Plan sponsors have transformed their fixed income portfolios post-2008 as they seek new sources of income and growth in challenging markets. But they’re not just shaking up what they invest in — many pension investors are also changing how they access fixed income. Exchange-traded funds now offer a liquid and relatively simple way to access a market that has traditionally been over-the-counter.

With the click of a button, investors of all sizes can now trade thousands of bonds across sectors and countries cheaply, and without a lot of legwork. It’s becoming a compelling value proposition for a growing number of institutions and pension investors, all of whom are seeking nimble and flexible exposure to bonds.

Here in Canada, however, plan sponsors have been slower to move into fixed income ETFs and there is still a lot of room for them to grow in Canadian pension portfolios. That’s changing, however, said experts at our first-ever fixed income roundtable, who think the tide will soon turn — provided pension investors in Canada can overcome barriers such as access, education and a lingering misconception that ETFs are weapons of mass destruction.
**Expiration Date**

**Sponsored Supplement**

**FIXED INCOME ETF ROUNDTABLE**

**About BlackRock**

BlackRock helps investors build better financial futures. As a fiduciary to our clients, we provide the investment and technology solutions they need when planning for their most important goals. As of September 30, 2017, the firm manages approximately US$5.977 trillion in assets on behalf of investors worldwide.

*Based on US$5.977 trillion in AUM as of 9/30/17

**SPDR ETFs**

As an industry pioneer, State Street Global Advisors created the first US listed ETF in 1993. Since then, each new member of the SPDR ETF family has been built to reflect our intimate knowledge of the ETF market. Our ETFs seek to provide a transparent way to access specific market segments.

**About State Street Global Advisors Ltd.**

For nearly four decades, State Street Global Advisors has been committed to helping financial professionals and those who rely on them achieve their investment objectives. We partner with institutions and financial professionals to help them reach their goals through a rigorous, research-driven process spanning both active and index disciplines. We take pride in working closely with our clients to develop precise investment strategies, including our pioneering family of SPDR® ETFs. With trillions* in assets under management, our scale and global footprint provide access to markets, geographies and asset classes, and allow us to deliver thoughtful insights and innovative solutions.

State Street Global Advisors is the investment management arm of State Street Corporation.

*Assets under management were CAD $3.38 trillion as of June 30, 2017.

AUM reflects approx. CAD $44.24 billion (as of June 30, 2017) with respect to which State Street Global Advisors Funds Distributors, LLC

---

**EXPERT PANEL**

Moderator: **CAROLINE CAKEBREAD**, editor, Canadian Investment Review

**SPONSORS**

**BlackRock**

**About BlackRock**

BlackRock helps investors build better financial futures. As a fiduciary to our clients, we provide the investment and technology solutions they need when planning for their most important goals. As of September 30, 2017, the firm manages approximately US$5.977 trillion in assets on behalf of investors worldwide.

*Based on US$5.977 trillion in AUM as of 9/30/17

**About BMO**

Founded in 1982, BMO Global Asset Management (BMO GAM) is an innovative-asset manager providing clients access to a global platform of investment solutions that span the risk-reward spectrum through four global centres of excellence including equities, fixed income, alternatives and solutions. In 1994, the firm became part of BMO Financial Group, a 200 year old Canadian financial institution. Headquartered in Toronto, Canada, BMO GAM manages over C$314 billion* with offices on 4 continents, in 14 countries and 20+ cities around the globe. Clients can expect dedicated service, innovative thought leadership, access to our global expertise and award-winning investment solutions.

*as of September 30, 2017

**State Street Global Advisors**

**SPDR ETFs**

As an industry pioneer, State Street Global Advisors created the first US listed ETF in 1993. Since then, each new member of the SPDR ETF family has been built to reflect our intimate knowledge of the ETF market. Our ETFs seek to provide a transparent way to access specific market segments.

**About State Street Global Advisors Ltd.**

For nearly four decades, State Street Global Advisors has been committed to helping financial professionals and those who rely on them achieve their investment objectives. We partner with institutions and financial professionals to help them reach their goals through a rigorous, research-driven process spanning both active and index disciplines. We take pride in working closely with our clients to develop precise investment strategies, including our pioneering family of SPDR® ETFs. With trillions* in assets under management, our scale and global footprint provide access to markets, geographies and asset classes, and allow us to deliver thoughtful insights and innovative solutions.

