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In Pursuit of Value

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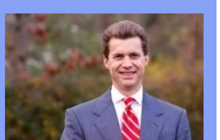
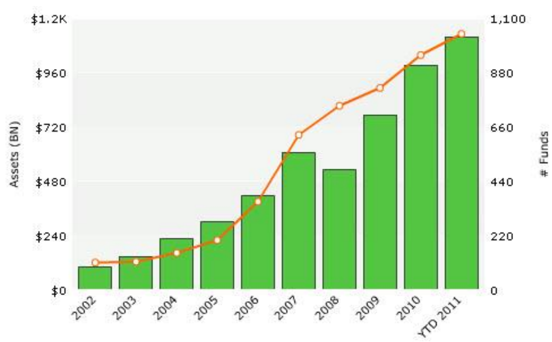


ETFs and the Bond Market

Recently I was asked to speak at a conference about the impact of ETFs on the broader market. Growth in ETFs is probably the most significant development in investing in recent years. Total U.S. outstandings reached $1 trillion at the end of 2010, and Barclays iShares dominates the market with a 40% share. The growth of ETFs is global though, with European funds representing $315BN (according to State Street), and there's no sign of it slowing down. By taking the familiar mutual fund structure and modifying it to allow intra-day trading activity the ETF industry has clearly tapped in to a new vein of demand. I was struck at the conference by how much focus there was on short term trading questions. High frequency trading (HFT) by hedge funds arbitraging the underlying components against the ETFs is a significant source of liquidity, and no doubt they generate healthy returns. But ETFs should be first and foremost an investment product, and while they do provide trading opportunities we generally have holding periods of many months and longer for the investments we make.

A little noticed but compelling feature of ETFs is the improved access to fixed income that they provide for investors too small to regularly trade "round lots" of $1 million or more in corporate bonds. Wall Street banks make enormous profits from markets being less than fully transparent. Bonds, Foreign Exchange and commodities are all markets where substantial volumes are executed in the OTC ("over the counter") market and away from the immediate public price disclosure of an exchange. Transaction costs faced by clients in equities are quite low; commissions are $9 per trade or less, and there's no pricing premium for smaller size. Making money as an equities broker is tough, as technology has brought electronic access and cheap transactions to the masses. In bonds by contrast, it's often hard to be sure you're obtaining wholesale pricing because of the vast number of different issues and less stringent SEC requirements on the reporting of trades. Bonds are also much more homogeneous than equities – substitution should in theory be much easier than in stocks because bonds are more highly correlated within a given sector than equities. If you want to buy GE stock you're unlikely to think AT&T is a good substitute, but if you're buying GE bonds it may well be that AT&T bonds are an acceptable substitute if pricing is slightly better. Few investors take this approach, and for the retail investor buying individual bonds can be one of the easiest ways to make your broker richer.



Source: State Street Global Advisors

For evidence on how well banks do out of making markets in Fixed Income, Currencies and Commodities ("FICC" in industry parlance) go no further than the annual reports of the largest among them. Everybody's favorite whipping boy Goldman Sachs typically generates at least a third of its operating income here; in 2009 when markets bottomed and rebounded creating all manner of urgent activity in opaque markets they made $23 billion, two thirds of their net revenue. No doubt recognizing the unfortunate optics of such success in knowing better than their clients where prices were, Goldman sensibly stopped breaking out their results in this way in 2010.

An academic paper (Corporate Bond Market Transparency and Transaction Costs, Edwards, Harris and

Piwowar, 2004) sought to identify the transaction costs incurred in corporate bonds by different types of investors. Although it's somewhat dated there's little reason to think the world has changed much. Contemporaneous pricing information on bonds is still much harder to access than for stocks, and since most bonds are not priced on screens obtaining the information requires talking to another person (usually pleasant but rarely fast). The paper found that for trades of $1 million in size the average cost was 0.11% which is comparable to the all-in costs of trading similar size in large cap equities. However, the average cost rose quickly as size fell; $100,000 orders cost 0.38% and $20,000 orders were 0.69% (I can't imagine why it would make sense for an investor to transact in such a small individual bond, but apparently many people do). Transaction costs for equities don't change much for lower size. By contrast, the iShares Barclays Aggregate Bond ETF (AGG) has tracked its eponymous benchmark over the past five years with only 0.29% of tracking error which is not bad considering that, (a) this includes their fees, and (b) investing even in an index can't be done without incurring transaction costs.

The municipal bond market is even more egregious, with large numbers of retail investors overpaying their brokers. A similar study on transaction costs (Municipal Bond Liquidity, Harris and Piwowar 2004) found that retail investors paid on average 2% in transaction costs on municipal bonds. Even institutions were found to incur a 1% cost. Munis are particularly expensive to access given the large number of outstanding issues that trade infrequently and the many (financially) unsophisticated clients. The iShares S&P National AMT-Free Muni Bond Fund (MUB), one of the larger such ETFs, lags its index by around 0.83% according to Morningstar. Not great, but still much better than the costs incurred by retail investors buying individual issues.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

The point is that fixed income ETFs achieve wholesale pricing for retail investors. They have democratized access to liquidity by making it possible to cut out the middle guy. Unless one has a large enough portfolio to justify individual trades of $500,000 or more, there seems to be little point in owning individual bonds. Returns on investment grade and municipal bonds are generally much more sensitive to systematic variables such as interest rates and credit spreads. Unless there is a real risk of default, similar looking bonds tend to travel in groups, so returns don't vary nearly as much as for stocks. So next time your broker suggests a portfolio of handpicked individual bonds, tell him you'd like to go with an ETF instead. Since he can't mark the price up it won't be that profitable (for him) but it'll help your returns over the long run.

What We Own

iShares Barclays 1-3 Year Credit Bond (CSJ) holds investment grade U.S. corporate bonds. Its duration is 1.88, so the average maturity of its portfolio is around two years. The average credit quality is single-A. They own a diverse collection of familiar names such as Citigroup, General Electric and Verizon. No position is greater than 1% of the fund.

We use CSJ to access diversified investment grade debt without having to buy individual names. Barclays can buy large amounts of individual bonds at wholesale prices since CSJ has a market cap of $8 BN. The annual expenses are 0.20%.

The yield is 2.3%, which is hardly going to excite anybody but reflects a compromise between earning some return greater than that offered by two year treasuries (a paltry 0.50%) and minimizing exposure to the possibility of rising interest rates. The combination of Round 2 of Quantitative Easing (QE 2), a non-existent Federal Funds rate and continued enormous Federal borrowing render long term bonds ever less attractive. Whether or not yields rise following the end of QE 2 in June, central banks (led by the Fed) are currently the only buyers of long term government debt and high grade bond yields are anchored to these artificially low levels. While you don't fight the government, you don't have to invest with them either. Consequently, although around one third of our Fixed Income Strategy is invested in non-US$ denominated debt our biggest domestic currency holdings are in CSJ and its intermediate maturity cousin CIU.