Marketing communication.
Capital at Risk

Corporate bonds: the hidden gem of the Active ETF world

- Global ETF assets under management have shown impressive resilience despite ongoing economic uncertainty in the past few years
- A notable portion of inflows is attributable to product innovation in less explored areas for ETFs including active management, fixed income, and sustainability[1)]
- Many different types of investors are increasingly seeing a fundamental role for active fixed income ETFs in exposing their portfolios to the potentially attractive yields on offer across corporate bond markets

[1)] Source: https://www.pwc.com/gx/en/industries/financial-services/publications/future-of-etf-2027-survey.html

Although passive equity continues to dominate global ETF AUM, investors now familiar with the potential benefits of the ETF structure – such as greater transparency and liquidity – are increasingly demanding more options for using ETFs in different ways.

This is driving significant growth across other segments of the ETF market. In particular, fixed income ETF AUM almost doubled in size between 2018 and 2022, while actively managed ETFs are also widely expected to see a rapid increase in demand over the coming years, and ESG remains as much in focus for ETF investors as elsewhere.[1)]

In our view, the expansion of the ETF product line into previously untapped areas does not replace more traditional uses of ETFs such as indexed equity, but rather compliments this by offering exposure to a broader opportunity set within a diversified and responsibly-focused portfolio.

For example, investment grade ('IG') corporate bonds are less well-known than equities in the ETF space. However, they can work just as well for investors as a cost efficient and diversifying tool. Today, IG credit is experiencing strong demand amid the current environment of far more attractive yield potential than has been on offer for some time, without having to reach too far out along the risk spectrum.

[1)] Source: https://www.morningstar.com/articles/1079775/7-charts-on-the-rapid-ascent-of-active-etfs

The role of credit in portfolios

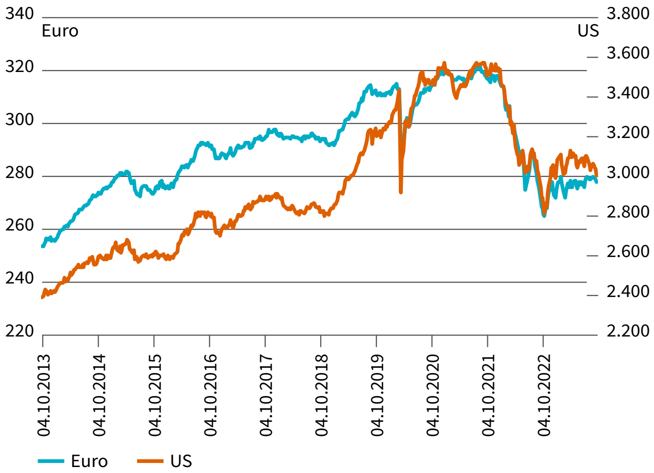
Fixed income has long provided a crucial role in any balanced portfolio but for a prolonged period, historically low – or even negative – interest rates have forced investors to reach for yield in riskier areas of the investment landscape.

In today's much higher rate environment, many fixed income segments are offering a much better entry point. Investment grade credit is now potentially providing attractive levels of yield for lower levels of risk relative to high yield or equities.

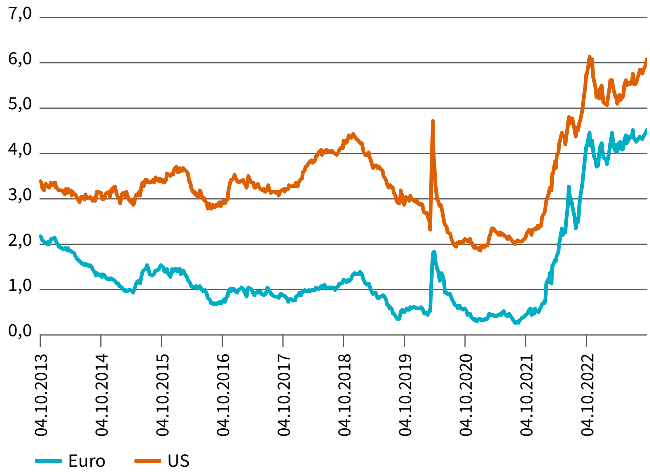
Of course, interest rates are unlikely to stay this high permanently as they are the result of aggressive monetary policy designed to fight unusually high inflation.

