Why All Investors Should be Using Fixed Income ETFs

It is often said that exchange-traded funds (ETFs) have "democratized investing." While that saying has become somewhat of a cliché, that statement couldn't be more valid for fixed income ETFs, as fixed income ETFs address many of the short-comings of the underlying bond market. The market structure of fixed income, especially when compared to that of equities, is significantly more archaic as it can suffer from a number of shortcomings, particularly during stressed markets. These include: lack of transparency and price discovery, cost inefficiency, accessibility and illiquidity. Below we highlight each of these issues and how fixed income ETFs can be used to effectively address many of these shortcomings.

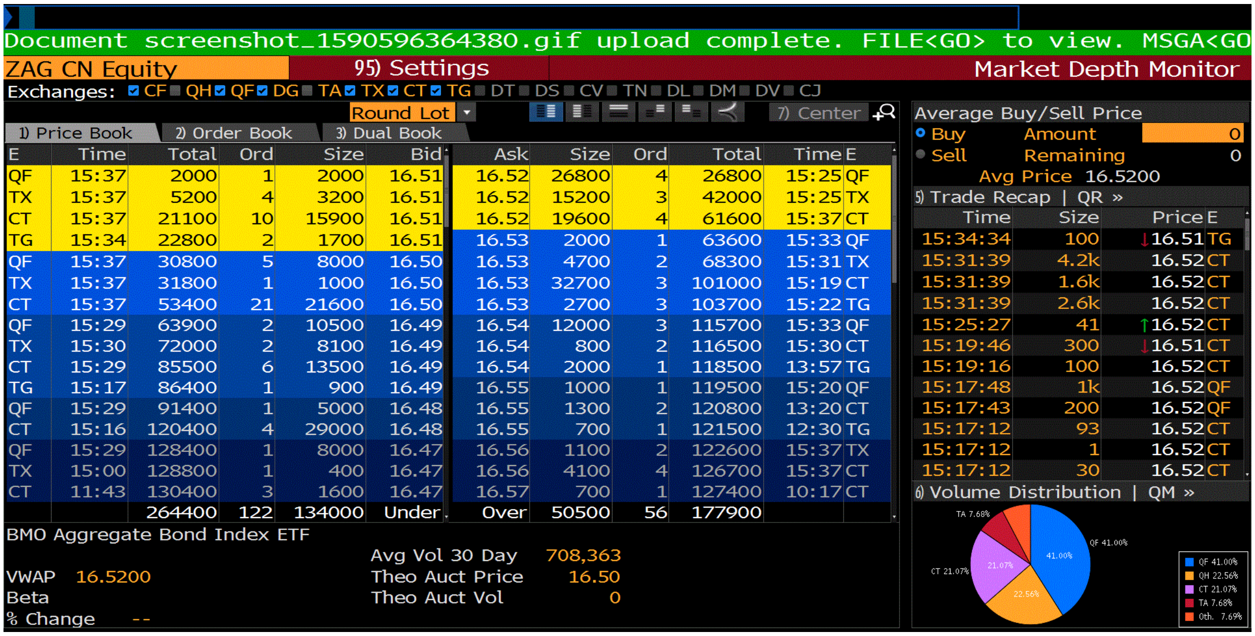
1) Transparency:

From a transparency standpoint, equities have a lot more visibility as they trade on a stock exchange, a centralized location where various types of investors buy and sell securities. A centralized exchange, allows for much greater visibility as it allows investors to know where buyers are willing to bid and sellers are willing to offer stock. Furthermore, additional statistics such as high, lows of the day and volume allow investors to have additional insight on a particular security. This visibility is why equity exchanges are often referred to as "lit venues."

In contrast fixed income securities trade over-the-counter (OTC), or on a decentralized market, where a buyers and sellers deal directly with one another or through a broker/dealer, rather than meeting on an exchange. Due to the "upstairs market" nature of bond transactions, significantly less information is made public. While in the U.S., broker-dealers who are Financial Industry Regulatory Authority (FINRA) members are obligated to report corporate bond transactions to the Trade Reporting and Compliance Engine (TRACE), the bond market as a whole lacks the same degree of information visibility of the equity market. In comparison, the Canadian bond market is even more opaque as even clearing data may lack sufficient detail.

In terms of transparency, fixed income ETFs address these specific issues by essentially taking an OTC market and placing it on a lit venue. As bond ETFs are essentially a basket of fixed income securities that are listed on a stock exchange, they are regulated by the rules and regulatory requirements of an exchange. This includes having a live bid-offer spread, historical high and lows, volume and additional information that allows end investors to have more transparency. Moreover, through a bond ETF, investors can also see the depth of liquidity in the order book for that specific ETF through a "level-two" stock quote. This allows investors not only to know where the current bid-offer is, but also how many shares are available on-screen at each price point. While this doesn't provide the entire picture of liquidity, as market makers can provide additional size on the bid or offer, it shows the minimum amount of liquidity available and is a significant value-add to traditional bond investors.

