

## Commentary

# Fixed Income vs. Fixed Income Exposure

ETFs have transformed fixed income investing, but there are key differences between bond ETFs and high-quality corporate bonds.

By Paul Mottola

The explosive growth of exchange-traded funds (ETFs) and the commensurate rise of asset allocation models in fee-based investment accounts have completely transformed how advisors and investors approach and implement fixed income allocations in their portfolios, challenging some of the most important portfolio benefits of the asset class.

The general model portfolio construct of these fee-based programs is to use a sector-based approach to fixed income allocations, using fixed income ETFs as the leading implementation tool. While ETFs do provide an efficient way to get market exposure, investors need to recognize some of the key structural differences versus individual bonds when constructing a portfolio and understand that receiving fixed income *exposure* may not be consistent with traditional expectations of the asset class — a predictable and defined cash flow, return of principal (absent issuer default), and subsequent option to reinvest these proceeds in a potentially higher interest rate environment. As investors increasingly seek high-quality fixed income, and especially for those approaching or in retirement, it's time to revisit the benefits of adding individual high-quality corporate bonds to their portfolios.

### **Fixed Income ETFs: Great Sector Diversification, But is It *Fixed Income*?**

The monumental growth of model-driven, fee-based programs has largely expanded the bias toward a sector-based approach to constructing



portfolios, and, by extension, how financial advisors manage the fixed income exposure in client portfolios. This has generally resulted in a broader acceptance of bond ETFs over the past decade as a main source for fixed income exposure.

These ETFs are an efficient way to get fixed income market exposure, especially in highly desirable sectors such as international, emerging markets and high yield. Plus, the multiple holdings within a bond ETF can accomplish many important investment objectives, such as issuer diversification.

Ease of tracking and liquidity has resulted in many investors using bond ETFs like stocks to access sectors that are complicated or hard to invest in. This ease of use has resulted in *investors now confusing fixed income exposure with actual fixed income*.

The equity-like qualities of a bond ETF mean that coupon payments are converted to periodic dividend payments that aren't necessarily predictable

— and predictable fixed income has long been a key objective for fixed income investors.

Furthermore, while bond ETFs have strong market liquidity and diversification, there is generally no end date when investors have their capital returned. A traditional bond has a fixed maturity date, which means that investors who own that bond will receive their principal back at full par value upon maturity (absent issuer default) — a particularly appealing benefit for investors seeking the principal protection that many ETFs can't offer.

Another important consideration is the interest rate sensitivity of individual bonds and bond ETFs. Both have interest rate, market and credit risk. While bond ETFs have strong diversification that mitigates the market and credit risk, they generally have a fixed interest rate duration, meaning that the interest rate sensitivity generally remains constant over time. Conversely, individual bonds have a fixed maturity date, which means their interest rate duration, (sensitivity to interest rate changes) will slowly decline over time, as the maturity date grows closer.

### **Bond Laddering: Classic Strategy for Rising Rates**

The stage is set for the possibility of more interest rate increases by the Federal Reserve — something every investor should consider when reviewing their portfolio. To mitigate interest rate risk exposure and position their portfolio to take advantage of the potential for higher rates, advisors and fixed income investors can turn to a traditional investment strategy called bond laddering.

Simply stated, investors make bond investments in multiple issues that have different maturity dates. Imagine the steps on a ladder with the lowest step the closest and shortest maturity date, while the highest step on the ladder is the furthest away, or longest maturity date.

When the bond on the lowest step of the ladder matures, the proceeds are reinvested in a bond with a maturity date that is longer than the bond

on the top step. This replenishes the bonds on the ladder as they mature.

A bond ladder strategy helps mitigate interest rate risk by reinvesting maturing proceeds at potentially higher interest rates and provides the opportunity to reassess the credit risk you have in the portfolio. In addition, investors can enjoy the actual benefits of the asset class — a predictable, reliable cash flow through fixed income, and the confidence of getting return of principal at maturity.

### **Take Another Look at Traditional Fixed Income**



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While fixed income ETFs certainly have a place in portfolios, so do individual bonds for very important and highly effective reasons. By adding simple high-quality, corporate bonds to your client's fixed income allocation, you have the potential to boost their cash flow through fixed and predictable income, position them to benefit from possibly higher interest rates, and offer the confidence associated with the return of principal at maturity.

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