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Bond ETFs and the path to $2 trillion

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BlackRock President

> “BlackRock believes that global bond ETF assets will double, to $2 trillion, by 2024.”

Bond exchange traded funds (ETFs) are transforming how investors—from individuals to institutions—can access fixed income.

Having spent more than 35 years in fixed income, I see bond ETFs as a game-changing technology because of how these products can bring convenience and transparency to a historically hard-to-access asset class. Their straightforward format—an ETF is bought and sold on exchange—lets investors manage diversified bond holdings simply and efficiently. Today, bond ETFs offer a rich diversity of exposures and good value.

Global bond ETF assets topped $1 trillion in June 2019, a growth milestone that highlights how far they have come in their first 17 years.[1] We're even more optimistic about the future. BlackRock believes that global bond ETF assets will double, to $2 trillion, by 2024.[2]

The next leg of growth will be driven by investors finding novel uses for these versatile tools. Individual savers will increasingly use bond ETFs to help generate income; asset managers, including BlackRock, will add them to strategies designed to beat their benchmarks; and asset owners such as pension funds will continue to rely on the greater liquidity and lower costs to execute complex portfolio strategies.

So while bond ETFs have already won over a generation of investors, we think they are poised for rapid growth over the next few years as clients continue to move beyond the "active versus passive" debate and use them as transparent building blocks for portfolio construction. Additionally, powerful advances in technology, market structure and product innovation will help lead more investors to bond ETFs for the first time. Taken together, these secular forces will accelerate the bond ETF market. All investors stand to benefit.

Capital Risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. You may not get back the amount originally invested.

All amounts given in this document are USD.

[1] BlackRock, GBI, Bloomberg (as of June 2019).

[2] BlackRock (as of June 2019).

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The path to $2 trillion

It was a novel idea: give investors simple, efficient and transparent access to opaque global bond markets.

Until iShares pioneered bond ETFs in 2002, ordinary investors had few low-cost options for building diversified bond portfolios on their own, especially in areas such as corporate and emerging-market debt. It was either use a broker—who could spend hours or longer working with Wall Street dealers—or invest in a mutual fund. The first bond ETFs gave all investors efficient, convenient tools for targeting fixed income assets in real time.

Fast-forward to today and global bond ETF assets are growing 22% annually, more than three times the rate of open-end bond funds.[3] The original four U.S. iShares bond ETFs now hold more than $81 billion, and more than 1,300 bond ETFs trade across the globe.[4]

There is tremendous runway for growth. Even at $1 trillion, bond ETF assets represent less than 1% of the $105 trillion global fixed income marketplace.[5] Growth is set to accelerate as all types of investors, from individuals to wealth managers to institutions, use bond ETFs in more and different ways. Today, individual bonds are held largely by banks, central banks, and corporations—market participants that are just beginning to adopt bond ETFs.

How much and how fast? BlackRock believes that global bond ETF assets are well positioned to double, to $2 trillion, by the end of 2024[6]—thanks to four long-term trends:

Stephen Cohen
Head of EMEA iShares

Armando Senra
Head of U.S., Canada and Latin America iShares

Carolyn Weinberg
iShares Global Head of Product

Chris Dieterich
ETF and Index Investments Group

[3] Morningstar (as of May 2019); bond ETF annualised growth rate of 21.9% compares with open-end mutual fund growth rate of 6.5% in the five years ended Dec. 31, 2018.
[4] BlackRock (as of May 2019).
[5] Bank of International Settlements (as of Dec. 2018).
[6] BlackRock (as of June 2019).

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Six ways investors use bond ETFs

1 Strategic asset allocation

Low-cost, efficient access to bond exposures for core positions

2 Tactical asset allocation

Opportunistic exposure to specific asset classes, geographic regions and maturity ranges

3 Cash management

Potential yield enhancement for long-term cash*

4 Liquidity management

Tools that can add liquidity while maintaining strategic asset allocations

5 Portfolio transitions

Stay in the market while adjusting active or non-liquid strategies

6 Hedging instrument

Potential alternatives to futures or swaps

For illustrative purposes only.
*An investment in fixed income funds is not equivalent to and involves risks not associated with an investment in cash.

