Getting a look under the fixed-income ETF hood

By Jason Kephart February 19, 2012 6:01 am ET

Amid the growing popularity of exchange-traded funds that invest in bonds, financial advisers should be aware of the potential problems and pitfalls associated with the products.

Because bond markets are a lot less liquid than stock markets, many bond ETFs fail to track — or even stay close to — the indexes to which they are linked. That undermines one of the main reasons for investing in an ETF in the first place — the predictability of its adherence to a particular index.

Advisers also need to be aware of the fact that the vast majority of bond ETFs use a market cap weighting methodology, which means that the most indebted issuers are overweight, and the least indebted issuers are underweight, in the portfolio.

Critics contend that a better approach would be to weight the funds' holdings based on the financial underpinnings of each issuer. That way, more fundamentally solid issuers would represent more of the portfolio.

"MORE HOMEWORK'

“Investors have more homework to do with fixed-income ETFs than they do with equity ones,” said Jim Ross, a senior managing director at **State Street Global Advisors**. “They have to make sure they understand the underlying holdings and how the ETF is getting its exposure.”

Last year was a banner year as bond ETFs were embraced by many advisers, who poured almost $43 billion of new money into the funds, nearly double the inflows of 2010.

Interest has shown no signs of slowing down.

January actually saw a single-month record of $7.2 billion of net inflows into such funds, according to **Morningstar Inc.** The fixed-income market has grown to more than $180 billion across 114 products.

Fixed-income ETF assets still are dwarfed by equity ETFs, which have about $550 billion in total assets, in part because they were much later to the party. The first fixed-income ETF didn't appear until 2005, a dozen years after the SPDR S&P 500 ETF made its debut.

The main reason it took so long for the first fixed-income ETF to get off the ground is simply that it isn't as easy to replicate a bond index as it is to replicate an equity index. Most of a bond ETF's holdings trade thinly and, as a result, fund companies must rely on representative “sampling” to approximate their returns — hence, the tracking error.

“Everything at some point drives off the liquidity of the underlying holdings,” Mr. Ross said.

Chad Carlson learned about bond ETFs' propensity for tracking errors the hard way in late 2008, when he discovered that a short-term-bond ETF that he was using actually outperformed its index by about 3 percentage points.

As Mr. Carlson, a principal at **Balasa Dinverno Foltz LLC**, saw that the ETF could outperform its index, he realized that it could underperform, as well.

"If we're trying to target specific indexes, we need to know we can trust the funds," he said.

A tracking error of 3 percentage points isn't the norm, but fixed-income ETFs are more likely to have tracking errors than equity ETFs because bonds have less liquidity.

Over the past six months, the average intermediate-term-bond ETF has had a tracking error of 0.68%, more than four times that of the average large-cap-equity ETF — and that is before expenses are factored in.

Some well-known providers are worse than others.

The $200 million Pimco Investment Grade Corporate Bond Index ETF (CORP) has a tracking error of 2%, and the $3 billion Vanguard Intermediate-Term Bond ETF (BIV) has a tracking error of 1.38%, according to Morningstar.

A spokeswoman for Vanguard disagreed with Morningstar's findings, based on the firms own analysis. A spokesman for PIMCO, meanwhile, declined to comment.

The culprit when it comes to tracking errors is largely the archaic bond indexes, which weren't designed to be trackable. The Barclays Capital Aggregate Bond Index, the most commonly known bond index, includes more than 8,000 bonds, many of which simply don't trade.

Because it is nearly impossible for a fixed-income ETF to own all the constituents of an index, ETF providers have had to turn to sampling methodology, which is designed to have the same return characteristics as the index.

"We create a process that should perform the same over time," said Matt Tucker, managing director of fixed-income strategy at iShares, BlackRock Inc.'s ETF arm.

The good news for investors is that the bigger a fixed-income ETF becomes, the better it should track its index, because it is able to add more holdings with new inflows, which have been coming in by the truckload over the past 12 months.

Of course the million-dollar question is, what will happen when the flows reverse? This likely will happen when interest rates finally begin to rise.

"Advisers need to make sure there's a game plan for that," said Tom Lydon, president of Global Trends Investments.

WEIGHTING SYSTEM

Another challenge that old-school bond indexes create for investors is their weighting system.

All but a handful of the 114 fixed-income ETFs use a market cap weighting methodology, which means that the companies that issue the most debt are the largest parts of the index.

"We've begun the discussions about whether or not market cap weighting makes the most sense," said Mitchell Reiner, chief investment officer at Capital Investment Advisors.

The alternative is fundamentally weighted indexes that look at factors such as debt-to-free-cash-flow ratios to determine the likelihood of a company being able to pay back its debt. Invesco PowerShares Capital Management LLC and State Street have launched the first two such fixed-income ETFs, the $846 million PowerShares Fundamental High Yield Corporate Bond ETF (PHB) and the $22 million SPDR Barclays Capital Issuers Scorecard Corporate Bond ETF (CBND), respectively.

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