TRANSCRIPT

Pursuing diversification and income with bond ETFs

Presenters: Dhruv Nagrath

Dhruv Nagrath: So hi there. My name is Dhruv Nagrath. I'm a member of the iShares Fixed Income Strategy Team at BlackRock, and my job is to represent our suite of 118 bond ETFs, iShares bond ETFs. So I spent the past five years working in headquarters here in New York, but as you can probably tell from hearing me speak, I'm actually originally from Sydney, Australia. So I joined BlackRock in Sydney eight years ago.

So the goal of today is to really help you understand what bond ETFs are, understand how to evaluate them, and then give you some really popular use cases for bond ETFs in a portfolio. And that's the part of the presentation that I really want to get to. And it's right at the end, but it's actually the most exciting part because you're actually putting your money to work in your portfolio.

Now, before I get started, I want to say that bonds are something that an asset class that can be challenging or mystifying to some people. I think it can be a little bit confusing. So I actually want to start with a confession.

The confession that I want to start with is that eight years ago, when I joined BlackRock, and when I first interviewed with BlackRock, I was doing my interview. And my interviewer would turn out to be my manager and he told me after the interview that I was doing a great job. I was acing every question, nailing everything, except when it came to bonds.

When it came to bonds, I actually completely bombed the question. I messed it up. I tried to make up an answer. It was awkward. It was really bad.

The reason I'm sharing this confession, the reason I'm getting this off my chest, is that I personally found it challenging to talk about bonds initially. But eight years later, I've come full circle and I'm actually working in fixed income markets. And I'm talking about bond ETFs every day. So honestly, if I can do it, plenty of other people can as well. And indeed, I want to try today with some of the things I'm sharing. I really want to try and empower you to be able to make decisions using bond ETFs in your portfolio.

So let's get into it. Now, to start off, I want to set some context to-- Let's see, is this I think working here? Do we roll it down? Yeah, OK. Now, [INAUDIBLE] alluded to this earlier on and as you all are no doubt aware, this has definitely been a challenging year for investing across markets, right? So what you see on screen here is that 2022 has been the third worst year to start to the year on record for stocks since 1926.

The previous worst year's first half, this is based on the first half of the year performance, were 1932 and 1962. But normally or historically, what you've found is in those years where it's been more challenging for stocks, you've had bonds help your portfolio. That hasn't necessarily been the case this year, right? So 2022 is actually the worst start on record for bonds.

So it's definitely been a challenging market and indeed bonds have had their worst year, worst start to the year going all the way back to 1926. So that's what I will say, this is an unusual situation. This is not the normal course of events.

Now, you have all no doubt heard the reason for this and the point of today's presentation is to not go into those reasons. We can talk about it in Q&A. But at the high level, we know that we have an economy that's running hot. We have inflation that's at 40-year highs. And we have a Fed that's trying to get that under control by keeping the foot on the brake pedal, right, by raising interest rates. So that's the proximate cause of this unusual situation that you see.

But in spite of this challenging market context, I want to share with you guys a counterintuitive outcome in this context. And I alluded to this in the prior session is that even in this really challenging year, arguably the most challenging year on record for bond markets, we've seen investors putting money to work in bond markets, right? So what you're seeing here on the left-hand side of your screen is it flows into iShares US bond ETFs in the first half of the year and the number is $37 billion into bond ETFs.

As of yesterday, that number actually had gone up to $84 billion[1]. And so in this environment, clients have actually been using bond ETFs to put money to work in their portfolios. And I'd call out two main reasons. One is that there has been some pretty tremendous tax-loss harvesting opportunities. I'll mention this at the end of this presentation, there's a chance to book some of those losses and use it in as a benefit in your portfolio and that's driving some moves.

And then the other part, and you see this on the right-hand side of your screens, is that you can now actually achieve some yield again in bond markets, right? So what you're seeing on the right-hand side is the yield on the 10-year US Treasury bond at the start of the year. It was around 1 1/2% and as of yesterday, we are going up to 4%.

Now, that's quite extraordinary because up until February of this year, the US 10-year Treasury yield was below 2% all the way going back to July 2019. So yields have been low for quite a while and what we've seen here, this year, is a repricing as rates go higher. There's been now opportunities to put money to work, right?

