ETF Know:How®

Insights on Exchange-Traded Funds
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charles SCHWAB Investment Management

Sea change: Investor dollars are flooding into bond ETFs

A massive sea change is underway in fixed income investing. Bond ETFs are supplanting both direct investment into single issues and actively managed bond mutual funds. In this article, we discuss the reasons this shift is occurring. We also consider how the evolving structure of the fixed income market coupled with a demographic tipping point could accelerate this move. What we are seeing now may only be a preview of a much more substantial migration toward bond ETFs in years to come.

Through the first half of 2019, more money was invested in bond ETFs than equity ETFs.[1] This is the first time that net flows to bond ETFs have exceeded those to equity ETFs for this length of time. Bond ETFs now have over $700B in assets spread across more than 400 ETFs listed in the U.S. (see Exhibit 1).

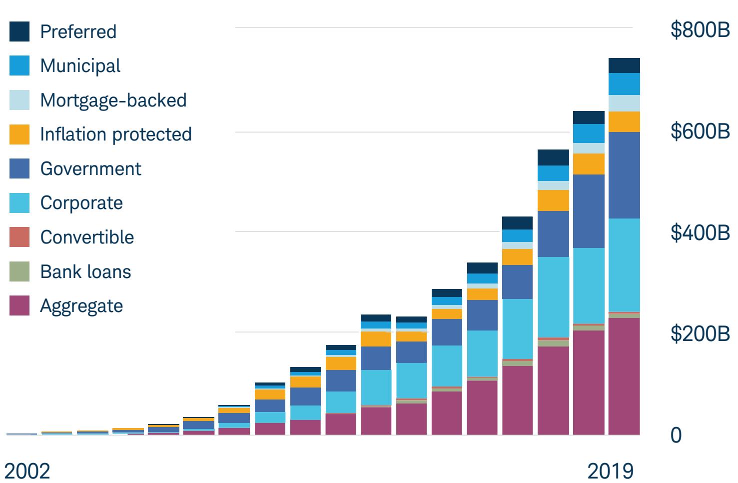
Year-to-date flows in bond ETFs have been largely characterized by a reach for yield with a tilt toward higher quality. Ultra-short maturities were in demand at the start of the year, but inflows have trended toward longer maturities more recently. While some of this positive flow has likely come at the expense of equity exposure thanks to cyclical factors, we believe much of the influx is coming at the expense of direct single-issue bond purchases and actively managed bond mutual funds.

Cost advantage and popularity are driving expanded options

2019 ETF flows represent an acceleration of a virtuous cycle that has been present for the last 10 years:

- Awareness of ETF cost advantages has grown and adoption has increased
- As adoption has increased, more and more specific subcategories of exposure have become available through additional product launches
- A wider breadth of market exposures has given investors and their advisors increased flexibility and precision for portfolio construction
- And the cycle repeats...

Exhibit 1: Assets in U.S. bond ETFs by sector



Source: Bloomberg as of June 30, 2019

Age-old problems of access and pricing, remedied

Investors have long faced challenges with both access to and understanding of the bond market. Knowing where to buy corporate, municipal, or Treasury bonds, and what represents fair pricing and transaction costs—these are real hurdles investors still face. Bond ETFs make buying bonds as simple as buying a share of stock. Meanwhile, there is a growing awareness of the cost advantage of bond ETFs. What's more, today's vast selection of bond ETFs gives investors the ability to implement flexible and tailored exposure (see Exhibit 2).

Bond ETFs vs. bond mutual funds

Like many index mutual funds, bond ETFs tend to have low management expenses. They benefit from economies of scale and provide attractive diversification for investors. However, the ETF structure provides several critical advantages that are not available through a traditional mutual fund. These advantages include:

