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Active ETFs: For Fixed Income Investors Who Don't Want to Follow the Pack

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In this connected world of 24-hour news and social media, many factors continue to vie for the market's attention, keeping volatility at the forefront of many investors' minds. Jason Xavier, head of EMEA ETF Capital Markets at Franklin Templeton Investments, explains volatility can present tactical investment opportunities, but not for those who are stuck following the crowd.

In my last article, I discussed the ways in which ETFs are helping to democratise price discovery within the fixed income sphere, opening up the asset class to a wider range of investors.

Here, I want to explore that idea of democratisation a little bit more and discuss how an active fixed income ETF could potentially offer better risk-adjusted opportunities for those willing to consider the tactical investment opportunities that volatility can sometimes present.

ETF Basics

First a quick reminder of the basics of ETFs and how they trade.

ETFs are open-ended investment funds which trade around the globe on regulated stock exchanges. In many instances, ETFs track indices which are developed according to either a market-capitalisation weighting approach or a fundamentally weighted approach.

Proponents of ETFs tout liquidity and the flexibility of intraday trading as benefits. The development of fixed income ETFs has brought those perceived benefits to an asset class that has traditionally been the preserve of institutional or professional investors.

The Challenges of Passive Indices

In our view, ETFs help democratise the fixed income sector, but passive ETFs may do little to offer democracy of asset choice.

Most passive indices are not constructed with the aim of meeting investors' fixed income goals or objectives, such as income, diversification and/or total return. Rather, they are constructed to measure broad market exposure to a particular market.

As a result, the lion's share of passive ETFs still follow the broad market exposure and market-cap weighting schemes. In the fixed income space, bond indices are generally issuance-weighted.

This means that the more debt a company or government issues that meets index criteria, the larger the relative weight it holds in the index as well. In order words, passive investors' holdings become increasingly centred on issuers that are expanding their debt load.

The Ability to Spot Outliers

On the capital markets desk, one of our jobs is to monitor activity of the underlying assets that make up an ETF and to observe how the performance of an individual asset or group of assets can contribute to or detract from the performance of the ETF itself.

While passive ETF managers, who are mandated only to follow an index, simply observe the outcomes, active ETF managers can work to mitigate the shifts that may change the risk/reward profile of a portfolio based on their research.

Even in apparently passive ETFs, there may be an element of manager discernment, given the sheer size of some the indices.

Some passive bond indices can contain more than 2,000 individual bonds. It's not really practical to own that many line items, so the manager of an ETF would likely make decisions which constituents to own (and which to omit), to best track that index.

We believe the ability for active fixed income participants to leverage their expertise with unrestricted allocations can often present a better risk-adjusted outcome for clients.

An active ETF can offer that ability, in our view.

Active ETF vs Passive ETF

So what are the differences between active and passive ETFs?

An active ETF doesn't follow an index. Most have a benchmark that the ETF manager will reference, and that benchmark may be an index normally associated with a passive product. However, it's not an index-tracking fund.

The aim of an active ETF—like many traditional mutual funds—is to outperform its benchmark or produce a certain outcome, such as regular income or lower volatility than a broad based index. As a result, the constituents of an active ETF are likely to deviate considerably from its benchmark index. But an active ETF differs from a traditional mutual fund because it offers intra-day price discovery and flexibility around trading.

In an active ETF, the manager or team of managers make investment decisions based on research and manager insights to determine the portfolio's underlying holdings and allocations.

Leveraging Informed Opportunities

We continue to believe that understanding the weighting mechanism and trading opportunities within fixed income and how such opportunities can be leveraged is crucial for informed investing.

At times of volatility, when momentum-driven movement of indices might present potential investment opportunities, active ETFs can provide access to investment-management expertise combined with the attractive features of an ETF vehicle.

So, for investors looking for transparent access to fixed income assets coupled with the flexibility and agility of active management, an active fixed income ETF may be an option to consider.

Read Jason Xavier's previous ETF capital markets articles here.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Brokerage commissions and ETF expenses will reduce returns. ETF shares may be bought or sold throughout the day at their market price on the exchange on which they are listed. ETFs trade like stocks, fluctuate in market value and may trade above or below the ETF's net asset value. However, there can be no guarantee that an active trading market for ETF shares will be developed or maintained or that their listing will continue or remain unchanged. While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

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