State Street Global Advisors is the investment management arm of State Street Corporation.

*Assets under management were CAD $3.38 trillion as of June 30, 2017.

AUM reflects approx. CAD $44.24 billion (as of June 30, 2017) with respect to which State Street Global Advisors Funds Distributors, LLC

---

**Sponsored Supplement**  |  FIXED INCOME ETF ROUNDTABLE
AS GOVERNMENTS PULL AWAY FROM THE POLICIES OF QUANTITATIVE EASING, NOT ALL CENTRAL BANKS ARE MOVING IN THE SAME WAY. WHAT IMPLICATIONS DOES THIS SITUATION HAVE FOR FIXED INCOME INVESTORS?

Aubrey Basdeo
I think it creates opportunities for bond investors to diversify exposures and capitalize on interest rate and policy differences between countries. That’s a good thing if you have the skill to manage across these different environments.

Alfred Lee
It also increases the risks. As central banks react in different ways, whether through continued QE or by aggressively setting the overnight rate, it’s clear they have become more involved in markets than they were before the 2008 financial crisis. Investors are trying to anticipate what central banks will do — that adds a lot of volatility to the market. At the same time, most debt before the crisis was held on the private side; now it’s mainly on the public side. As a result, what we think of as safe havens — government bonds — aren’t as safe anymore. It means investors must be more thoughtful about their fixed income exposure.

Bill Ahmuty
In the U.S., the Fed has communicated that it’s in the process of tapering — and if the economy maintains its momentum, rates should continue to increase. Investors are repositioning their bond portfolios in response, shortening duration and turning to floating rate products in anticipation of higher rates.

Dexton Blackstock
Decision-making is a lot tougher in this environment for plan sponsors. They may not have the necessary tools or resources to navigate the fixed income market, so they’re relying on their investment managers to do more.

Bobby Eng
Aubrey mentioned opportunity, and Alfred mentioned risk. I think we can expect more volatility as central banks continue this tug of war between growth expectations and low inflation. Plan sponsors must continue to adjust accordingly, especially with the expectation that rates will eventually rise or continue to rise.

WHAT ARE THE BIGGEST CHALLENGES PLAN SPONSORS FACE TODAY WHEN IT COMES TO FIXED INCOME INVESTING — HOW ARE THEY CHANGING THEIR INVESTMENT APPROACH IN RESPONSE?

Dexton Blackstock
As I mentioned earlier, plan sponsors don’t have the information or capacity to make decisions as quickly as they need to in this type of market environment. So instead of making the decision on how much to allocate to each segment, they’re now giving more discretion to fixed income managers to actively make those calls for them in areas such as high yield and emerging market debt.

Aubrey Basdeo
It really depends on funded status. If a plan is well below 100% funded status, it will have to take more risk. This often means that the fixed income allocation is both a source for returns as well as a hedging tool for liabilities. In today’s low rate environment, underfunded plans have been allocating some of their risk budget to active bond strategies like core plus to generate returns above the benchmark. Of course, rising interest rates will help, especially if coupled with changing solvency rules in Quebec and, potentially, Ontario.

For plans that are fully funded, it’s a different story — plans are likely to purchase more fixed income to de-risk.

Alfred Lee
Unconstrained bond strategies are also on the rise — people are starting to see the flaws in the fixed income universe so they want “go-anywhere” type strategies to help get around these problems. On the de-risking side, there is a move to fixed income but, as I mentioned earlier, bonds have become riskier. That’s one thing to keep in mind; especially for plans that expect fixed income to be a reliable asset class that delivers risk-free returns.

Bobby Eng
I think it’s important to take a step back and talk about what has happened in fixed income. Since the financial crisis,
capital charges and restrictions in proprietary trading that have led to a decrease in dealer inventory. Institutional investors are now stretching to find cash bonds and liquidity, which is why fixed income ETFs have grown so dramatically. It’s become another tool for institutions to manage their bond exposure.

ARE MANY CANADIAN PENSION FUNDS USING FIXED INCOME ETFS RIGHT NOW?