However, as bond yields and prices move inversely, as yields eventually start to come down, the implied return from credit could potentially be more attractive now than it has been for most of the past decade (as can be seen in the charts below).

Euro/US Credit – Performance (index level)



Euro/US Credit – Yield to Maturity



Source: AXA IM, Bloomberg as of 30th September 2023. Index is ICE BofA Euro Corporate Index, US refers to ICE BofA US Corporate Index.

Credit – or corporate bonds – has typically been used by investors to provide a steady income stream through the regular coupon payments as well as a means to reducing a portfolio's overall risk profile. Like with any investment, there are certain factors that investors may want to consider when investing in corporate bonds:

Benefits:

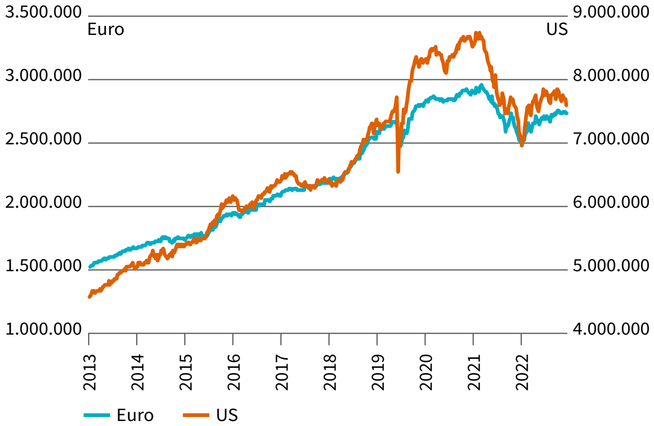
- Corporate bonds tend to be less volatile than their equity counterparts.
- While over the long term, equities would be expected to outperform bonds, bonds should perform better in slow growth or recessionary situations.
- Debtholders tend to be repaid ahead of stockholders and so have a greater chance of getting their money back.

Risks:

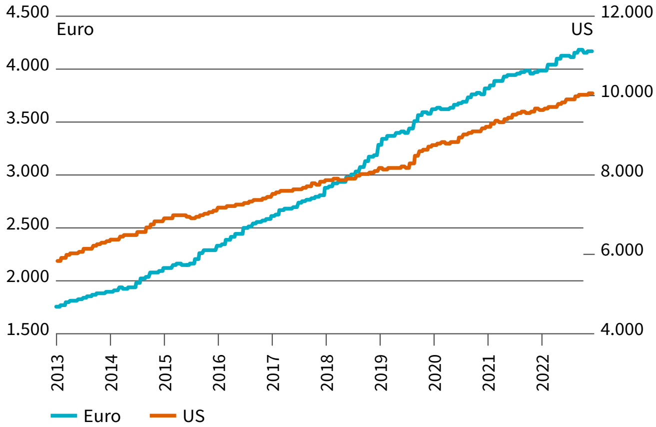
- Interest rates impact the price of bonds, with rising interest rates resulting in falling bond prices.
- Inflation can erode a bond's rate of return.
- Each corporate bond will have its own credit risk rating. This can give investors an indication of what the perceived risk of default is. If a default occurs, an investor may not receive their expected return.

The corporate bond market offers a large and diverse opportunity set. Across the globe there are now over 18,000 issuers of corporate debt – euro credit alone has seen an increase of over 30 % in issuer numbers in the last 10 years.

Euro/US Credit – Growth evolution (AUM)



Euro/US Credit – Growth evolution (nb of bonds)



Source: AXA IM, Bloomberg as of 30th September 2023. Index is ICE BofA Euro Corporate Index, US refers to ICE BofA US Corporate Index.

Importantly, in fixed income, diversification doesn't just come from issuer sectors and geographies, but also from credit rating and maturity, meaning a fixed income portfolio has access to multiple levers from which to aim to generate alpha.