Order Book Visibility for Fixed Income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ZAG CN Equity 95) Settings Market Depth Monitor
Exchanges: CF QH QF DG TA TX CT TG DT DS CV TN DL DM DV CJ
Round Lot 7) Center
1) Price Book 2) Order Book 3) Dual Book

E	Time	Total	Ord	Size	Bid	Ask	Size	Ord	Total	Time	E
QF	15:37	2000	1	2000	16.51	16.52	26800	4	26800	15:25	QF
TX	15:37	5200	4	3200	16.51	16.52	15200	3	42000	15:25	TX
CT	15:37	21100	10	15900	16.51	16.52	19600	4	61600	15:37	CT
TG	15:34	22800	2	1700	16.51	16.53	2000	1	63600	15:33	QF
QF	15:37	30800	5	8000	16.50	16.53	4700	2	68300	15:31	TX
TX	15:37	31800	1	1000	16.50	16.53	32700	3	101000	15:19	CT
CT	15:37	53400	21	21600	16.50	16.53	2700	3	103700	15:22	TG
QF	15:29	63900	2	10500	16.49	16.54	12000	3	115700	15:33	QF
TX	15:30	72000	2	8100	16.49	16.54	800	2	116500	15:30	CT
CT	15:29	85500	6	13500	16.49	16.54	2000	1	118500	13:57	TG
TG	15:17	86400	1	900	16.49	16.55	1000	1	119500	15:20	QF
QF	15:29	91400	1	5000	16.48	16.55	1300	2	120800	13:20	CT
CT	15:16	120400	4	29000	16.48	16.55	700	1	121500	12:30	TG
QF	15:29	128400	1	8000	16.47	16.56	1100	2	122600	15:37	TX
TX	15:00	128800	1	400	16.47	16.56	4100	4	126700	15:37	CT
CT	11:43	130400	3	1600	16.47	16.57	700	1	127400	10:17	CT
		264400	122	134000	Under	Over	50500	56	177900		

BMO Aggregate Bond Index ETF
Avg Vol 30 Day 708,363
VWAP 16.5200 Theo Auct Price 16.50
Beta Theo Auct Vol 0
% Change --

Average Buy/Sell Price
Buy Amount 0
Sell Remaining 0
Avg Price 16.5200
5) Trade Recap | QR »

Time	Size	Price	E
15:34:34	100	16.51	TG
15:31:39	4.2k	16.52	CT
15:31:39	1.6k	16.52	CT
15:31:39	2.6k	16.52	CT
15:25:27	41	16.52	CT
15:19:46	300	16.51	CT
15:19:16	100	16.52	CT
15:17:48	1k	16.52	QF
15:17:43	200	16.52	QF
15:17:12	93	16.52	CT
15:17:12	1	16.52	CT
15:17:12	30	16.52	CT

6) Volume Distribution | QM »
QF 41.00%
QH 22.56%
CT 21.07%
TA 7.68%
0th. 7.69%

Source: Bloomberg, Level Two quote on the BMO Aggregate Bond Index ETF (ZAG), BBO <GO>

2) Price Discovery:

At times and particularly when the underlying bond market is stressed, ETFs have demonstrated an ability to provide price discovery to investors. The crisis of March 2020 was no exception when the underlying fixed income market seized up and essentially went “no-bid.” During this time, all market participants essentially became sellers of bonds simultaneously, which prevented dealers from absorbing any additional inventory. With no buyers or providers of liquidity to offset the selling pressure, investors could no longer sell any additional bonds. Bond ETFs, however, continued to trade. This was due to holders of ETFs being able to sell ETF units, albeit at a discount to net asset value (NAV).

It should be noted that while NAV is an efficient measure of the value of a fund’s assets in normalized periods, it does present some shortcomings during times of stress. Bond fund NAVs, which are calculated using dealer quotes, are often inflated during major market sell-offs as dealers are reluctant to mark down their inventory. Furthermore, if a bond hasn’t traded in days, the likelihood is that a dealer quote being submitted is likely stale. This is precisely why bond ETF prices often trade at a discount heading into a significant bond market sell-off and a premium coming out, as their ability to provide price discovery are more reflective of current market conditions. By definition, if a market goes “no-bid”, that means prices in which assets are being offered is not where buyers and sellers are willing to transact. During these times an ETF can trade at a discount, as the ETF uses its own demand and supply to find a price where buyers are willing to step in. By doing so, fixed income ETFs provide a better price discovery mechanism than the underlying bond market, as it is able to establish a true clearing price for bonds.

