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Challenging the top 10 myths about fixed income indexing

After yields surged to multi-year highs in 2023, fixed income finally offers "income" again. As we adapt to a new macro regime, investors are re-evaluating the role of fixed income in portfolios, re-embracing the asset class for the first time in years, while re-thinking the composition of fixed income sleeves. At the same time, greater macro and market volatility has increased the value of flexibility in portfolios.

Against this backdrop, we see continued adoption of fixed income indexing. However, while most investors are inherently familiar with index investing in equities, views questioning the practice in fixed income still abound. We have long believed that the active/index choice was a false dichotomy, and we see investors increasingly recognising the advantages of blending index with actively managed strategies in fixed income. Here, we address the most common misconceptions or "myths" we hear about fixed income indices and index investing.

Five myths about fixed income indices

Myth 01	Fact
Fixed income is too broad of an asset class and therefore indices are unable to help investors build efficient portfolios, while being nimble.	Indices transform the fragmented bond market into standardised exposures that can simplify portfolio construction and act as reference tools to understand the drivers of risk and return, as well as helping to quantify true alpha.

Myth 02	Fact
Fixed income indices fail to capture the evolution of underlying bond markets, missing out on new investable opportunities.	Fixed income indices can evolve to include new markets, while new indices also enable novel access to diversified sources of yield by extending the investable universe.

Myth 03	Fact
Indices are slow to respond to sudden changes in market conditions and extreme volatility.	Over the past three years indices have proven to be resilient and dynamic in their responses to several idiosyncratic market events.

Myth 04	Fact
Indices are not investable and therefore do not consider the realities of trading in the underlying markets.	Indices incorporate diversification and liquidity rules which help portfolio managers effectively replicate the risk and return characteristics of their benchmarks across a diverse set of fixed income markets.

Myth 05	Fact
Indices cannot add value through Environmental, Social and Governance (ESG) analysis and scoring systems in the way active managers can.	BlackRock has worked with index and ESG data providers to develop sustainable fixed income indices which help meet investors' needs and satisfy regulatory requirements, in addition to promoting standardisation across the industry.

Five myths about fixed income index investing

Myth 01 | Fact

Myth: Index managers incur the highest turnover during month end, suffering from information slippage and high transaction costs.

Fact: iShares portfolio managers trade flexibly through the month to proactively rebalance towards the forward-looking benchmark to deliver on investment objectives for investors. We take advantage of new issue markets, primary flows and internal crossing opportunities to limit excessive turnover and the market impact of rebalancing activities.

Myth 02 | Fact

Myth: Index portfolio managers with the highest primary flows (creation/redemption of ETF units) suffer more during market volatility as they are forced to trade at the worst time.

Fact: iShares portfolio managers use primary flows to rebalance the fund toward the forward benchmark during the month, limiting the impact of rebalancing during volatile markets. In addition, ETF transaction costs are externalised, protecting existing investors in the fund.

Myth 03 | Fact

Myth: Index portfolio managers are forced buyers and sellers during credit events.

Fact: iShares portfolio managers are never forced buyers or sellers during credit events. We have flexibility on when to trade bonds which are exiting/entering the indices and can take advantage of internal crossing opportunities to ensure the best outcome for clients. iShares PMs take an activist approach to index investing in emerging market debt, actively engaging with restructuring sovereigns.

Myth 04 | Fact

Myth: Index managers cannot benefit from new issue premia.

Fact: iShares portfolio managers can participate in new issues to benefit from liquidity, new issue premia and the absence of transaction costs. Indices are also evolving in this area, speeding up the inclusion of newly issued bonds in certain segments.

Myth 05 | Fact

Myth: Active managers are better able to navigate illiquid markets.

Fact: As index portfolios tend to be highly diversified, iShares index portfolio managers are able to navigate illiquid markets while still maintaining close tracking to their benchmark. In addition, for ETFs, the in-kind primary process helps to rebalance the portfolio proactively throughout the month.

