



ASSET MANAGEMENT

FIXED INCOME
ETFs VERSUS
ACTIVE FUNDS:
**WHAT'S THE
DIFFERENCE?**

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Finance is full of acronyms, and ETFs is one of the latest to gain prominence and momentum among investors over recent years. Having begun as a vehicle for investing in esoteric or hard-to-access asset classes, such as gold or agricultural commodities, ETFs (Exchange Traded Funds) have branched out into mainstream equity and fixed income markets.

But what exactly are ETFs, and how do they differ from active mutual funds? In this article, we look at what fixed income ETFs invest in, and some important differences between ETFs and our mutual fixed income funds. In doing so, we explain why we believe that, for long-term investors, actively managed mutual funds are a better option for fixed income investment.

Summary

ETFs	RLAM's actively managed bond funds
<ul style="list-style-type: none">• ETFs are funds designed around market indices. Some of them aim to replicate indices, while others may replicate only a portion of an index.	<ul style="list-style-type: none">• In all our fixed income funds, we aim to outperform the market by using our research capabilities and management skill to uncover mispricing opportunities. Our funds are not constrained by reference to benchmark indices, and we are able to control exposure to sectors and issuers, and to adjust duration (sensitivity to changes in interest rates) and sector positioning to reflect our economic views. We are also able to invest in off-benchmark securities as part of our aim to outperform the market.
<ul style="list-style-type: none">• You invest in an ETF by purchasing ETF 'shares' on an exchange, in the same way that you can purchase equities on an exchange.	<ul style="list-style-type: none">• You invest in our funds by applying directly to us to buy units, which are traded at specific times of the day.

ETF features: LIQUIDITY

ETF 'shares' are bought and sold on exchanges, and **can be traded at any time of day**, unlike mutual funds, whose units trade at specific pricing times. If investors wish to sell their ETF shares, they can do so at any time on the secondary market, with more flexibility to control the price at which these shares are sold, instead of having to wait for units to be priced and then redeemed at a particular point in the day.

As ETFs track market indices, like passive funds, there is a **frequent requirement to rebalance** the fund to maintain its similarity to the index. ETFs are known for being liquid, but it is unclear whether ETF assets are liquid because they are held in ETFs, or whether it is simply that in order to function, ETFs can only hold the most liquid assets.

At RLAM, **we are active fixed income investors**. We seek to exploit mispricing opportunities in government bonds, credit, high yield and loans in order to generate incremental returns. These mispricing opportunities derive in part from what we consider to be an over-reliance by the market and by investors on indices; ETF investment is part of this over-reliance. We have the freedom to invest in non-benchmark securities, which enables us to use our expert analysis and experience to seek securities that offer a more attractive balance of risk and return than those securities in market indices, which often become overpriced by comparison. **The growth of ETF funds actually provides us with more opportunities** to generate stable long-term returns, by drawing greater numbers of investors away from the off-benchmark securities on which we focus.

Frequent trading certainly has its uses, for example for a large multi-asset investment fund that needs temporary exposure to commodities, a commodity ETF is an ideal solution. However, for long-term investors who do not trade on a daily, or even on a monthly, basis, **it is worth questioning whether being able to trade as frequently as ETFs allow is really an advantage**.

The other side of liquidity: VOLATILITY

The liquidity of ETFs is an aspect often cited as an advantage, but the susceptibility of liquid assets to volatility is often overlooked. A liquid asset class dominated by retail investors is **sensitive to inflows and outflows**. Since the credit crunch, markets have been characterised by *en masse* 'risk on/ risk off' swings, where investors sell riskier assets at signs of worry and pile into 'safe haven' securities.

ETF liquidity is dependent upon more factors than secondary market trading. The underlying assets within the ETF are still a significant influence upon liquidity; **investing in ETFs does not remove the relationship to the assets actually held**, and although investors are one step removed, they still have an effective relationship with the underlying asset. If the underlying assets experience a bout of volatility, so will the ETFs.

The efficiency of the process by which the ETF 'shares' are created in the primary market also has an impact upon liquidity, which is evident by the fact that **ETFs tracking the same index do not behave in the same way**. The relationship here is less transparent, and ETF investors should be aware that there are more layers of liquidity, and therefore potential volatility, than might appear at first glance.

At RLAM, liquidity is a factor that we assess carefully as part of our overall analysis of risk and return of individual securities, and also as part of our ongoing portfolio management. We invest directly in assets, with transparent ownership and accountability, and **we monitor and understand the different factors contributing to our funds' liquidity profiles**, and to their risk and return. As active managers, if we believe that volatility is likely to increase, we can adjust our portfolios to provide extra protection; equally if we think markets will remain calm, we can take advantage by increasing exposure to riskier assets.

Our ability to control our portfolios without reference to a benchmark means that **we can take action to mitigate the impact of negative market events**, instead of being completely beholden to market movements. This means that we are able to achieve superior risk-adjusted returns, as shown by the **information ratio** (excess return per unit of risk versus the benchmark) and alpha. The **Sharpe ratio** indicates excess return above the risk free rate for each unit of risk; the higher score of our Sterling Credit Fund compared to its benchmark index (the iBoxx Sterling Non Gilt Index) demonstrates that through active management, we are using risk more efficiently to generate returns than the index.

RLAM STERLING CREDIT FUND	2 Years	3 Years	4 Years	5 Years
Information Ratio	1.10	0.79	1.19	1.56
Alpha*	1.39%	0.60%	1.26%	2.12%
Portfolio Sharpe Ratio*	1.45	1.38	1.50	1.47
Benchmark Sharpe Ratio*	1.10	1.05	1.09	1.01
* For these calculations, the BOE base rate of 0.25% has been used as the risk free rate.				

Source: Royal London Asset Management, as at 31.07.2017. Royal London Sterling Credit Fund, (Z share class, gross). Benchmark: iBoxx sterling non-gilt all maturities index. Alpha measure is Jensen's Alpha – risk adjusted performance in relation to the expected market return

For long-term investors who have sufficient time horizons to withstand episodes of short-term volatility, the ability to invest in less liquid assets can be turned to their advantage, especially when considering that 'illiquid' asset often offer a higher return. The financial crisis of 2008 demonstrated, among other things, that **in a significant market shock, all asset classes can be hit, including those that are meant to be more liquid**. The value placed upon 'liquidity', particularly for investors who do not have frequent trading requirements, is therefore debatable.

ETFs and fees

One of the main arguments in favour of ETFs is that they are a **low-cost method of gaining exposure to certain asset classes**. While we agree that this is true in many cases, for example in commodities or also to an extent in equities, it is less the case for fixed income, where active management fees, while in a range, do not tend to be as high.

Nevertheless, it is crucial for active managers to be able to justify the fees that they charge by meeting their investment objectives. **Fees are a crucial point for all investors**, and it is important to assess whether the fees and fee structure are appropriate in the context of the fund type and the fund performance, given its objective.

Conclusion: why the differences matter

ETFs are growing in popularity, but we question whether their most feted attributes (liquidity and low fees) are really advantages for long-term investors. At the heart of a successful investment strategy is a thorough understanding of what you are trying to achieve, what you are invested in and how your investments are designed to meet your objectives.

For investors who require shorter-term, easily traded exposure to an asset class, ETFs can provide a means by which to achieve this. We believe, however, that for long-term fixed income investors who require security and stable returns, our active management approach holds many advantages in terms of transparency and asset quality, and our experienced investment team brings a depth of expertise and analysis to enable us to build robust, distinctive portfolios.

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