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Trend #1: An evolution in portfolio construction

Bond ETF investors are hardly passive. Millions of people are actively using them in new and innovative ways to achieve a variety of outcomes.

Early adopters used bond ETFs as buy-and-hold positions that replaced individual bonds, higher-cost mutual funds and separately managed accounts.[7] Today, more investors are recognising that, just as with stocks, bond ETFs are an efficient way to access different sources of return and manage risk. Individuals can use bond ETFs to build diversified portfolios across multiple asset classes, and term-maturity bond ETFs to help generate predictable income through laddering. Professional portfolio managers can use high yield bond ETFs alongside individual securities in actively managed funds. Hedge funds can use ETFs for targeted long and short positions. In all cases, bond ETFs make it easy to build and manage fixed income allocations.

Traditional portfolio construction has typically been perceived as binary in nature—active vs. passive, stocks vs. bonds, domestic vs. international, and so on. Today, institutional and wealth managers are increasingly taking a "whole portfolio" approach that focuses first on desired outcomes, second on asset allocations, and finally on the most efficient way to implement them. Meanwhile, cost and transparency have become key considerations for many investors.

ETFs have been the big beneficiaries of this shift. More and more portfolios are built with low-cost index exposures, style factors (such as quality and momentum) and alpha strategies. While this trend began with equities, bond ETFs have quickly followed suit.

Adoption of ETFs by wealth managers has been further driven by two phenomena: first, the transition of the financial advice business to fee-based pricing from transaction-based pricing; and second, the growing use of model portfolios (which feature ETFs) to simplify and scale their investing.

[7] BlackRock, "Transforming the Bond Markets With Fixed Income ETFs," July 2012.
[8] Securities and Exchange Commission, "Pre-trade Information in the Municipal Bond Market," July 2018.

Investor-protection rules favor ETFs

Regulatory initiatives aimed at providing fee transparency have accelerated the shift to fee-based advisory models. For example, Europe's Markets in Financial Instruments Directive II (MiFID II) requires fund companies, private banks and independent financial advisors to disclose commission and retrocession charges paid to them by fund companies.

In the U.S., recent rule changes have given individual investors more transparency into the full cost to trade municipal bonds. Historically, it was almost impossible for individual investors to determine the magnitude of bond price markups, even though they can amount to between 1% to 2%.[8] Starting in 2018, Municipal Securities Rulemaking Board (MSRB) and Financial Industry Regulatory Authority (FINRA) rules required greater fee transparency, which BlackRock believes will accelerate the shift to fee-based advisory and into bond ETFs.

Trend #2: Growing adoption by institutional investors

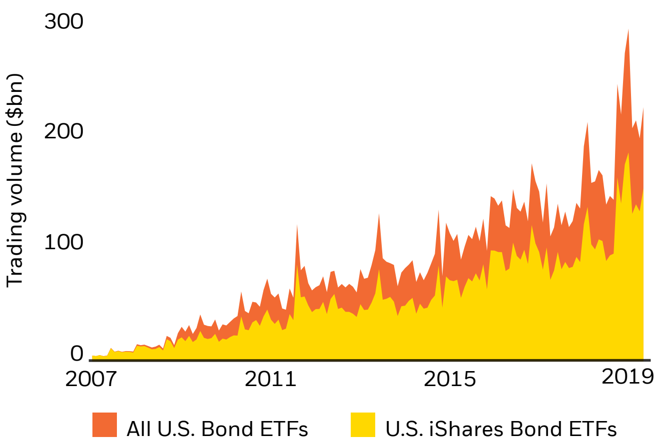
Institutions—pension funds, asset managers, and insurance companies—rely on bond ETFs for quick, efficient market access.