Bobby Eng
Fixed income ETFs are still relatively new in the investment landscape and there’s still quite a bit of education required. Some large institutions are comfortable with how fixed income ETFs trade and the structure behind it, but not everyone is there yet. The growth has just begun in Canada.

Aubrey Basdeo
We are seeing an evolution in Canada, but adoption of fixed income ETFs by pension funds has generally been slower than in the U.S. and Europe. Among Canadian pension funds, ETFs are primarily being used by the 20 biggest plans that can trade them in-house. We see them using ETFs tactically in areas where the total costs of ownership and liquidity are both compelling — for high yield or emerging markets, for example. Depending on the holding period, it’s often cheaper to use an ETF for tactical exposure.

Beyond the largest plans, we do expect mid- to smaller-sized plans to start using ETFs as a tool that allows them to better separate alpha and beta.

HOW CAN ETFS HELP PENSION INVESTORS MEET SOME OF THE CHALLENGES IN THE FIXED INCOME ENVIRONMENT?

Bill Ahmuty
ETFs give investors quick exposure to the areas of fixed income they are interested in. You can gain targeted exposure to a specific asset class while minimizing idiosyncratic risk. They can also use ETFs for access to bonds securities that provide income, like convertible or preferred securities. In the U.S., ETFs are being used to manage duration or credit risk in a portfolio of individual bonds or other index products. Multi-asset class managers are also using fixed income ETFs to gain exposure to different areas of the bond market. They’ve also begun to play a role in transition management.

Alfred Lee
Pension plans looking to offload risk or take on more bond inventory are facing a big challenge in the market as dealers shift from a principal-type bond market to more of an agency style model. In that context, ETFs make it easier to buy and sell — if an investor is unable to find a certain kind of bond, they can use an ETF with similar characteristics to get exposure. The structure allows investors to be nimble at a time when regulation has removed liquidity from the market. Now we’re actually seeing fixed income ETFs being used as a replacement for individual bonds, rather than traditional bond funds.

“We’re actually seeing fixed income ETFs being used as a replacement for individual bonds, rather than traditional bond funds.”

— ALFRED LEE

Bobby Eng
Another driver of growth in fixed income ETFs is the need for liquidity — in reality, that’s why approximately 80% of institutional investors are using them. Take high yield for example — ETFs can add a sliver of liquidity of anywhere from 5% to 15% in a portfolio to help manage redemptions or cash flow or take advantage of other buying opportunities. If the ETF tracks the same index as the portfolio’s benchmark, tracking error will remain relatively low, which is another benefit in a fixed income portfolio.

Alfred Lee
During a liquidity crisis, fixed income ETFs can help manage risk in your portfolio. If liquidity is a problem, you’re likely going to sell the most liquid bonds first — and in the end, you’ll be left with a portfolio of less liquid assets that looks very different than your target portfolio. By holding a small position in an ETF as a buffer, you can quickly sell it without affecting the overall portfolio. Compared to holding cash for liquidity purposes, it’s not going to cause cash drag either.

Dexton Blackstock
In a total portfolio context, using ETFs alongside traditional exposure through active managers helps plan sponsors further manage portfolio risk. So, it’s not just tactical — they
can have an important strategic use. Pension investors can use the ETFs to manage any exposure gaps in the portfolio and to mitigate any unintentional risks while their managers stay the course.

**HOW EASY IS IT FOR PENSION FUNDS TO BUY AND SELL ETFS? IT’S NOT LIKE THEY CAN GO OUT AND OPEN A DISCOUNT BROKERAGE ACCOUNT.**

**Dexton Blackstock**
The large plans with internal asset management capabilities can ETFs through their own trading desk. However, the smaller plans aren’t comfortable executing these trades yet. It’s getting there — some now realize they can directly purchase ETFs.

**Bobby Eng**
We have spent a lot of time educating smaller plans and many don’t have trading capabilities — that can stall the ETF conversation. But there are some ways to go ahead and trade. You can work with a custodian for example. But it does require additional paperwork and some just don’t see the value in going that route. Overall, plans are very interested in the ETF structure, but the conversation dries up because it may be too difficult for them to set up trading capabilities.

I think that will eventually change as these plans get larger and the OCIO model comes into play, which will make it much easier to trade. But they need to see the value first.