And so that flow trend that we're seeing is actually part of a bigger overall adoption of bond ETFs. And so just a quick point that I want to share with you

[1] *Source: BlackRock. As of 10/26/22*

here is that bond ETFs globally are $1.7 trillion category. And here in the US, it's $1.2 trillion of assets. So this is a very established, now, tool in various investor toolkits.

So let's get to the formal part of the agenda, which is, like I said want to talk about what a bond ETFs. I want to give you some ways of evaluating them and then really get to the use cases.

So firstly, I love that we've got an image of this wall of keys here, by the way, because at the heart of what I think bond ETFs are is that they provide access, right? They're unlocking an opportunity to access a market. So firstly, and you saw this slide in the earlier presentation, what is a bond ETF or what is an ETF in general?

It's a diversified portfolio of securities that trades on the Stock Exchange, right? So it has all the benefits of a mutual fund in the diversification, but it also is tradable throughout the day, like an individual stock. Now, this is the same benefit with bond ETFs themselves except that these are bonds, right?

So it's making it easier to access what otherwise is an asset class that sometimes is a little bit trickier for us individual investors to access. Now with your Fidelity account and really just a few clicks of a mouse button, you can get access to portfolios of thousands of bonds just using individual tickers. So that's the real benefit there. Like I said, it's about access. So that's the first piece.

And then I'll say that there's been some pretty powerful benefits of using bond ETFs in your portfolio that have really driven that growth, that big chart that I showed you, the growth to $1.2 trillion. I would argue that it's because of one, low cost, that's really at the heart of it. The bond ETFs tend to track indexes so there can be lower cost.

Liquidity, they trade on a centralized exchange and trade thousands of times during the day. And tax efficiency, and I know we got into this in the earlier session, there's some structural advantages that make it the ETF quite a tax-efficient structure. So I'll get into each of those in a moment.

So firstly, keeping costs low. The goal here or the focus here is that over time costs can really add up. And so the point about keeping your investment costs low, keeping your fees low, is to put yourself closer to your ultimate investment goals. So there's a great example. There's three great examples here on this slide.

So you've looked at these comparisons so AGG which is an ETF. It's an iShare ETF, you, guys, saw it on the screen earlier on. It's a bond ETF that tracks the US investment grade bond market.

Now the fee on that product is 3 basis points per annum. That's 300, so 10% per annum that you're paying to have access to that portfolio of thousands of bonds close to 9,000 bonds that's professionally managed, and it tracks that benchmark very closely. Now, if you compare that to the average fee of the funds in the Morningstar core category, intermediate core category, that average fee is 59 basis points.

So if you're paying a fraction of the typical fee that you would normally associate with getting access to that part of the market, and I should make the distinction that there are some funds in that category that are active funds. So there are some funds that are seeking to outperform the benchmark. And so they would, of course, be charging a higher fee because you're making a trade off there. And you're saying, "I'm willing to pay a higher fee if I believe this manager can deliver or return above the benchmark."

But one of the powerful things that we've recognized in using ETFs and a lot of investors have recognized is that half the battle is just doing that piece that Brad talked about, which is setting a plan and making sure that your asset allocation is right. That's the core of it. So using ETFs at the core of a portfolio and keeping costs low make sense as a way of getting yourself closer to your investment goals.

There are a couple of other examples there. A USB, which is a more universal benchmark, it tracks more universal benchmark. It has some high-yield bonds in there that also has a very low fee of 6 basis points per annum compared to a category fee, an average of 74 basis points. And there's similar benefits in the high-yield category, right? So it's a USHY there, which is a core high-yield exposure, that's one sixth of the category average.

The third piece is liquidity. Actually, sorry, the second piece is liquidity. I realize I've been rambling a little bit too much about lower cost. So liquidity, the key point here is that you have to have the ability to get in and out when you want to trade, right? And one of the things that we've seen is in periods of market stress on ETFs have actually traded more or traded higher volumes because they've provided that centralized exchange that place for people to be able to trade in and out and take a view on the market.

And so that what we've just got there on the left-hand side of your slide is an article that came out around the time of the March 2020 COVID shock. We don't want to go through that shock again in markets. I mean there are going to be a couple of examples that I'm going to go through a little bit. But they've performed well. But this is at the right-hand side is the key thing here.