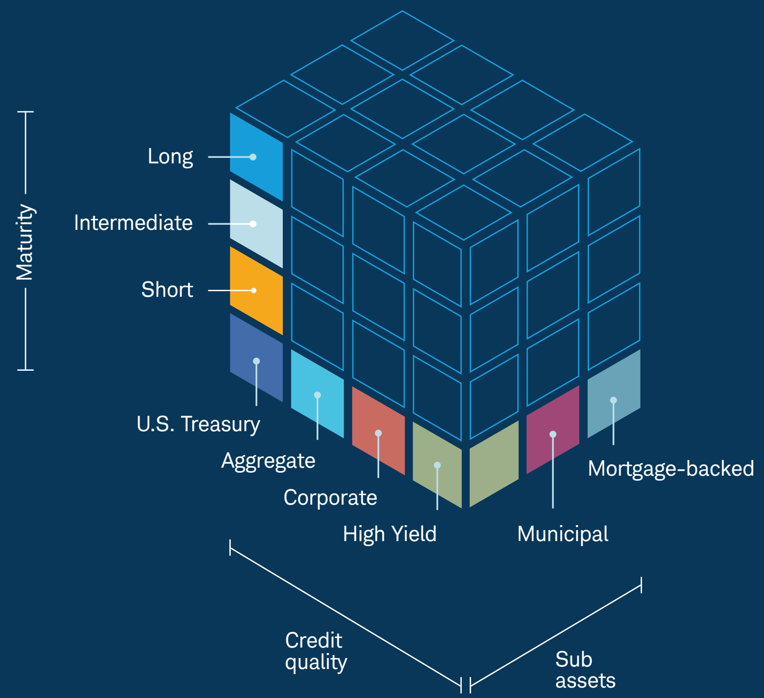
- The ability to buy or sell shares throughout trading hours*
- The potential for better tax efficiency
- Daily transparency of portfolio holdings

ETFs vs. individual bonds

The advantage of an ETF is even more pronounced when compared to the costs and complexity of managing a portfolio of single bond issues. The difference is stark when we compare the average relative spread impact of buying and selling several core bond strategies using an ETF versus a direct investment in the underlying portfolio of bonds. For example, as shown in Exhibit 3, U.S. Aggregate Bond ETFs have historically traded at a bid/offer spread of approximately 2 basis points while the underlying portfolio's asset-weighted bid/offer spread is 14 basis points. The ETFs are often able to achieve a tighter bid/offer spread than the underlying portfolio of bonds. This is a result of the large volume of buyers and sellers that efficiently meet on the price-transparent stock exchange.

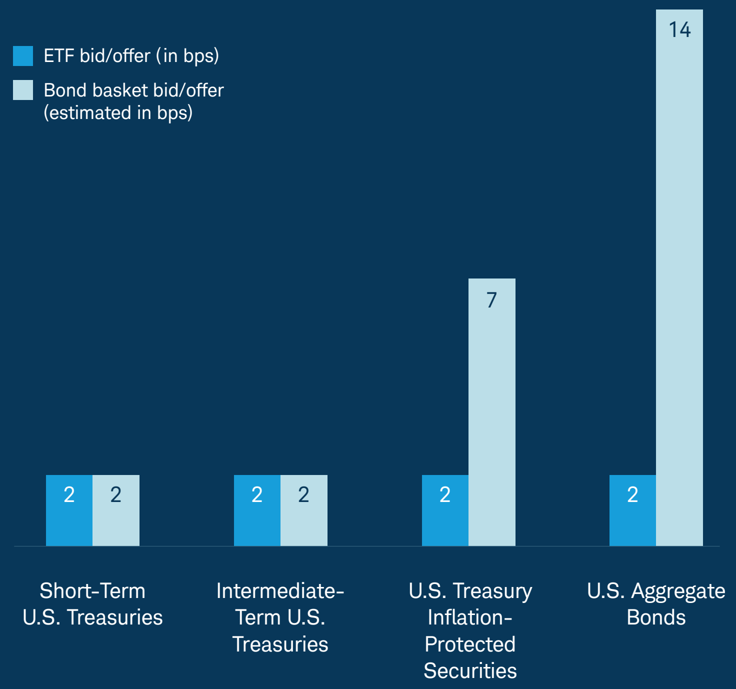
*Comparative advantage versus mutual funds, which can only be traded daily at market close

Exhibit 2: Offerings now cover every sector, duration, and quality



For illustrative purposes

Exhibit 3: Bid/offer advantage—lower transaction costs for bond ETFs vs. individual bonds



ETF bid/offer spreads reflect the representative spread for each category.
Source: ICE Data Services and Bloomberg Barclays as of September 2019.

For illustrative purposes

Bonds as a potential solution for retirees

The particular characteristics of bonds—coupon income, capital preservation, and the tendency to offset stock market movements—make them important in any diversified portfolio. But they are particularly relevant to investors approaching and in retirement. We believe the Baby Boomer generation will propel demand for bonds over the next 10 years, as this sizeable cohort experiences a more urgent need for sustainable income and a preference for capital preservation over the potential for capital appreciation (see Exhibit 4).