Significant adoption by these investors traces back to 2008, when banks and broker-dealers pulled back from bond market-making amid market distress and its aftermath. With post-crisis regulation increasing the cost of capital, investors found trading volumes and liquidity were diminishing just when they were needed most.

In contrast, efficient bond ETFs traded continuously on exchange throughout and after the crisis, providing large investors with a much-needed alternative.[9] Institutional adoption drove higher trading volumes, which in turn provided the foundation for today's liquid bond ETF market. In Europe, implementation of MiFID II has brought enhanced visibility to the depth of bond ETF trading. This in turn is driving further adoption of bond ETFs by providing fixed income investors the much-needed transparency in trading bond markets.[10]

[9] BlackRock, "Transforming the Bond Markets With Fixed Income ETFs," July 2012.
[10] BlackRock, Bloomberg (as of May 2019).

Bond ETF trading volume continues to grow



Source: BlackRock, Bloomberg (as of May 2019). **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.**

Institutions continue to find new ways to use bond ETFs.[11] For instance:

- Insurers deploy short-term government bond ETFs to manage cash reserves slated for future payments.
- Fund managers hold high yield bond ETFs instead of cash in anticipation of a bond offering.
- Pensions draw on the securities-lending market to help bolster returns from bond ETF ownership.
- Endowments use bond ETFs while transitioning between non-liquid strategies and active managers.
- Dealers use bond ETFs to help manage their inventories and credit risk.

Increasingly, institutions use bond ETFs as complements and sometimes replacements for futures or swaps.[12] Robust bond ETF options trading helps to manage risk or express granular market views. Growth has only enhanced liquidity.

Regulatory initiatives are further supporting bond ETF adoption globally. In particular, Europe's MiFID II, implemented in 2018, ushered in greater transparency around ETF trading. Historically, a significant portion of Europe's ETF trading was not reported, blinding investors from the full picture of market activity. Already, enhanced reporting of ETF transactions has enabled larger ETF transactions; the largest trade in a European bond ETF to date, worth $550 million (approximately €480 million), hit in January 2019.[13] In the years ahead, efforts to centrally consolidate ETF trading information across Europe could help reinforce market liquidity and institutional adoption.

Trend #3: Modernisation of the bond market

Bond trading as a percentage of debt outstanding has declined in the post-crisis, dealer-centric world, and market participants look to ETFs and electronic trading to help improve liquidity.[14] Together these forces are contributing to a universe of bonds that are priced and traded daily—a virtuous circle that will support the growth of both bond ETFs and digital-first transactions.

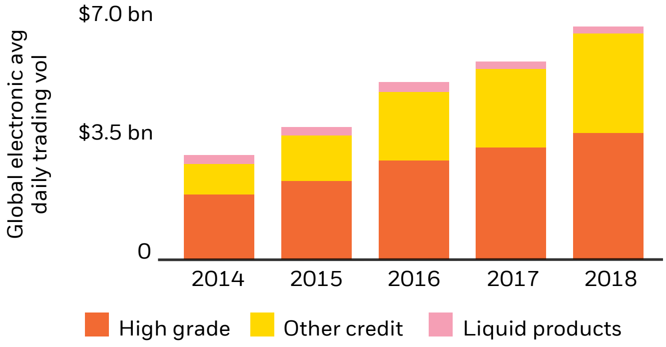
Electronic bond trading is already prevalent in major government bond markets, and is growing in corporate, emerging-market and municipal debt markets.[15] Electronic bond trading enables a hybrid trading architecture that relies less on broker-dealer inventories. Increasingly, asset managers interact with dealers and other institutions in an "all-to-all" trading environment, rather than interact with principals that use balance sheet capital to stockpile bond inventories.

