ETF Insights

What's Next for Active Fixed Income ETFs

A Conversation with Avi Sharon of PIMCO

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In our recent paper, The ETF Landscape: Reflections on a Transformational Year and the Path Forward, we discussed global megatrends affecting fixed income, ESG and active management. In this edition, we focus on fixed income and active management through the lens of one of the largest and most-respected bond managers in the industry: PIMCO.

The ETF landscape continues to grow rapidly, with global inflows of $661 billion through the second quarter of 2021 – nearly 87% of 2020's record inflows.[1] Innovation continues to abound with the introduction of dual-registry ETFs in Australia, cryptocurrency products in Canada and Europe, and semitransparent active ETFs in the United States.

One area of the ETF landscape that remains relatively untapped is actively managed fixed income. Although fixed income makes up 52% of the $400 billion[2] in active ETF assets, some of the best investment strategies are absent due to daily transparency requirements in most jurisdictions. But that has begun to change as US regulators loosen regulatory roadblocks for active equity managers. Beginning in April 2020, the US Securities and Exchange Commission (SEC) approved several models enabling active equity managers to launch domestic equity ETFs without disclosing daily holdings. To date, eleven issuers have launched 36 products, raising $1.7 billion in assets in a year.[3] We believe it's only a matter of time before approvals are expanded to international equity and fixed income products.

With this in mind, State Street's Frank Koudelka, global head of ETF servicing, and Ciarán Fitzpatrick, EMEA head of ETF servicing, met with Avi Sharon, executive vice president and product strategist at PIMCO to discuss the burgeoning ETF marketplace and how PIMCO is thinking about future innovation.

[1] ETFGI, Global ETF and ETP Insights, June 2021

[2] Ibid.

[3] State Street analysis, as of June 2021

A Conversation on What's Next for Active Fixed Income ETFs

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Frank: PIMCO has been a pioneer in active ETFs, launching its first two products in November 2009. One of them, the PIMCO Enhanced Short Maturity Strategy Fund, remains among the largest active ETFs globally. Why did PIMCO become an early adopter of active ETFs?

Avi: The story may be apocryphal, but it stems from a visionary statement of Bill Gross, who co-founded PIMCO in 1971. He told his colleagues that the ETF was the cell phone of investment vehicles. In other words, it's an important technological advance in the world of investing – one offering a simple, fast, and effective means for our portfolio management teams to express their differentiated views, and for clients to absorb them. We've always seen ETFs simply as representing another vehicle option for clients– and we are vehicle-agnostic. What's more important is what we put in the vehicle, or what we communicate on that cell phone – whether it be a robocall or a sonnet of Shakespeare. Of course, every vehicle has different benefits and liabilities, from less liquid private funds to highly tradeable closed-end funds. But the sheer scale and growth in allocations to fixed income ETFs constitutes a clear message that PIMCO will likely deliver more of its leading fixed income strategies in an ETF format.

Frank: Has the active ETF space evolved as originally imagined?

Avi: When we began in 2009, actively managed ETFs composed only 0.9% of fixed income ETFs and 0.05% of all fixed income assets.[4] The notion of an active ETF seemed a contradiction in terms. For most investors, the letters ETF spelled "passive." And since bonds often seem to take a back seat to equities (and bond ETFs only really began to grow in 2009, a decade or more after equity ETFs took off), an active bond ETF was doubly questioned. But it's heartening to acknowledge that, while equity ETFs have remained almost exclusively passive (and even to this day active strategies constitute only about 1% of the total value of equity ETFs), active bond ETFs have grown to over $125 billion and account for more than 10% of all fixed income ETFs.[5] And while forecasts of fixed income ETF assets are typically quite bullish, the rate of growth of active fixed income ETFs exceeds their passive siblings. We see a future where active bond ETFs may constitute up to 25% of all bond ETFs, with as much as $1 trillion in assets by 2030.

[4] Morningstar Direct[SM] as of June 30, 2021

[5] Ibid.

Ciarán: Following up on your successful active ETF launches in the US marketplace, you entered the European active ETF market in January 2011. PIMCO now has over 50% of the AUM of this market, albeit a small one. What makes the European ETF market more challenging for an active manager to enter?

Avi: We think many of the headwinds we typically attribute to the slower pace of ETF adoption in Europe relative to the US – fragmented liquidity, less of a fee-based advisor culture, limited sales tracking – will ease and evolve. In many respects, Europe is pursuing a path we've lived through in the US, and similar pressures will drive it along a familiar trajectory. In fact, one could argue that, if anything, there's a more acute perception in Europe of the value of active management – particularly in fixed income. We are confident the combined appeal of strong active bond management and the efficiency of the ETF vehicle will line up in due course and drive both awareness and growth of active bond ETFs in Europe and beyond.

Frank: In October 2017, PIMCO entered the Canadian ETF marketplace. Canada is unique in that mutual fund managers can launch an ETF share class with no specific transparency requirements, which is the direction PIMCO took. Did this make the decision to launch in Canada easier and if so, why?