HYG, which is a liquid high-yield bond ETF, actually trades more than most of the top 30 stocks in the Dow, right? So just thinking about that, if you think about accessing markets at trades trading over $2 billion a day at a 1 basis point spread. The point here is just, basically, I mean-- And just by the way, that is an instrument that is used by a lot of those institutional investors that I talked about. But it's also used by-- this is the beauty of the structure as you can use it as an individual investor as much as you can use it as individual. But the point here is the ability to get in and out as you need.

And the third piece is about tax efficiency. Now it's about the goal here is to keep more of what you've earned, right? And here, there's this two drivers of why ETFs can offer tax efficiency relative to some of the other strategies out there. So the one is lower portfolio turnover.

So ETFs tend to track an index, right? So they'll track an index and that index was not going to trade, it's not going to shift as frequently as for example, say, if you're an active manager that's trying to outperform the market, you're probably going to be trying to move your portfolio around more overweighting things, underweighting things, trying to beat the market, right? So if you're tracking an index, you're going to be tracking that index pretty closely. And the idea here with an ETF is it's not going to be as much trading turnover as you're doing that.

The second piece is that holders in the ETF, because they are trading existing shares on the exchange, there's a lot of trading that happens on the exchange just between existing holders of ETF shares. So you don't need to transact with the actual, say, the mutual fund company if you wanted to do a redemption. You're actually trading on the exchange. So there's a bit of an insulation from the buying and selling actions of other shareholders because of the structure. And by all means, if there are questions about this, we can go into this in Q&A.

But the key point here is that historically, if you look at on the right-hand side of your slide, over the past 10 years, this was as of the end of last year, the percentage of funds that distributed capital gains for mutual funds, traditional mutual funds is 54%. And for ETFs, it was 80%. So they've had a better track record of not paying out those capital gains, which obviously makes a difference in terms of tax time.

So we're going to get to the second section of my presentation, which is evaluating bond ETFs. Hopefully, that was a good refresher on the benefits of bond ETFs. This is not just about evaluating bond ETFs, but actually thinking about two key ways to think about bond markets. Like I said at the start, I want to try and demystify thinking about bonds. And so hopefully, I'll do that, and by all means, you can give me feedback afterwards on whether I did it or not.

So the first thing I'd just say, and this is because I mean, I think some of my colleagues might slap me afterwards for oversimplifying this, but I will, which is that at the heart of it, if you think about a bond, a bond is just a piece of paper.

Bond is just a piece of paper that says, I'm going to pay you back. So I say, I'm borrowing from you. I'm going to give you this piece of paper saying, If you give me $100 today, I'm going to pay you back in, say, five years, I'm going to make you regular interest payments along the way. So it's an IOU, right?

Now, there's two things that are going to drive the price of that piece of paper, that value. One is the risk that I run away with your money and I abscond, right? Credit risk, right? So the risk of not getting paid back, but that's one part of it. And then the second part is, well, what about missing out on a better return elsewhere, right?

So I say to you, I'm going to pay a certain set amount of payments of interest payments to you. What if rates in the market move higher, right? So you've looked into my borrowing, but you could have gone somewhere else. So at the core of it, that piece of paper, those are the two key things that drive value, and we describe that as credit risk and interest rate risk.

Now, what I will illustrate is when it comes to credit risk, let's use some hypothetical examples of these people. These people, ABC, I'm not going to give them too much descriptive context, I'm going to trying to keep it as anonymous as possible. So person A, just for argument's sake, is a billionaire. Person A is a billionaire. They have real estate all over the country, maybe they own an NFL team, I don't know. I'm just making up an imaginary person.

Person B is, say, a retired dentist. They paid off their home. The kids have moved out. And then person 3 is a young professional, who's just starting their career and has some student loans, and they've just moved into a studio down the road in Murray Hill.

Now, if you think about these three people, if I'm thinking about lending money to them, right? Who am I going to want the most interest from, most compensation for the risk that they might not pay me back? It's person C, right? It's the young professional who's just started their career. There's more likelihood that they're going to default, right?

So as a bond investor, I want to have more compensation for that risk of them being potentially defaulting, right? And so at the top of this slide, we say yield is a measure of compensation for risk, right? And that's a key concept that we think about throughout bond markets. So that's one dimension to it. That's the credit risk piece, right?