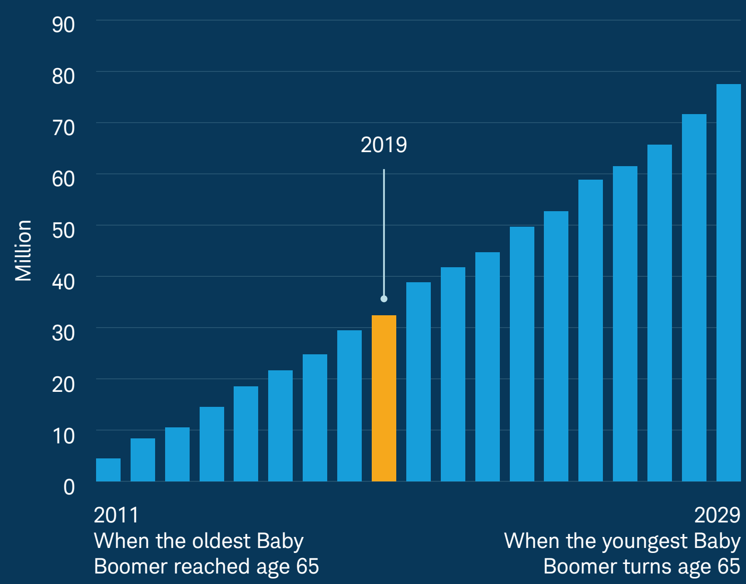
As retirees and near-retirees shift to higher bond allocations, they will encounter the challenges traditionally associated with bond investing—most of which relate to access and pricing. These impediments have historically led advisors to active bond funds or separately managed accounts, but this is clearly changing.

Further fuel for growth

In addition to the wave of Boomers entering retirement, there are two other developments that should further boost growth in bond ETFs. The first is a movement toward electronic trading in bonds. In the old days, bonds that hadn't traded in weeks would get back-of-the-envelope pricing. But the move toward electronic trading is finally pushing market makers to adopt proxy-pricing methods and trading techniques more like those already used in stock markets.

The second development is what is being referred to by the industry as the ETF Rule (or SEC Rule 6c-11). This is a formal codification of the existing disparate rules governing ETFs into a consistent, flexible framework under the Investment Company Act of 1940. The ETF Rule is likely to drive a more efficient creation/redemption mechanism in ETFs, which should translate directly into tighter ETF spreads and even broader product offerings.

Exhibit 4: Roughly 3.4 million Boomers are expected to turn 65 each year, or about 10,000 daily



Source: Pew Research Center, July 2019

A sea change, but still in early days

The marketplace for bond ETFs still trails the equity marketplace considerably. Among global equities, ETFs account for about $4 trillion in AUM, nearly 5% of the $83 trillion global equity market capitalization. Bond ETFs, on the other hand, only represent about $1 trillion, about 0.8% of the $96 trillion global bond market.[1]

But the significant trend of growing flows shows that investors are embracing the benefits of bond ETFs. The appeal of low fees has driven an explosion of new offerings. These have enabled investors to achieve similar exposures to individual bond portfolios, but with lower costs and more diversification. Compared with actively managed funds, ETFs often offer cost advantages and, in some cases, liquidity advantages. As the demographic trend of aging Boomers drives continued demand, we anticipate continued growth for bond ETFs for years to come.

[1] Bloomberg as of June 30, 2019

About the authors

D.J. Tierney is a Managing Director and Client Portfolio Strategist at Charles Schwab and Co., Inc. supporting Charles Schwab Investment Management, Inc. (CSIM). In this role, he represents Schwab ETFs™ to sales channels, clients, and the media. He also works with CSIM's product team to optimize Schwab's ETF offerings. Mr. Tierney assists in managing relationships and communications for Schwab ETFs with authorized participants, broker-dealers, and regulatory agencies. Prior to joining Schwab in December 2016, Mr. Tierney spent 16 years with Morgan Stanley as a senior institutional sales, trading, and relationship management professional. Mr. Tierney earned a BA in economics from the University of California, Los Angeles, and an MBA from the University of California, Berkeley, Haas School of Business.

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