This is why active management could be worth considering, especially in an environment where the policy, macro and inflation outlook remains so uncertain.

Do you need to choose between active and indexed ETFs?

Historically, ETFs were passively managed vehicles designed to track a benchmark as closely as possible with the aim of replicating the performance of that benchmark. This can provide a cost-effective way to gain exposure to a diversified portfolio of securities and enables investors to quickly and efficiently allocate between regions and asset classes.

Active ETFs, on the other hand, combine some of the potential benefits of mutual fund investing with the convenience, transparency, and liquidity of an ETF vehicle. They aim to reflect a model portfolio built and actively managed by a portfolio manager who decides which securities to buy or sell, while they are still traded on an exchange.

The differences in the two approaches mean that investors don't have to necessarily choose one path or another. Instead, they can combine passive and active ETFs in order to reflect different outcomes within their portfolio, such as:

- Investors can choose an active ETF to access opportunities or themes that can't be easily replicated through index investing, including responsible investment outcomes.
- Investors may want some fixed income investments to simply follow the market index through a Passive ETF, while other strategies may suit the Active ETF approach of aiming to deliver performance through active security selection.

Of course, there is no guarantee that any investment will achieve its aims, while the costs associated with Active ETFs are usually higher than Passive ETFs as they rely on portfolio managers' expertise, skills and judgement to select securities.

ESG: a less-trodden path for bonds

The high level of analysis on environment, social and governance (ESG) factors seen in equities has taken a while to catch on for many in the bond space. Beyond impact bonds such as green, social and sustainability bonds, only a few investment managers had applied ESG analysis to assessing corporate bonds. This has begun to change, helped by the rating agencies increasing efforts to integrate ESG factors into their considerations. With this changing attitude, more bond solutions that are tied to ESG considerations have come to market. The Paris-Aligned Benchmark (PAB), which excludes Fossil Fuels and has additional exclusions related to fossil fuel business involvements, is an example of this evolution in sustainable investing within fixed income.

How to get the most out of Active ETFs and ESG

We believe that active ETFs go hand in hand with ESG integration as the approach allows for ESG screening in a way that a passive ETF cannot do as effectively. When looking at active ETF funds with ESG integration, it is important to consider:

- **What benchmark the fund is referencing: is it a dedicated climate benchmark or the standard index?**
  If the active EFT fund has a climate focus, then a dedicated climate benchmark should provide investors with a clearer and more accurate comparison to the active ETF. Even for active ETFs with strict ESG implementation, a climate benchmark may be more appropriate given the sectors will be closer to those that the fund invests in – e. g. they will both probably exclude energy.