**Dexton Blackstock**
Right now it really depends on the size of the plan. Again, among mid- and smaller sized plans, there is a lack of awareness of the various roles ETFs can play in their investment management process — plus, it’s uncommon for consultants to include ETFs as an option when helping plans with their asset allocation decisions.

**Alfred Lee**
I agree a lot of the large plans already have the internal capabilities because they manage assets in house — they can go out and buy ETFs. And a lot of smaller plans gravitate to pooled funds, because for now they tend to be more cost competitive. But that’s changing — we are seeing a lot more price competition within the core plain vanilla ETFs, and fees are being compressed. For example, you can get an ETF that tracks the S&P/TSX Composite for 5 bps now. ETFs are becoming more competitive with pooled funds — we are getting there.

While some institutions have been hesitant about using ETFs as a core allocation, we are having good discussions about alternative uses of ETFs — liquidity management, transition management. It’s a starting point — once they get comfortable using ETFs, plan sponsors may start using them as core allocations as they become more familiar with their benefits.

**Aubrey Basdeo**
In the fixed income space, ETFs are becoming a critical capital markets tool — they are being used as cheaper surrogates for things like futures contracts, for example. This is happening in the U.S. and Europe, primarily — but there is a groundswell driving other markets too. We’re in early innings in Canada in the fixed income space — it is further along in other areas like equities, however. We will get there.

**WHICH TYPES OF FIXED INCOME ARE PLAN SPONSORS MORE LIKELY TO ACCESS THROUGH AN ETF RIGHT NOW?**

**Alfred Lee**
I’d say the less liquid asset classes are probably natural candidates — preferred shares ETFs, for example. Instead of trading or getting exposure through the underlying market, they can go straight to the ETFs where the liquidity profile is much better than the underlying market, given the secondary market trading of ETF units. Preferred share ETFs are a good example of where we have seen notable pick-up in institutional activity.

**Bill Ahmuty**
In the U.S., they’re focused on core exposures and a lot of money is flowing into aggregate or investment grade bond

---

“In the fixed income space, ETFs are becoming a critical capital markets tool — they are being used as cheaper surrogates for things like futures contracts, for example.”

— AUBREY BASDEO
ETFs. Keeping the cost of core exposures low through ETFs is key — and investors still maintain the ability to find asset classes that are higher yielding, and to invest more tactically through loans, preferreds, convertibles or high yield.

Bobby Eng
High yield seems to be a hot topic of conversation right now, simply because of the yield and liquidity profile of that market. We’re also having conversations about emerging market debt as well — not just the asset class but the ETF structure. Plans want exposure but they can’t find the right managers at the right cost. That gap has generated a lot of interest in gaining lower cost exposure through ETFs.

Aubrey Basdeo
Clearly there must be a value proposition if you’re going to use ETFs. Alpha and beta separation is important — and liquidity, so that you can move tactically and without moving fixed income markets when you make large trades. And because capital markets have changed in many ways since 2008, ETFs have helped to mitigate the structural deficiencies that are now present in the bond market in terms of liquidity. It does what it says on the can — so whether it’s tracking a Canadian aggregate index or an emerging market index, you’re getting the exposure it says you’re getting. Nothing different.

AS ETFS BECOME A BIGGER PART OF THE LANDSCAPE, DO YOU THINK INVESTORS COULD UNINTENTIONALLY BE TAKING ON MORE EQUITY-LIKE RISK IN THEIR FIXED INCOME PORTFOLIOS?

Alfred Lee
Investors aren’t taking equity risk, because fixed income ETFs trade like equities. The exposure is to the underlying asset class. However, if you look at how the composition of portfolios has changed over the years, we’ve seen a higher degree of credit exposure in bond portfolios. Given credit has a higher correlation to equities than traditional rate products, fixed income portfolios may be more “equity-like” in that respect, but that’s not due to ETFs.

Bill Ahumty
Fixed income ETFs are just a wrapper for bonds. While the ETF itself is structured as an equity product, the underlying instruments are fixed income securities. ETFs provide daily transparency on holdings and the industry has built tools for investors to help analyze fixed income ETFs using traditional fixed income metrics.