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Five myths about fixed income indices

Myth 01

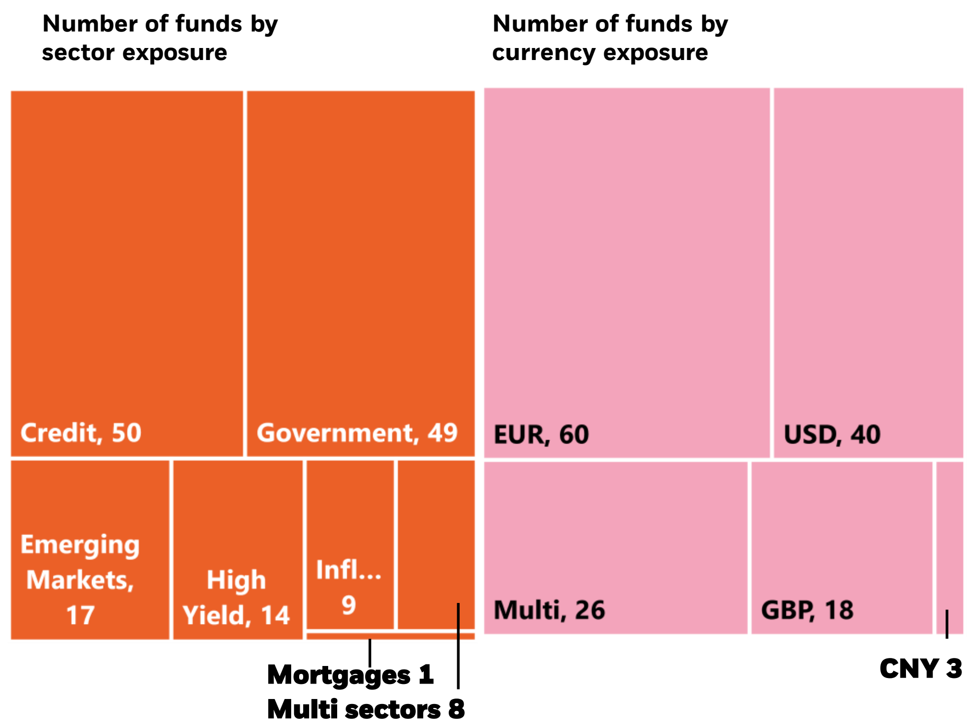
Fixed income is too broad of an asset class and therefore indices are unable to help investors build efficient portfolios, while being nimble.

Fact

Indices transform the fragmented bond market into standardised exposures that can simplify portfolio construction and act as reference tools to understand the drivers of risk and return, as well as helping to quantify true alpha.

Over time, ever more granular indices are being developed, providing access to exposures across credit sectors, duration, factors, sustainable as well as defined outcomes, such as hedged exposures. The increasing granularity of indices allows investors to redefine their desired market exposure. For example, an investor can pull apart a broad-based market exposure such as the Bloomberg US Aggregate Bond Index and insert an inflation protection component by replacing US Treasury bond exposure with Treasury Inflation-Protected Securities (TIPS) exposure. Another example are fixed maturity ETFs, which allow investors to target a specific point on the curve within credit or government bond asset classes. The proliferation of indices in fixed income is also helping investors to blend more index and active strategies together, leading to better portfolio outcomes.

Figure 1: iShares range provides choice across a variety of sector and currency exposures



Source: BlackRock, as at 13 December 2023. Data relates to iShares fixed income UCITS ETFs and index mutual funds.