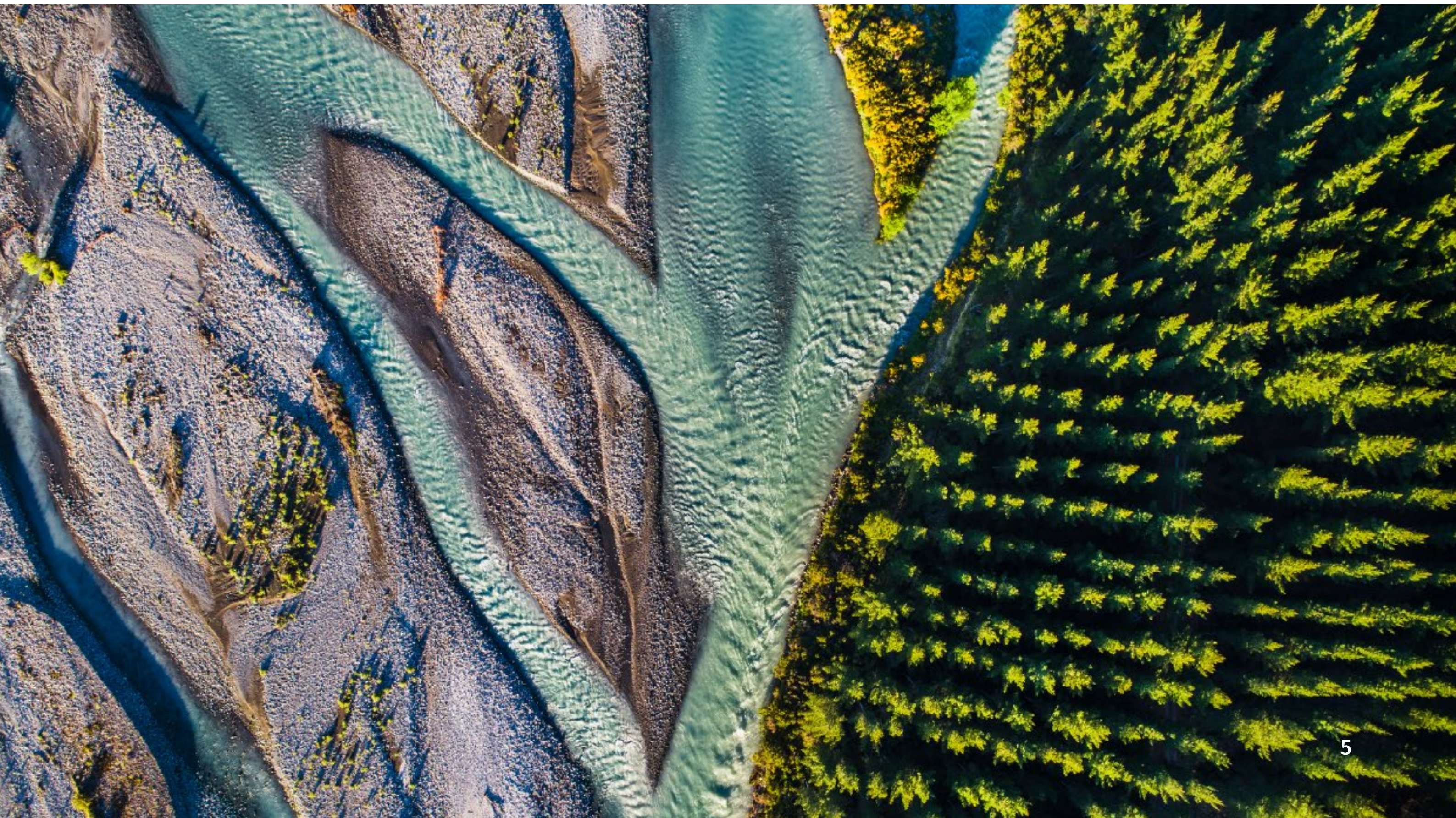
- **What criteria and red flags are in place to integrate ESG research into the investment process?**
  How ESG is defined and the red flags that the investment process implements are important for understanding how effectively it will be implemented. Most investment processes with ESG criteria implemented will screen out certain sectors such as gambling, armaments and adult entertainment. For investors looking to reflect ESG integration within their portfolios, one decision they may want to consider is how far they want negative and positive screening applied and does the benchmark and ETF reflect those priorities.

- **How is ESG research and analysis used by the portfolio managers?**
  Some investment managers integrate ESG analysis into the overall rating of an issuer making it as much a consideration as other, more traditional factors. However, others will see the ESG research as a "nice to have" and not necessarily influence their decision. These approaches may produce different selection outcomes and investors may want to confirm how robust the investment decision process is if they are looking to reflect ESG integration in their investments.

How ETFs can play an important role in portfolios

ETFs can be used in a variety of ways – as building blocks for a portfolio or a means to diversification. Extensive product innovation in recent years means investors who appreciate the benefits of the ETF format such as transparency, liquidity and cost efficiency (through both fee levels and tax effective mechanisms such as in-kind creation) can now choose to use ETFs in a wide variety of ways. This might mean the investment style, including both active and passive management, and the ability to gain exposure to interesting opportunities across asset classes, geographies and sectors, and to themes like decarbonisation.

At a time where ETF investors are increasingly crying out for more innovative options to access the attractive opportunities across the fixed income landscape, active credit ETFs may provide another compelling option in the investor toolkit.



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