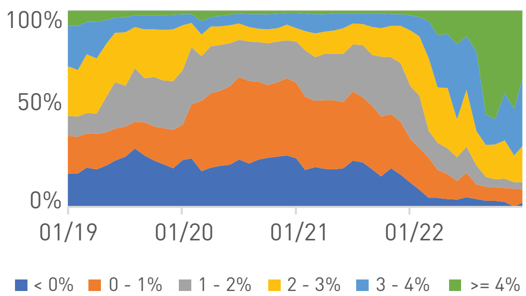
The Great Reallocation and what it means for fixed income investors

"Income is back in fixed income" – If there was a contest for the catchphrase of the year 2022, this one would certainly be a hopeful contender as it captures the essence of market evolution. The fixed income space has undergone a significant transformation and reallocation implications reverberate into 2023. This has resulted in a year-to-date influx of USD 87bn in global fixed income ETFs.[1]

Figure 1: Income is back – yield distribution in global fixed income universe



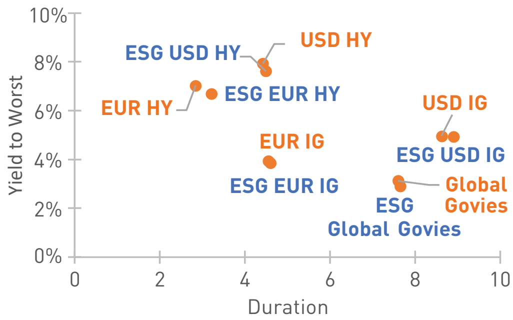
Yield distribution in % based on the Bloomberg Global Aggregate Index. Sources: Bloomberg, DWS International GmbH, as of January 2023

In light of a benign outlook for fixed income assets in 2023, we recap how investors can leverage the passive toolkit. A holistic consideration of this toolkit should not only include an examination of fixed income assets most suitable, but also a consideration of the specifics of the investment vehicles utilised. Afterall, the efficacy of ETFs as a means of accessing the fixed income markets can vary, and investors would be well-advised to uphold the principles they adopted in the past decade of ultra-low interest rates: Utilising the full breadth of the passive fixed income toolkit, but always with a focus on efficient replication. In the following we recap three essential dimensions investors should be mindful of: (i) a growing core, (ii) the role of innovative solutions and (iii) the metrics to watch in implementation.

The role of a green core for portfolio construction

The ESG investment landscape continues to experience significant growth and momentum, as evidenced by the proliferation of ESG-focused products in the European ETF market. As investors increasingly shift away from traditional fixed income, they now have access to a wide range of ESG building blocks to choose from. The shift towards ESG investments is driven by competitive and cost-efficient solutions that align with traditional investments in terms of yield, duration, and rating and reflects a change in investment attitudes as investors seek to align their portfolios with their values. The availability of compelling solutions allows them to do so while maintaining representative market exposure and achieving similar yields.

Figure 2: Yield to Worst and Duration of ESG solutions and their non-ESG counterparts



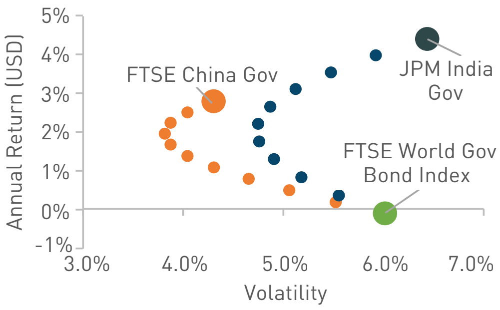
Sources: Bloomberg, DWS International GmbH, as of January 2023

The role of fixed income innovation

As recent developments have demonstrated, with long-term sovereign bond yields surpassing 2.5% and 3.5% in the Eurozone and US respectively, even government bonds have emerged as a compelling investment alternative. However, while carry and yield to maturity are certainly important factors, it should not be the sole consideration in making fixed income allocation decisions. Afterall, a key role of fixed income in portfolio construction is to provide diversification, and here, traditional core exposures in government and investment grade bonds have struggled to deliver in 2022 – a record year for equity and bond correlation.

Allocation to non-core investments can provide meaningful diversification benefits. As recent events have highlighted, this is particularly true for emerging market government bonds, where countries like China and India have proven to be resilient sources of diversification, even in the face of global volatility. China Government Bonds have already established themselves as a cornerstone of fixed income portfolios, recently peaking at €15 billion in assets in European UCITS ETFs.[2] Meanwhile, India is fast becoming a compelling option for investors seeking a combination of yield and diversification, supported by a range of structural drivers. Also in 2023 investors may benefit from incorporating innovative fixed income solutions into their investment strategies, even in modest allocations, to further diversify existing portfolios and capitalise on long-term growth.

Figure 3: The role of China and India



Sources: Bloomberg, DWS International GmbH, as of January 2023

The role of an efficient implementation

When selecting fixed income products, investors must consider two crucial factors: quality of replication and cost of implementation. Both factors are fundamental to the success of an investment strategy and warrant close examination.

In terms of quality of replication, two commonly used metrics are tracking difference and tracking error. Tracking difference quantifies the deviation of a fund's performance from its benchmark index, while tracking error measures the stability of this deviation and is calculated as the standard deviation of the tracking difference. The tracking difference can be impacted by several factors, with the Total Expense Ratio (TER) being a source of performance drag. Yet, in the fixed income space it worth analysing performance-enhancing features such as securities lending or primary-market participation in new issues. If implemented correctly, these can contribute to significantly tighter tracking differences than TERs might suggest.

To judge the quality of portfolio management, however, tracking error might be the more important variable. A low tracking error is a sign that portfolio managers replicate the index closely while managing the sources of tracking difference consistently. Since in fixed income tracking errors can be large relative to tracking difference, they warrant special attention. Take high yield ETFs as an example: The average EUR HY ETF has a tracking error of 27 bps, which implies about a one-third chance that the ETF deviates by more than 27 bps from the longer-term tracking difference path per year. However, not all ETFs are created equal, and some offerings feature single basis point tracking errors resulting in much lower implementation risks. For investors with a shorter-term investment horizon tracking error is therefore a highly relevant dimension, one that is often neglected when decision making is driven by total cost of ownership considerations.

Overall, the fixed income market has undergone a significant transformation, with yields becoming increasingly competitive. Despite this, investor's principles of product selection should not change much. Poor implementation, excessive costs, and undesirable asset allocations still negatively impact performance. Investors are therefore well advised to maintain their disciplined selection approach to effectively leverage the full potential of the fixed income market in 2023.

FOOTNOTES:

1 Source: Bloomberg, as of April 2023, based on global ETF universe
2 Source: Bloomberg, as of January 2023, based on UCITS ETF universe

Think ETF. Think X.