Avi: Canada is in many ways a forerunner. Recall that the first ETF launched in Canada in 1989, and, as of January 2021, active ETFs constituted about 25% of all ETF assets there, according to the National Bank of Canada. It is a model we think the world may gravitate to – specifically the latitude provided to all issuers in Canada to readily incorporate ETFs as a share class of a mutual fund, and what we think is a more common-sense view around transparency requirements based on market maker needs. That combination of factors helped to create a true testing ground for an active ETF future for PIMCO. It provides an environment where we are able to launch ETF versions of all our flagship funds, retaining the performance history, brand recognition, and product communications around these well-known funds without any breakage or friction. All of our ETFs trade effectively there as a share class of their corresponding mutual funds – and constitute a meaningful percentage of total flows to those strategies. It simply enables investor freedom of choice across strategies and vehicles.

Ciarán: The US marketplace has had a lot of buzz with the launch of active ETFs that are not required to disclose their holdings on a daily basis. This allows active managers to protect their intellectual property. To date, this is only available for equity managers. Is this important for fixed income managers as well? Why or why not?

Avi: That's a definitive yes. Remember that PIMCO's start came in 1971, when it became clear that fixed income investing could be far more than sitting passively with bonds, simply clipping coupons. Everything we built since then has been based on the concept of differentiated bond management and total return. We invested in and built expertise and scale in all of the fixed income categories – with world-leading research teams in Treasury Inflation-Protected Securities (TIPS), credit analytics, emerging market (EM) currencies, mortgages and beyond – that we believe will differentiate our views and lead to strong risk-adjusted returns for clients. Moreover, active fixed income managers (not just PIMCO) may take advantage of inefficiencies native to bonds, bond indices and bond trading and have historically delivered some return advantage relative to passive peers and benchmarks – unlike the much-questioned performance history of active equity managers.[6] So, yes, the proprietary nature of the views we derive from our investment in active fixed income research and trading, and the positioning decisions that our portfolio managers navigate, deserve some protection.

How are bonds different?

Persistent inefficiencies create opportunities for active managers

Market Structure

- Not all fixed income participants have the same goals and objectives
- The bond market is large and complex

Index Structure

- The finite life of bonds means indices are reconstituted more often
- Sampling is often required—full replication may not be practical or cost-effective
- Index design may be suboptimal

Investor Segmentation

- Investor segmentation can occur based on credit ratings
- Credit research is often based on the reviews of a handful of nationally recognized credit rating organizations

Source: PIMCO

[6] For further discussion, please reference PIMCO: "Bonds Are Different," April 2017. https://www.pimco.com/en-us/insights/blog/bonds-are-different-the-active-advantage

Ciarán: Will the models developed in the US marketplace work for fixed income ETFs? Do daily transparency requirements restrict PIMCO from offering some of its active strategies as an ETF?

Avi: The requirement to provide full daily transparency of holdings does impede the ability to offer some of our larger, more well-known strategies in the ETF vehicle. And we are actively pursuing an approach to solve for this, as we think it will allow us to deliver our flagship funds in an ETF vehicle for clients across jurisdictions. To your question about the presumed fungibility of existing non-transparent models for equities, we still believe that bonds are different and require a different approach. But we clearly share the enthusiasm for the structure and the importance of allowing more market participants to enter the space, enabling more product choice for investors across active ETFs.

Frank: What does PIMCO believe is necessary to provide to the marketplace to price ETFs effectively while not providing daily holdings transparency?

Avi: Equity ETFs can be valued rather simply as the sum product of the price and quantity of each line item intraday. This approach may not translate directly to ETFs holding fixed income securities, which trade and price under fundamentally different conventions (e.g., yield and/or spread). Our goal is to find an efficient solution that aligns with how market makers evaluate and price transparent fixed income ETFs.

Frank: Does PIMCO see further expansion to other markets for its active ETFs? If so, where and when?

Avi: The combination of market-leading active fixed income franchises in both the US and in UCITS provides both the breadth and flexibility to expand the suite to new geographies – and we are constantly monitoring and reviewing those opportunities. We mentioned Canada, and, staying in the same hemisphere, we've recently begun selectively cross-listing both US and UCITS ETFs in Mexico, with an eye also on capturing distinct opportunities across the broader Latin America market. Meanwhile, we are intrigued by developments in active bond ETFs in Australia and the broader APAC region. It's a global business, and we are building on solid bedrock with all of the elements in place, including portfolio management, capital markets, legal and compliance, technology and sales. At this point, it's mostly a matter of scaling up the effort, which we're excited and ready to do.

"We share the enthusiasm for the structure and the importance of allowing more market participants to enter the space, enabling more product choice for investors across active ETFs."

— AVI SHARON
Executive Vice President and Product Strategist at PIMCO

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