I'm going to maybe charge a little less yield for person B, that retired dentist. And then probably, that person A probably, I'm not going to charge them as much and it's a crazy outcome but I'm not going to charge them as much because I've got more comfort that they're going to be able to pay me back, right? So that compensation I demand for the risk I take on varies across these three people.

Now, it's helpful that we've got this A, B and C because when we think about bonds, risky bonds like corporate bonds, for example, there are ratings agencies out there. I'm sure you've heard of agencies like S&P, Moody's and Fitch, they're the big ones. Now, they issue ratings for risky corporate bonds, and they actually rate issuers. And they go along those lines. I think the highest ratings are AAA, and they go down to AA, and then there is BBB, BB, and then the C's.

That kind of taxonomy in your minds as you're thinking about those bonds, you don't need to go into the weeds on that. But that's an intuitive thing. That's how they're thinking about it. They'll have the history of the highest ratings so those companies that have the strongest balance sheets, the most comfort that they're going to be able to pay off their debts as when they're due.

Now the second dimension is interest rate risk. Now I'm actually quite happy to share, to present this slide to you because that little seesaw image that you see on your screen is probably one of the most useful memory tools that you could have for thinking about interest rate risk in bonds.

Now, I mentioned to you, if I showed you a piece of paper saying that I'm going to pay you back, and say, I'm paying you a yield of 3% per annum. If yields in the market, if rates in the market go higher to say 5%, that piece of paper is worth less, right? So the idea of interest rate risk is a big deal as saying that classic relationship, I'm sure a few of you have heard this in the room, is that as interest rates in the market go higher, the price of the bonds goes down.

And then similarly, as interest rates in the market go lower, the price of the bonds that you hold goes higher, right? That seesaw. The layer that I'll add to this, like I said, this visual tool, which is really neat, is that if I think about that seesaw as the length of time that the maturity of the bond, that, at the heart of it, is interest rate risk. It's because the longer the maturity of the bond, the higher it goes up, and the higher it goes down when you think about the impact of the negative relationship between [? rate ?] interest rates in the market and bond prices, right?

So keeping that in mind, yields down, bond prices higher, yields or rates higher, bond prices lower, right? Just keep that in mind. We'll have another example that will bring it to life. Keep myself honest on time.

So credit risk, the first one, the risk of not getting paid back, right? So this is the flashback that I was talking about in terms of going back to 2020. A crazy time it was and if you think about Q1 2020, what we had was a global economic situation where we were turning off the global economy in one fell swoop, right? And so, there was serious concern around the ability of companies to keep functioning and pay off their debts.

So what we're showing here on this slide is those three lines. The yellow line is treasury bonds. I'm a little bit colorblind, by the way, so I had to ask a colleague whether that was yellow or not.

So anyway, but it's yellow, I'm assured. So yellow line is treasury bonds. The black line is high-yield bonds. So those are the bonds that are issued by the riskiest companies and the corporate market.

And then the white line is investment-grade bonds. So that's relatively safer, higher quality companies relative to high-yield bonds. And what you saw is that the prices of the bonds of the riskiest companies, those high-yield bonds, fell by the most in that March 2020 crisis, right?

And then the prices of the investment-grade bonds, they also fell. They actually felt pretty meaningfully because there was still a serious concern with the global pandemic of how some of these big corporations are going to function when you're just stopping all economic activity. And treasury bonds which are seen as higher quality, they actually did better. They actually rallied over that period of time. So that's a very vivid illustration of credit risk, that there on that left-hand side in an environment where the market was selling off.

Now, you then flip to the second half, or not second half, everything after March 2020 when very widespread stimulus packages were announced, the Fed dropped interest rates and started pumping money into the economy. And investors formed the view that, hey, we're going to be able to get through this. That chart is basically flipped, right? So the riskiest bonds then performed the best, right? Those high-yield bonds perform the best.

Then investment-grade bonds were sort of what were after that, I mean it didn't go up as much. And then there's treasury bonds just held their value over that period of time, right? So that's a very vivid illustration of that quality piece there, right?