Myth 02

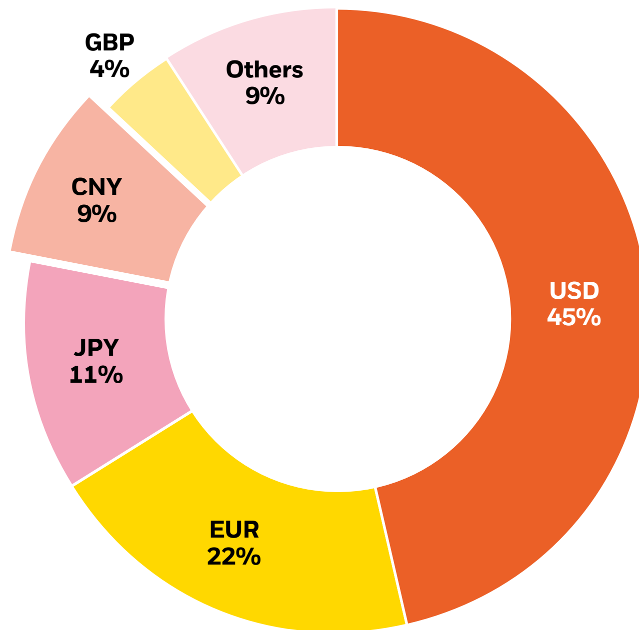
Fixed income indices fail to capture the evolution of underlying bond markets, missing out on new investable opportunities.

Fact

Fixed income indices can evolve to include new markets, while new indices also enable novel access to diversified sources of yield by extending the investable universe.

One example of this is the inclusion of China onshore bonds in various key fixed income indices, including the flagship Bloomberg Global Aggregate Index in April 2019. At the same time, index providers started publishing standalone China onshore bond indices, allowing investors to model the impact of China inclusion in their portfolios, while several asset managers launched products on the back of those newly developed indices. More recently, J.P. Morgan announced the inclusion of India government bonds in its emerging market indices starting June 2024.

Figure 2: CNY bonds comprise 9% of the Bloomberg Global Aggregate Index



Source: BlackRock, as at 30 November 2023. Reference to Bloomberg Global Aggregate Index.

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Myth 03

Indices are slow to respond to sudden changes in market conditions and extreme volatility.

Fact

Over the past three years indices have proven to be resilient and dynamic in their responses to several idiosyncratic market events.

Index providers responded quickly in a coordinated, timely fashion during the COVID-19 selloff in March 2020 and again in March 2022 following the Russia/Ukraine conflict to avoid disorderly outcomes during month-end rebalancing in highly volatile and illiquid markets.

In March 2020 at the height of the market selloff, most major fixed income index providers came together to partially delay index rebalancing actions for the majority of their indices. We estimate that around 40% of BlackRock's global fixed income index platform rebalancing at March month-end was delayed following this coordinated effort. While the April month-end rebalance saw significant changes across fixed income indices, BlackRock's experience trading these changes was orderly.

Most major fixed income index providers came together again in March 2022, deciding to remove all bonds with Russia as country of risk at March month-end with a valuation at or near zero. These actions applied to both sovereigns and corporates and included non-sanctioned names. This meant that portfolio managers (PMs) had the flexibility to manage down positions in a risk-controlled manner.

In both instances, we believe the coordinated and dynamic response of index providers helped to promote market stability and better outcomes for end clients than if no action had been taken.