Another important note, is that while fixed income ETFs don’t allow for unlimited liquidity during a crisis, they do provide additional liquidity to the underlying bond market. If liquidity in the underlying market cannot be accessed, the market maker of an ETF can absorb additional selling pressure to underlying market. Therefore, an investor of an ETF can take advantage of the balance sheet of the individual bond dealing desks, but when these desks cannot take on anymore risk, the ETF market makers also can absorb additional ETF selling pressure before being forced to tap the underlying bond market for liquidity.

3) Cost efficiency

For direct bond transactions, bid-offer spreads can vary, particularly depending on what type of investor you are. Investors such as pensions and asset managers can transact in more sizable quantities at tight bid-offer spreads through an institutional trading desk. Retail investors, however, are subject to much wider spreads and trade via their retail desk.

When a bond ETF is launched, its bid-offer spread on an exchange is based on an institutional bid-offer spread given that is the cost in which the manager of the ETF or market maker can source the bonds. Over time, however, as an ETF matures and its trading activity on the secondary market increases, its bid-offer spread will become even tighter than what's available to institutions. This is the case due to the trading of ETF units on the secondary market. For example, for larger more mature ETFs, the likelihood is that you are buying the ETF from an ETF seller and vice versa. This is achieved as the increased trading of ETF units, allows market makers to buy and sell units, without having to access the underlying market. This is particularly true for ETFs that have two-way flow of both buying and selling activity and market makers compete with one another through tighter bid-offer spreads to capture more volume. This is beneficial as tighter bid-offer spreads mean lower costs of implementation for investors.

		Underlying		ETF	
		Spread / Mid (bps)	Bid/Ask Spread ($)	Spread / Mid (bps)	Bid/Ask Spread ($)
Aggregate Bonds					
BMO Aggregate Bond Index ETF	ZAG	0.367%	0.41	0.12%	0.02
Federal Bonds					
BMO Short Federal Bond Index ETF	ZFS	0.07%	0.07	0.07%	0.01
BMO Mid Federal Bond Index ETF	ZFM	0.09%	0.10	0.06%	0.01
BMO Long Federal Bond Index ETF	ZFL	0.11%	0.15	0.10%	0.02
Provincial Bonds					
BMO Short Provincial Bond Index ETF	ZPS	0.06%	0.07	0.06%	0.01
BMO Mid Provincial Bond Index ETF	ZMP	0.10%	0.11	0.09%	0.02
BMO Long Provincial Bond Index ETF	ZPL	0.22%	0.28	0.17%	0.03
Corporate Bonds					
BMO Short Corporate Bond Index ETF	ZCS	0.24%	0.24	0.21%	0.03
BMO Mid Corporate Bond Index ETF	ZCM	0.55%	0.59	0.30%	0.05
BMO Long Corporate Bond Index ETF	ZLC	0.71%	0.85	0.21%	0.04

Source: BMO Global Asset Management, FTSE/TMX, Bloomberg

4) Accessibility

While bonds are commonly held in the portfolio of many types of investors, accessing certain parts of the bond market may be challenging even for even some of the most sophisticated investors. An asset allocator or a pension fund looking to gain exposure to U.S. high-yield bonds may not have the necessary accounts, internal infrastructure or expertise to do so. An ETF allows investors to take on the beta-exposure of any asset class that is available through the growing ETF universe. While ETFs have expanded the investable universe for all-types of investors, it has also allowed retail investors to play on a level playing field. This is the reason why ETFs have been called “access products.”

5) Liquidity and Scalability

The majority of companies only have one-listed common equity, whereas it can have many more issued bonds. Consequently, the bond market is not only much larger in terms of market capitalization, but also in terms of numbers of securities available. Liquidity for bonds tends to be lower partly because the greater number of bonds, prevents investors from having a standardized security for buyers and sellers to transact. This becomes problematic for some investors such as family offices, which follow a common model for its clientele, but are subject to whatever bonds are available when capital is received.

A bond ETF, provides investors with a standardized product for all buyers and sellers to focus on. Furthermore, it allows investors to allocate all capital to a specific ETF and scale up their operations, rather than being subject to whatever bonds are available from a dealer at particular times. This allows firms to increase operational efficiency as client reporting becomes standardized across accounts and inventory of a particular bond exposure is always available.

Summary

While fixed income ETFs are often compared to traditional bond funds both in the institutional and retail space, ETF applications should be viewed more broadly. In reality, fixed income ETFs should be viewed as a capital markets vehicle that could be used by various institutional and retail investors to both compliment and replace funds and individual bonds. In recent years, it has been encouraging that fixed income ETFs are gaining traction. We’ve had an increasing number of conversations with a growing number of types of investors who in the past have been reluctant to utilize fixed income ETF as part of their portfolio construction process. With the ETF industry as a whole ramping up their efforts in education, we believe fixed income usage will continue to trend higher in the coming decade.

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