In the market selling off, you had the riskiest bonds falling by the most. But in that market picking up, coming out of that crisis, you had the riskiest bonds rallying the most. So that's a very simple illustration there, but it makes a big difference to illustrate it. And then the second piece was that the interest rate risk, interest rate risk piece, right? So now, this is where I said keep that seesaw in mind.

Audience: You mean high-yield bonds are the junk bonds, that's the same thing?

Dhruv Nagrath: Yes, that's right. High-yield, yeah, we prefer to refer to them-- Sorry, the question for the folks there on the line was-- No, that's fine. The question was are high-yield bonds also referred to as junk bonds, and the answer is, yes, that's the terminology. We tend to prefer high-yield bonds as our terminology. But, yeah, that is what some people in the market have referred to them as, yes.

So then when we talk about interest rate risk, what we're talking about is that seesaw, right? And longer maturity bonds are more affected by moves in interest rates in the market. And this is what we saw. So that same episode that I talked about in Q1 2020 on the left-hand side of the screen, what we saw is that when rates, when interest rates fell, there's longer maturity bonds, right? The longer seesaw went higher.

And then similarly, on the other side, this year, what we are illustrating on the right-hand side, is this year, is that those longer-term bonds as rates have risen, there's longer-term bonds have fallen by more in their bond prices. So there's that seesaw effect, it's interest rate risk. And if I were to just really solidify that concept as a bit of an intuition, it's just thinking about it and say, I give you two bonds.

Both of them are yielding 3%. One of them matures in five years from now, and then the other one matures in 10 years from now. If rates in the market move higher by 5%, I'm losing more money on that 10-year bond because I've locked in for a longer period of time, right? That intuition is a big one. It's important to keep in mind.

So let's get to the use cases and hopefully we'll bring this home. And Bill's got a bunch of questions to ask me so I'm going to prepare myself for them. And these are the use cases. So this is trying to put some of these intuitions to work in your portfolio. So how do you apply this in your portfolio?

So there's three main use cases that we talk about when it comes to using bonds in a portfolio. The first one, and probably one of the most powerful ones for building a balanced portfolio, is the idea of diversifying the exposure you have on the equity side of your portfolio, right? So it's the classic shock absorber effect.

Now I said at the start, this year has been an unusual year. So you haven't had that benefit this year as much. We do have some reasons to believe that that's changing. And we think that the way that yields have moved higher this year, now there's the ability of bonds to offset some of the risk in equities, is somewhat coming back.

So what we see on the left-hand side is some of those key tickers that I mentioned earlier on AGG, exposure to the core investment-grade bond market. It's a kind of representative exposure to the bond market. IUSB, which is a more universal exposure, has a little bit of high-yield in there.

And then GOVT which just holds all US Treasury bonds issued across all the different maturities. So these are all 3, 6 and 5 basis points. They're really high-quality exposures to have in a portfolio. And the goal of using something like these is to zig when your stocks zag, right? That's the intuition there.

And so what you see on the right-hand side is a number of episodes and I'm not going to go through each one of them. But a number of episodes where your stocks sold off, where the S&P 500 sold off. And what you see is that the litte white bars is what bonds did in that period of time, specifically what AGG did in each of those periods of time.

So even in the most recent COVID crisis, you saw them sell off, but not by as much as stocks, right? You had stocks selling off by 33.8% and you had AGG down by 1.1%. So it was a relative benefit.

So that's one classic use case. And if anyone wants to understand the intuition behind why you have that historical negative relationship between stock prices and bond prices, we can talk about that. But in the interest of time, I'll just talk about a couple of other pretty meaningful use cases.

So one is the idea of stepping out of cash. Now, there's a part of your portfolio that you're keeping lower risk, right? Lower risk in those two dimensions, I mentioned, in terms of credit risk and interest rate risk, and the shorter duration part of your portfolio.

So with that part of your portfolio, for the past couple of years, we've been starved of yield. We've been starved of having any kind of income on that portfolio when we see it in-- This is the national averages of savings and money markets accounts and even CDs, really low. Now, you've got a couple of different types of bonds either floating rate bonds, so either issued by the Treasury.

And there's the ticker there is TFLO, T-F-L-O, or issued by investment-grade corporate issuers, corporate companies. They have floating-rate bonds, and the deal with floating-rate bonds is that actually the yield that they pay out rises over time with reference to a particular reference rate. And so what we've seen is that as the Fed has raised rates this year, the yields on some of these exposures have gone up, right?