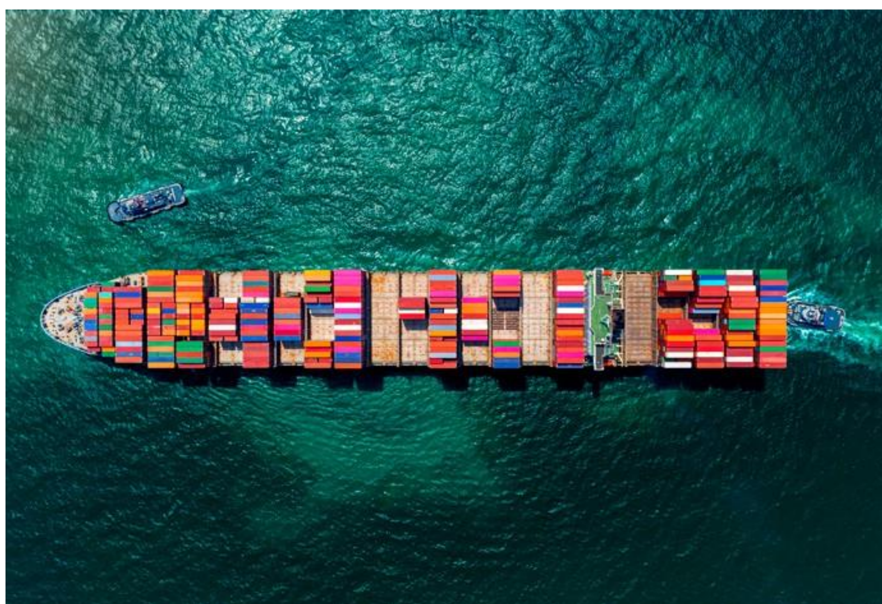
Myth 04

Indices are not investable and therefore do not consider the realities of trading in the underlying markets.

Fact

Indices incorporate diversification and liquidity rules which help portfolio managers effectively replicate the risk and return characteristics of their benchmarks across a diverse set of fixed income markets.

Index rules such as caps, floors and minimum issue sizes help ensure appropriate diversification and investability of an index. Caps prevent any large issuer from dominating the index, while floors ensure that small issuers whose bonds may be illiquid and hard to get hold of are excluded. Caps and floors are often found in credit and emerging market debt indices. In addition, indices across fixed income markets incorporate rules on minimum issue sizes to ensure that only bonds which are likely to be relatively freely traded are included. For example, the iShares JP Morgan EM Local Govt Bond UCITS ETF tracks the J.P. Morgan GBI-EM Global Diversified 10% Cap 1% Floor Index, which incorporates a 10% cap and 1% floor diversification schema, as well as a minimum issue size of US$1B equivalent for onshore local currency bonds, and US$500m for global (offshore currency linked) bonds. Transaction costs and/or taxes are also incorporated into the calculation of total returns for some indices, providing a more realistic view of trading underlying markets. For instance, from September 2023 rebalance, the J.P. Morgan GBI-EM Global Diversified 10% Cap 1% Floor Index evolved from gross to net of withholding taxes in the index calculations, to ensure a more accurate and realistic view of investing in local currency emerging market bonds, where taxes are a key consideration.



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Myth 05

Indices cannot add value through Environmental, Social and Governance (ESG) analysis and scoring systems in the way active managers can.

Fact

BlackRock has worked with index and ESG data providers to develop sustainable fixed income indices which help meet investors' needs and satisfy regulatory requirements, in addition to promoting standardisation across the industry.

Sustainable fixed income indices offer a transparent, rules-based approach to sustainable investing. Most adopt a Sustainable Responsible Investing (SRI) approach, by incorporating business involvement screens, while targeting specific sustainable objectives through minimum ESG ratings and controversy scores. BlackRock offers one of the widest ranges of sustainable fixed income index funds in EMEA, spanning credit, government bonds and emerging market debt. As sustainable index construction and investors' desired sustainable outcomes evolve, BlackRock has also worked closely with index providers to develop indices that meet investors' needs for products that incorporate an increasing degree of complexity. In recent years, BlackRock has partnered closely with Bloomberg to develop Paris-Aligned investment grade and high yield benchmarks, which incorporate nuanced optimisation constraints developed with fixed income asset class specificities in mind. This led to solutions that meet and exceed the requirements on Paris-aligned benchmarks, offer an improved sustainability profile and focus on greener businesses, while also maintaining broad asset class representation relative to the parent index.