Bobby Eng
You have to separate the investment product from the asset class. For example, in the case of a credit crisis or a volatility event, high yield ETFs performed as the market did and as expected. If there is volatility in the high yield market, there will be volatility in the high yield ETFs as well.

Aubrey Basdeo
Investors have been paying a lot of attention to ETF liquidity, especially as they gather more assets. Critics try to paint the growth of ETFs as a doomsday scenario. But when you go back to 2008, when it was extremely challenging to trade in physical bonds, price discovery was found in the ETF market, especially for the riskier assets such as high yield. And since that time, this has occurred over and over again.

THERE ARE THOSE WHO WOULD ARGUE THAT ETFS MAKE FIXED INCOME MARKETS MORE FRAGILE — YOU DON’T AGREE?

Aubrey Basdeo
People fear that ETFs are weapons of mass destruction — that if everybody had to liquidate at once, the whole ecosystem would blow up. People have pointed to high yield and emerging markets bonds as areas of risk. But that fear highlights a fundamental misunderstanding of the ETF ecosystem. For one thing, ETFs have two levels of liquidity: the primary market, where the underlying assets are bought and sold; and the secondary market, where ETFs trade on the exchange. Typically, there is a lot more trading in the secondary market as investors, as opposed to market makers, exchange risk. Because of this you can argue that ETFs have enhanced the ecosystem in the fixed income space.

Bill Ahumty
There’s also a lot of transparency in fixed income ETFs — who’s making the market, what the underlying index is made of, and transparency of reporting. All that brings in more people to trade them. That’s important to recognize.

Bobby Eng
In the ETF ecosystem, I would argue that ETF investors tend to be a lot more diverse with different objectives than investors in some traditional products like pooled funds or even credit default swaps. With the broader set of investors that use ETFs, it contributes to a more liquid and efficient market.

Aubrey Basdeo
I would echo that point. ETFs bring new investors into markets and that enhances liquidity. Investors who might have been
held hostage in the past with, say, individual preferred shares on their books, can now work with ETF providers and even create ETF units with those securities. All this enhances the market structure — it adds a lot more liquidity and diversity.

**Alfred Lee**
ETFs have done the exact opposite of making the market fragile — having secondary market liquidity in the bond space has strengthened it. Fixed income ETFs have become a price discovery mechanism during periods when investors wouldn’t have been able to trade their bonds otherwise. Even in a worst-case scenario, ETFs still traded. You might not like the price you get, but you still get a price. It can be argued, however, that the ETF is the more accurate price, as that is where buyers and sellers are willing to transact.

THERE ARE SOME WHO BELIEVE ETFs ARE CONTRIBUTING TO A HIGH YIELD BOND BUBBLE — DO YOU WANT TO ADDRESS THAT?

**Bill Ahmuty**
The high yield market in the U.S. stands at $1.4 trillion — ETFs are just 3% to 4% of that on an assets under management basis. That doesn’t define a bubble. When it comes to trading, we see it being closer to 15% to 20% in the secondary market relative to the cash high yield trading market. Yes, that’s higher — but at the end of the day, it is providing price discovery to bonds that may not trade frequently. And that doesn’t hit prices on the underlying. It’s not driving a bubble in terms of the trading activity either.

**Aubrey Basdeo**
If you look across the spectrum, all assets are rich on a relative basis. But that’s because central banks have been motivating investors to move out the risk spectrum by holding interest rates low. As a result, investors have had to move into places like high yield for a higher yield or income. I think the argument about a bubble in high yield is really fueled by the idea that assets are rich compared to 20 years ago, when interest rates peaked at 12% to 14%. Anyone could make that case — it’s not about ETFs.

**Alfred Lee**
I don’t buy into the bubble argument. It comes down to a lack of understanding about the differences between activity in the primary market and the secondary market. Because of secondary market activity in the trading of the ETFs, a lot of the new money that’s traded in the ETFs doesn’t necessarily have to touch the underlying. ETFs are just the product — the wrapper.

WHAT BARRIERS STILL EXIST TO GREATER USE OF FIXED INCOME ETFs IN THE PENSION SPACE?

**Dexton Blackstock**
We need to provide more education to get pension investors more comfortable with ETFs — the methodology used to construct a particular ETF and the characteristics of the underlying assets. Executing an ETF trade is a big challenge for most pension investors. There are also questions about how the market is structured and the liquidity levels. We need to overcome the perception that there is a lack of liquidity in the market, as well as other misconceptions.

