ETF Know:How®

Fixed income ETFs: Indexing vs. active management

Understanding key approaches to fixed income investing

When it comes to fixed income exchange-traded fund (ETF) investment choices, investors have two main management strategies to consider: passive (via indexing) and active. In this installment of the ETF Know:How™ series, we explore some of the differences between index and active fixed income strategies plus some of the benefits they offer investors.

Charles Schwab Investment Management

Indexing approaches

In the fixed income realm, it's important to understand the two main approaches to index investing: replication and sampling.

Replication

In this approach, an ETF aims to track the performance of an index by holding all the securities held by the index, at generally the same weights. Many equity ETFs take this approach. However, replication is less common among fixed income ETFs, for two key reasons:

1. Fixed income indexes typically include more securities than equity indexes—potentially thousands of bonds—which complicates purchase of the full set of securities.
2. The constituents in a fixed income index may be less liquid because many investors buy bonds intending to hold them until maturity. This makes it difficult to purchase bonds, thus making it difficult to fully replicate the fixed income index.

Key terms

Replication: The ETF aims to replicate the performance of a chosen index, typically by holding the same securities at generally the same weights as the index.

Sampling: The portfolio manager uses quantitative, qualitative, and statistical analysis to select certain securities held by the index to create a representative sample that resembles the index in selected characteristics, such as risk factors and performance attributes.

Sampling

Rather than using replication as a fixed income ETF approach, a portfolio manager may employ a sampling approach instead. Here the portfolio manager selects a subset of securities from the index with the goal of mimicking the characteristics, performance, risk factors, and dimensions of the fixed income index. These characteristics may include maturity, credit quality, industry sector, correlations, exposure, and credit risk.

Sampling offers a way to track an index that otherwise would be difficult to track because it contains many constituents, lower liquidity, or both. Plus, saving on trading costs and expenses may help the portfolio manager deliver the returns of the index.

However, unlike replication, sampling leaves open the possibility that returns could diverge from the index based on how well a portfolio manager samples the index to the portfolio.

Replication

Sampling

This hypothetical example is for illustrative purposes only.

Active management

The alternative to indexing is active management. Typically, investors who choose this method do so because they want to seek greater returns than those of a respective index.

In active management of a fixed income portfolio, the portfolio manager allocates among various sectors and risk factors of the fixed income market that fluctuate over time. This is similar to active management of an equity portfolio, where the manager seeks the best performers among the overall market of stocks.

Fixed income portfolio managers can also customize portfolios by managing sector strategy, duration, interest rate expectations, and credit risk.

Sector management

Selecting among government, mortgage-backed, and corporate fixed income securities can help a portfolio manager capture gains or preserve principal in varying economic and interest rate environments. Additionally, the manager can add value by identifying which sectors to overweight and underweight given the valuations of specific bond market sectors, a strategy that is known as sector rotation.

Duration and yield curve management

Since interest rates typically don't rise uniformly on the yield curve, an active manager has the flexibility to emphasize a certain part of the curve (short-, intermediate-, or long-term). Managing interest rate risk by choosing the weighted maturity or duration of an ETF is a key performance driver in actively managed ETFs.

Credit risk management

If a portfolio manager can accurately identify bonds that are undervalued or overvalued given their credit risk profile, the manager can seek to outperform an index by overweighting higher yielding bonds. The portfolio manager can also seek to outperform by overweighting or underweighting industries or parts of the credit quality spectrum.

Fixed Income ETFs: Comparing indexing and active management

	Indexing approach	Active approach
Goal	Seeks to track the performance of an index to reproduce its returns	Seeks returns greater than a selected index
Strategy	Portfolio manager purchases all or a representative sample of fixed income securities in the index	Portfolio manager uses knowledge and research to overweight or underweight bond sectors, lengthen or shorten duration, and manage credit quality
Costs	Typically low because portfolio manager doesn't need to spend resources to assess various fixed income factors	Typically higher than indexing because portfolio manager will need to allocate resources to analyze factors to help outperform the ETF's benchmark index
Risk	In line with risks associated with the specific bond market tracked by the ETF	Additional risk that the portfolio manager may not outperform the ETF's index

Summary

Both indexed and active fixed income ETFs offer diversified ways to access the bond market. Indexed fixed income ETFs may provide a more cost-effective way to access individual markets because the portfolio manager doesn't need to spend resources to assess various fixed income factors.

Active management of a fixed income ETF portfolio may help achieve gains beyond index returns or preserve capital, depending on the interest rate environment. Often, active managers can minimize the impact of rising rates by moving away from potentially lower yielding bonds.

Each investor should review their options and determine their preference for cost and risk. Ultimately this will help them decide if an indexed or active fixed income ETF is right for them.

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Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF. Shares of ETFs are bought and sold at market price, which may be higher or lower than the net asset value (NAV).

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors.

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JUT (0919-9EWS) MKT108469-00 (09/19)

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