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Five myths about fixed income index investing

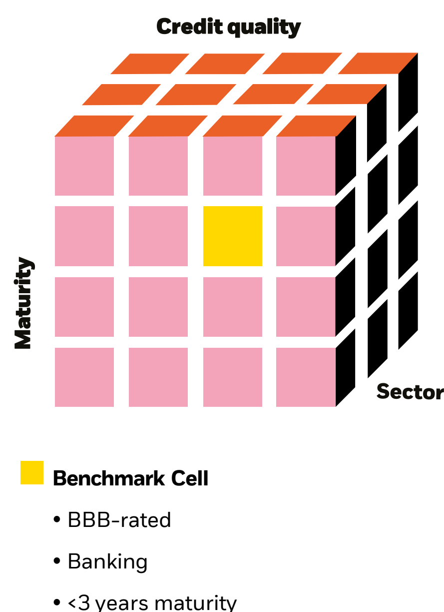
iShares' approach to index investing in fixed income

At BlackRock, index investing is anything but 'passive'. Rather than being strictly bound by the monthly rebalance cycle, iShares index portfolio managers (PMs) follow a stratified sampled approach using data, technology and a long history of index investing expertise to navigate fixed income index rebalances. This approach seeks to deliver the risk and return characteristics of the index by holding a subset of the index's securities. To do this, we divide each index into groups of bonds with specific risk factors (such as sector, maturity, credit rating, seniority, country and currency), then select bonds from each subset to build a portfolio that reflects the characteristics of its underlying index, including yield and duration, to replicate the index returns as closely as possible.

Figure 3: Stratified sampling process

Dividing the various indices into subsets (cells) based upon relative parameters

Government Bonds	Mortgage-Backed Securities	Credit & Asset-Backed Securities
Issuing country	Issuer (GNMA, FNMA, FHLMC)	Sector/issue type
Currency	Mortgage type (30 year, 15 year, balloon)	Maturity/average life
Maturity	Coupon	Credit rating
	Age (year of issuance)	Call/payment structure
	Specified Pools "Story"	



Source: BlackRock. For illustrative purposes only.

Under this approach, iShares PMs are not required to hold every single bond in the index. The investment process balances tracking error, liquidity and transaction costs when selecting securities. For example, the Bloomberg Global Aggregate Bond Index includes 29,613 bonds, while iShares Core Global Aggregate Bond UCITS ETF (AGGG) holds 13,464 bonds. This fund has consistently delivered tight annualised tracking difference of -10bps net of fees since inception (source: BlackRock, as at 30 November 2023).

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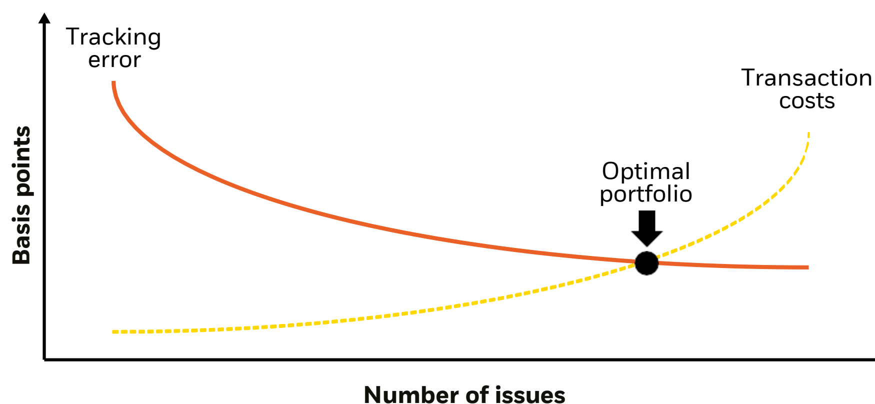
Still, most of our seasoned funds with sizeable AUM tend to hold similar number of bonds in the index and in some cases even slightly more bonds, for example, iShares € High Yield Corp Bond UCITS ETF (IHYG) held 600 bonds while the benchmark held 585 bonds, as at 30 November 2023. Holding more bonds than the index is typically the result of buying new issues in the primary market before they enter the index at month-end or holding bonds to maturity as opposed to selling them at the 12-month cut off point.

