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Craig Vardy
head of fixed income,
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Is it time to rethink bonds?

The case for increasing fixed income exposures and using ETFs to do so.

While 2022 might be a year most investors would like to forget, it was particularly unkind to those with their money in fixed income. After four decades of above average returns and relative safety, last year the asset class delivered an outsized negative return.

However, with an eye to the future and hopes of a rebound, despite the catastrophes unfolding in bond markets, 2022 was also the year of the most local fixed income exchange-traded product launches to date. According to Rainmaker Information, fixed interest was the fastest growing asset class of ETPs in Australia last year. In the 12 months to December 2022, the sector grew by 16% to $16 billion on net flows of $3.4 billion.

It's not hard to see why, given ETFs are an increasingly attractive vehicle for investing. BlackRock is one of the biggest players in the space as well, commanding about 21% of market share as at December 2022, Rainmaker says. It's also got the longest track record when it comes to fixed income ETFs, with iShares having launched the first in 2002.

Issuers clearly believe fixed income is due to bounce back, and BlackRock's head of fixed income in Australia Craig Vardy agrees.

He says portfolios have been tested due to recent volatility; bond yields have been low and cash rates have been close to zero, leading investors to minimise their fixed income allocations. But the environment has changed.

"We now have an environment where investors are getting paid income for investing in the asset class. Bond yields rose very quickly through 2022, meaning the starting point for earning decent income in 2023 is now skewed more favourably for investors," he says.

"The last time we saw the yield above 4% on the benchmark Australian fixed income index was over a decade ago. So now is a good time for investors to start looking at their fixed income allocations again."

This is also because fixed income is now playing a role in portfolios that Vardy says it probably wasn't previously, being diversification.

"You want fixed income because you want it to perform when your risk assets are selling off. So now, in times where there is market volatility, fixed income will start to play that role – yields will start to fall, capital prices will start to rise," he says.

"A lot of investors had given up on the asset class, but that dynamic has changed now."

What's making the asset class so attractive now is repricing.

"We're coming out of a pandemic, an environment where monetary and fiscal policy has been very loose, while liquidity in global markets has been very high. That's led to the rapidly rising inflation we're seeing, which is the key factor here. Central banks are addressing that through rising cash rates, but now is probably the time to think about where we are in that rate rise cycle," Vardy says.

Tamara Stats, lead specialist at BlackRock, agrees.

"Locally, we are seeing renewed interest from investors across the broad spectrum of BlackRock fixed income and cash ETF products. So far this year we have seen net flows into the iShares inflation ETF (ILB) of circa AUD $12million; as well as net flows of circa AUD $47m into the iShares Core Global Corporate Bond (AUD Hedged) ETF (IHCB)," she says.

"For investors looking to take advantage of high cash yields, we have seen net flows into the iShares Core Cash ETF (BILL) of circa AUD $114 million and AUD $65m net flows into the iShares Enhanced Cash ETF (ISEC)."

Another trend Vardy sees is around the precision investors are able to access via ETFs; the ability for financial advisers and institutions to be very precise about the fixed income allocations. He says investors are becoming increasingly active in the way they use ETFs, and it's evidenced in the flows BlackRock is seeing.

"In a market environment of higher yields and increased market volatility, the ability to be more precise with your fixed income allocation by using ETFs has been a huge benefit for advisers and investors," he says.

Vardy says a big driver of these flows and of asset growth is the adoption of model portfolios within advice practices.

"I think the ability to put together model portfolios that are efficient, transparent and cost-effective is a huge plus for advisers," he says.

"Secondly, given the proliferation of ETF exposures, it's the ability to use different building blocks – whether it's a model portfolio and you're tacking on tactical, satellite exposures, you blend that with your core portfolio and you can get some really interesting outcomes in terms of how you're using ETFs and how you're accessing the fixed income market."

For advisers, Vardy says the key is to keep it simple, referring to the BlackRock Bond Pyramid.

"It's important to consider what's driving your allocation. If it's income, then if the rate environment is appropriate – yields are high enough, credit spreads widened – that's a good time to access income and therefore you should be looking at things like global credit, emerging market, or even domestic investment grade credit, there's certainly ETF exposures available to you," he explains.

"With the capital preservation layer of the pyramid, think of that as taking a conservative approach. Consider some exposures like cash or cash-plus, or very short duration with some yield tacked on.

"If it's diversification, if equity markets are-looking toppy and you want to take some risk down, then allocate to something like government exposures there to diversify away some of the risk while sourcing some uncorrelated returns." **FS**

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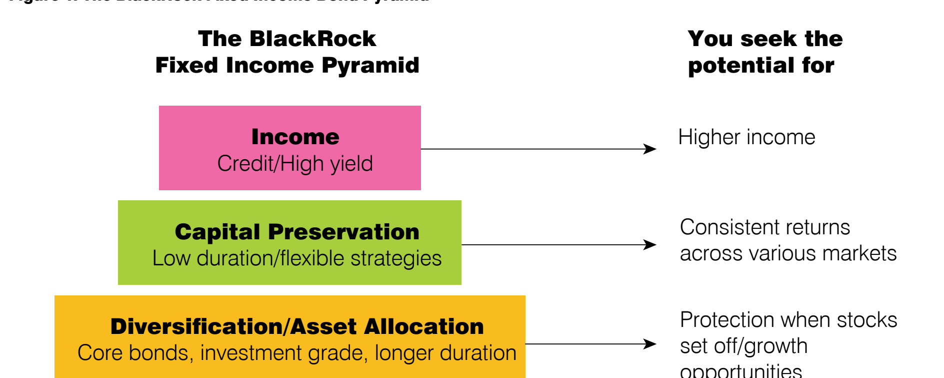
Figure 1: The BlackRock Fixed Income Bond Pyramid



Source: BlackRock. For illustrative purposes only. There is no guarantee that a positive investment outcome will be achieved. Diversification and asset allocation may not fully protect you from market risk.

Note: iShares ETF flows as at 31 March 2023

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