UCITS: The ETF crosses borders

UCITS ETFs (Undertakings for Collective Investment in Transferable Securities), regulated by the European Union, offer a unique cross-border standard of disclosure and investor protection. That has led many global investors to consider UCITS ETFs for their portfolios.[16] Indeed, the largest bond UCITS ETFs have crossed $10 billion in assets under management; for some exposures, such as euro-based high yield, UCITS ETFs now offer the largest vehicles available to investors.[17]

[11] Greenwich Associates, "Institutions Turn to ETFs for Bond Market Liquidity," Sept. 2018.
[12] Greenwich Associates, "ETFs: Valuable Versatility in a Newly Volatile Market," April 2018.
[13] BlackRock (as of May 2019).
[14] SIFMA Fact Book 2018; Greenwich Associates, "ETFs: U.S. Institutions' New Tool of Choice for Portfolio Construction," Feb. 2019.
[15] Greenwich Associates, "Corporate Bond Trading in 2019," Jan. 2019.
[16] Greenwich Associates, "Corporate Bond Trading in 2019," June 2019.
[17] BlackRock, Bloomberg (as of May 2019).

Electronic bond trading volumes have more than doubled since 2014



Source: MarketAxess (as of December 2018).

At the same time, ETF market makers and authorised participants (APs)—financial institutions that create and redeem ETF shares—are becoming adept at managing bond inventories. Increased primary and secondary bond ETF trading by APs has enhanced underlying bond market transparency, liquidity and real-time valuation methods. The bond ETF ecosystem has evolved to enable rapid pricing and execution of individual bonds and, importantly, bond portfolios.

These developments support future bond ETF growth, as well as entrench bond ETFs as part of a vibrant fixed income marketplace.

Trend #4: Constant ETF innovation

Finally, the development of new bond ETF exposures will add convenience for investors, provide new tools for customising portfolios and drive future bond ETF adoption.

Demand for sustainable bond ETFs will grow as more people seek to match their personal values with their investments. More bond ETFs will incorporate environmental, social and governance (ESG) inputs into their methodologies, or target green bonds used to fund sustainable projects, such as solar panels and clean transportation.

More investors are also likely to turn to the convenience of bond ETFs that seek to neutralise interest rate and currency risks. Currency-hedged bond ETFs, for example, can help investors dampen unintended volatility that comes with owning international bonds.

Innovations in factor-based bond ETFs, now in the early stages, will provide investors with new ways to calibrate portfolios, for instance by helping investors seek to balance credit and duration risk, or select bonds according to financial traits such as quality and value.

Shock absorbers in stressed markets

In periods of market stress, bond ETF trading has typically risen, which has helped to absorb market activity as underlying bond trading recedes. This pattern shows that investors increasingly seek out the liquidity and transparency of ETFs in addition to the traditional over-the-counter market.

The stabilising role of bond ETFs in volatile markets has been on display time and again. For example, in December 2018, an unusually wild month for investors, on-exchange trading in U.S. high yield corporate bond ETFs surged to a monthly record of $72 billion, while trading in individual high yield bonds fell to $154 billion, the lowest in four years.[18] The episode, like many others before it, underscored how ETFs play an important role in providing additional liquidity and maintaining healthy capital markets.

Conclusion

Bond ETFs have transformed how all investors access fixed income markets. But the movement is only beginning. It took nearly two decades for bond ETFs to surpass $1 trillion in global assets. BlackRock believes the next leg of growth will be swifter and broader, with bond ETFs surpassing $2 trillion by the end of 2024.[19]

How will it happen? As with all innovative technologies, bond ETF adoption will be driven by greater recognition of their versatility and convenience. We envision a not-too-distant future in which individual investors move beyond individual bonds, and more asset managers pursue active fixed income strategies with index-tracking ETFs as building blocks. For all investors, bond ETFs will offer transparent, simple and effective ways to assemble diversified bond portfolios.

[18] BlackRock; Bloomberg; SIFMA TRACE (as of Jan. 2019).
[19] BlackRock (as of June 2019).

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