Figure 4: Balancing tracking error and cost



Source: BlackRock. For illustrative purposes only.

Myth 01

Index managers incur the highest turnover during the month end, suffering from information slippage and high transaction costs.

Fact

iShares portfolio managers trade flexibly through the month to proactively rebalance towards the forward-looking benchmark to deliver on investment objectives for investors. We take advantage of new issue markets, primary flows and internal crossing opportunities to limit excessive turnover and the market impact of rebalancing activities.

While there is still a need for better quality and standardised index analytics, we leverage proprietary and third-party data in Aladdin, BlackRock's risk management system, to improve transparency around upcoming benchmark changes and performance drivers. Importantly, because we methodically sample bond indices as opposed to fully replicating them, we have the flexibility to adjust portfolios in a pragmatic and dynamic fashion. We may also hold bonds to maturity if deemed beneficial, even if the index does not. Rebalancing trades are executed with our investors in mind. For our large funds, such as iShares Core € Corp Bond UCITS ETF (AUM: €15.2B as at 30 November 2023) most rebalancing activity takes place dynamically through the month with an eye on the forward index, with very little adjustments made at month-end.

Myth 02

Index portfolio managers with the highest primary flows (creation/redemption of ETF units) suffer more during market volatility as they are forced to trade at the worst time.

Fact

iShares portfolio managers use primary flows to rebalance the fund toward the forward benchmark during the month, limiting the impact of rebalancing during volatile markets. In addition, ETF transaction costs are externalised, protecting existing investors in the fund.

Most creations and redemptions of iShares fixed income ETFs occur "in-kind" via custom baskets, which means the ETF provider and the Authorised Participant (AP) exchange diversified baskets of bonds for ETF shares. This process allows our portfolio managers to proactively rebalance the fund during the month with an eye on the forward index, reflecting the continuous evolution of the market the fund tracks. The custom baskets dealt during the creation and redemption process reflect the diversified nature of the portfolio, with nearly identical risk, return and liquidity characteristics. This comes down to the strength of our investment and trading platforms, as well as the pragmatism and proactivity of portfolio managers in using ETF primary flows to help the rebalancing process, while adhering to strict risk tolerances. As a result, redemption baskets may have a slightly bigger portion of bonds under one year to maturity included in them versus the main fund, as these bonds tend to be removed from indices, while creation baskets may include more newly issued bonds in anticipation of them being included in the index at month end. These activities aim to minimise transaction costs, improve liquidity inside the fund and deliver tighter tracking for investors.

For funds with large AUM, using the creation and redemption process to rebalance funds can reduce fund turnover relative to the benchmark. Through this process, transaction costs associated with primary flows into and out of ETFs are externalised, limiting the impact on existing investors in the fund.

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Myth 03

Index portfolio managers are forced buyers and sellers during credit events.

Fact

iShares portfolio managers are never forced buyers or sellers during credit events. We have flexibility on when to trade bonds which are exiting/entering the indices and can take advantage of internal crossing opportunities to ensure the best outcome for clients. iShares PMs take an activist approach to index investing in emerging market debt, actively engaging with restructuring sovereigns.

iShares PMs have flexibility on when to trade any issuers entering and exiting indices, allowing us to avoid trading at the same time as others who may be forced buyers or sellers. In addition, in EMEA, we have internal crossing opportunities at mid prices where bonds drop out of one fund due to index changes (e.g., investment grade credit or IG), while entering another (e.g., high yield or HY), allowing us to save on transaction costs. In the case of fallen angels, BlackRock may end up being a net buyer during credit downgrades, given the size of the HY market and the scale of our HY funds across the firm.

In emerging market debt, the indices tracked by iShares index funds keep restructuring credits within the index. This allows investors to benefit from any potential upside post credit event while also enabling us to take an activist approach, engaging with sovereign issuers during restructuring phases, to maximise value for clients while promoting a healthy market. For example, BlackRock engaged with the Argentinean government and more recently, the Ukrainian government in their debt restructuring.