So now, in that part of your portfolio where you want to put a little, earn a little bit extra income on that cash, you can actually, potentially put that to work using something like TFLO. You're getting it at-- This was as of the middle of the year, you're getting a 2.85% yield.

And then FLOT, which like I said, it has some corporate bonds. So there's a little bit more risk associated with it. It actually offers, at that time, was offering a yield above 3%. Those yields have gone higher since then because the Fed's had a couple more rate hikes since then.

Last piece, before I try and wrap it up, is there's a part of your portfolio where you might be seeking to generate extra income, generate extra additional return. Now, this is I would call it the higher octane part of your portfolio, right? So it's not without risk. It's definitely worth keeping in mind, it's not without risk.

But if there's a part of your portfolio where you generate more meaningful income, there are trade-off that you can make. And so there's areas like high-yield bonds, now which are yielding above 9%. Now, there are riskier issuers, right? So we have to keep that in mind. There are riskier companies.

But if there's-- The key that I'd say here is a slice of your portfolio, if you can size it up and say, "This is just a slice of the portfolio," then I'll feel comfortable about having that risk, right? So it's important to make sure how much of your allocation when you're thinking about something like this. And like I said, you've got to weigh it up and definitely speak to your Fidelity representatives about what the implications are. But there's a part of the portfolio where if you're willing to take that trade-off for that risk, those riskier bonds, you can earn additional yield, which is quite remarkable in this kind of environment.

I would say an interesting area, a ticker that's not covered on this screen that I would just call out, is short-dated investment-grade corporate bonds, IGSB, it's 1 to 5-year data maturity corporate bonds, high-quality corporate bonds.

That's been an area that we've been looking at pretty closely, and that's giving you a yield, I mean you see the investment-grade corporate bonds here of 5.76. The ticker there IGSB is a pretty interesting one in terms of generating a bit of extra income, but holding higher quality corporate issuers. So that's another use case for pursuing income.

Last piece, and this is really coming full circle because I started the presentation talking about inflation and saying that it's the cause of a lot of the market woes we've been having, it's running hot. We've got-- There's a type of security that's issued by the US Treasury which is TIPS, Treasury Inflation Protected Securities. They're very similar to the normal treasuries that we were referring to, except that one catch, which is that the capital value of the bonds, right? The principal value of those bonds moves higher with inflation, with CPI, with the specific measure of CPI, and so it moves higher.

Now, just like other treasuries, I mentioned earlier on, they do have interest rate risk, right? So you saw this year, what you see on this right-hand side chart, is that as the Fed has raised rates, they've also gone down. But there's the difference that you've gotten in that white line is based on the fact that those TIPS bonds are indexed higher to inflation. So as inflation CPI prints have gone higher, the capital value of those bonds has gone higher. So that's been a really interesting area of discussion with a lot of our clients, has been thinking about how do we use some of these potential exposures to protect against inflation.

Now with tip securities, like I mentioned, that interest rate risk is there. So there's ways of holding shorter-dated TIPS as well. And so that's the ticker there on the bottom of your screen, STIP, that has an annual fee of 3 basis points per annum that holds just the TIPS that are maturing between 0 to five years. So you have less of that interest rate risk then the whole TIP exposure.

So anyway, I know I'm running potentially a little bit long, so I'm going to wrap it up by saying, look in summary, we think that bond ETFs have become a very important part of investor toolkits for investors of all shapes and sizes. And there's some really key benefits there in terms of low cost, liquidity, and tax efficiency. Hopefully, I did a decent job of sharing with you how you can evaluate bond ETFs and think about those two dimensions of credit risk, the risk of not getting your money back, and then interest rate risk, the risk of alternative yields, the opportunity costs that you give up when you lock into a particular level of yield.

And then there's some really interesting use cases that, right now, for the first time in a while, we can actually put money to work in bond exposures, so whether it's to diversify, to seek to diversify your equity exposure with something like AGG, to generate some additional income with whether it's a high-yield exposure or an investment-grade corporate bond exposure, or indeed to try and protect against inflation with using something like STIP. So with that I will I'll wrap it there.

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