**Aubrey Basdeo**
Another challenge is the perception that ETFs are still largely a retail product, for retail use. From an institutional perspective, adoption is still in relatively early stages. Most plan sponsors are not using ETFs yet — going ahead and using them therefore means you are venturing into something new. But we will get there.

**Alfred Lee**
Education remains a challenge. While some investors are very familiar with ETFs and their mechanics, the majority are still rather new to ETFs. As existing ETF users are becoming more sophisticated, it is important that newer users continue to be addressed with the basics.

**Bobby Eng**
Fees are a challenge — many plans have access to pooled funds, which are very competitive in terms of fees. But that’s

“Some large institutions are comfortable with how fixed income ETFs trade and the structure behind it, but not everyone is there yet. The growth has just begun in Canada.”

— BOBBY ENG
changing due to increased competition that is driving down fees. Compared to pooled funds, ETFs also offer exposure to a wider universe — basically any asset class in different parts of the market compared. Pooled funds can also be a less attractive investment vehicle if liquidity is a concern for the pension plan.

**WHAT CRITERIA SHOULD PLAN SPONSORS USE TO SELECT A FIXED INCOME ETF?**

**Bobby Eng**
As with any ETF, you need to look at the index construction and index methodology to make sure it's giving you the exposure you are looking for. You also need to understand liquidity — not only trading volume but the liquidity of the underlying holdings of the ETF. Costs are another factor — many investors just look at the management expense ratio but that's only one part of the cost. You need to look at the total cost, including bid-ask spreads and trading.

**Bill Ahmuty**
Index construction is key—you need to start with that in discussing beta products. Because these are beta products, you have to understand your index exposure and then find the one that is close to that benchmark. Also, with fixed income, the create and redeem process is different for all providers — you need to understand how it impacts the fund manager's ability to manage and how the fund trades at a premium or discount. All this can impact the fund’s daily liquidity.

**Aubrey Basdeo**
One is liquidity and another is total cost of ownership, which includes costs not captured by the total expense ratio. A third is to understand the index that the ETF is tracking to and how this may differ from the exposure you are looking to capture.

**WHAT FACTORS SHOULD PLAN SPONSORS KEEP IN MIND WHEN CONSIDERING GLOBAL FIXED INCOME ETFS?**

**Bill Ahmuty**
In the emerging markets space, investors have many permutations: hard currency, local currency, corporates and sovereigns. They must understand their risks and exposures with each. And compared to developed market fixed income, there could be less transparency in emerging markets debt products. There is also currency — that can weigh into premiums and discounts.

**Bobby Eng**
When we see international products trading locally, there is often a lack of understanding about the price discovery mechanism. This happens when the local markets are closed but local market makers are relying on fair value to determine that price for the ETF. Investors should be aware of that.

---

“ETFs give investors quick exposure to the areas of fixed income they are interested in.”

— BILL AHMUTY

**WHERE DO YOU SEE FIXED INCOME ETFS BEING USED IN THE NEXT FIVE YEARS?**

**Bobby Eng**
The clear majority of ETFs available are equity ETFs. But fixed income products have been growing exponentially and will continue to grow especially as we educate the marketplace and large institutional investors become more comfortable with the structure and how they work. Most my ETF conversations with institutional clients end up gravitating towards fixed income and there is a natural curiosity about that space. It’s only going to grow.

**Dexton Blackstock**
I do think plans need easier access to ETFs — right now, it’s at the larger end of the DB pension market. But as ETFs become more widely understood and accepted by asset-owners as a viable alternative to other tools, there will be some type of mechanism put in place to provide medium and smaller plans with greater access to the ETF market.

**Aubrey Basdeo**
I think we’ve barely scratched the surface. In the last couple of years, we’ve seen institutional clients become a lot more creative in terms of how they use ETFs. We’ve seen investors using them for liquidity management and looking at more diverse type of products. ETFs address a lot of the challenges around liquidity that plan sponsors face — and on the fixed income side, this issue is a lot more pronounced. So, I think there’s a great deal of potential for growth in fixed income ETFs.