Over the years, we have also shared insights and feedback with index providers to evolve index rules in a pragmatic manner. For example, we collaborated with one index provider in 2020 to align the timing between downgraded bonds exiting certain USD IG indices with when they enter USD HY indices. This rule change aligned natural sellers of downgraded bonds (IG funds) with natural buyers of the bonds (HY funds), improving liquidity and reducing transaction costs of trading such events.

Myth 04

Index managers cannot benefit from new issue premia.

Fact

iShares portfolio managers can participate in new issues to benefit from liquidity, new issue premia and the absence of transaction costs. Indices are also evolving in this area, speeding up the inclusion of newly issued bonds in certain segments.

Portfolio managers will weigh up the benefits of improved liquidity, the new issue concession and the absence of transaction costs of a new bond issue versus the potential tracking error created by owning it prior to its official inclusion in the index at the next rebalance. The process works because index funds generally have some flexibility to hold up to a certain percentage of non-index bonds.

In some asset classes, such as EMD, where the universe can be concentrated and sometimes illiquid, using the new issue market to access liquidity can be very beneficial to investors. With this in mind, BlackRock advocated with one index provider to include newly issued bonds more promptly within Emerging Market Debt indices from January 2021. By lowering the average time lag between the date of issuance of an index-eligible bond and its inclusion into the index, the breadth of the universe covered by the index increased, with the resulting index a better reflection of the evolution of the underlying market.

Myth 05

Active managers are better able to navigate illiquid markets.

Fact

As index portfolios tend to be highly diversified, iShares index portfolio managers are able to navigate illiquid markets while still maintaining close tracking to their benchmark. In addition, for ETFs, the in-kind primary process helps to rebalance the portfolio proactively throughout the month.

Index portfolios typically track highly diversified benchmarks and contain hundreds, if not thousands, of bonds. As a result, any individual position is unlikely to impact their ability to maintain tight tracking through the stratified sampling process. At BlackRock, managing index portfolios is never “passive” and we incorporate active insights such as single name news, market conditions and liquidity considerations in managing index portfolios to reduce portfolio turnover and unnecessary trading costs, thus enhancing overall tracking quality.

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Conclusion

As investors re-examine the role of fixed income in portfolios in a new macro regime, we see the adoption of fixed income indexing continuing. While the highly fragmented and discontinuously liquid nature of the bond market has led to claims that index investing cannot work in fixed income and that active management is the only solution, we argue that it is the very nature of fixed income that makes indexing valuable for all styles of investing. Indexing transforms the fragmented bond market into standardised, predictable and efficient exposures that greatly simplify portfolio construction. The broadening range of fixed income indices, index funds and ETFs afford investors an increasing degree of precision and flexibility in creating highly customised and nimble portfolios, that can be adjusted efficiently to capture opportunities in changing market environments. Index funds including ETFs can be used to rapidly and cost effectively scale portfolios, enabling portfolio managers to focus on higher conviction trades. For these reasons, we believe that not only does fixed income indexing work, but that it is becoming indispensable for more and more portfolio managers.

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iShares € High Yield Corp Bond UCITS ETF
Combined Credit and Non-investment Grade Risk, Counterparty Risk, Credit Risk, Liquidity Risk

iShares Core € Corp Bond UCITS ETF EUR (Dist)
Counterparty Risk, Credit Bail in Risk, Liquidity Risk

iShares Core Global Aggregate Bond UCITS ETF USD (Dist)
Counterparty Risk, Credit Risk, Currency Risk

iShares J.P. Morgan EM Local Govt Bond UCITS ETF USD (Dist)
Counterparty Risk, Credit Risk, Currency Risk, Emerging Market Government Fixed Income Securities Risk, Emerging Markets Risk, Liquidity Risk

Description of Product Risks

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