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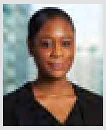
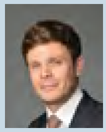


Hannah Smith, Head of UK Pension Coverage, SPDR ETFs

Hannah is a vice president at State Street Global Advisors, leading in the coverage of pension funds for the UK SPDR ETF business. She also covers hedge funds, asset managers and insurers. Hannah previously worked on the credit sales desk at Mitsubishi UFJ International, focused on growing the firm's UK institutional client base. Prior to this, she spent five years at Goldman Sachs International where she was responsible for advising family offices and UHNW clients on how to gain access to investment themes through the mutual fund and ETF universe.

PANEL



Joe Abrams, Principal, Fixed Income Researcher, Mercer

Joe is a principal within the fixed income manager research boutique, a unit within Mercer's investments business. Joe leads Mercer's research into global credit and absolute return fixed income. He researches bond strategies and assists clients in formulating their strategic allocations within fixed income and selecting managers. Joe is also a member of Mercer's strategic research group, which oversees the production of Mercer's intellectual capital, ranging from asset class specific material to multi-asset strategy.

Nico Aspinall, Chief Investment Officer, B&CE provider to The People's Pension

Nico is the CIO at B&CE. Previously, he was head of defined contribution (DC) investment at Towers Watson and head of DC for the Barclays staff pension scheme. He also chaired the resource and environment board and is a member of the Institute and Faculty of Actuaries council. Nico is a qualified actuary and has published papers on resource depletion and monetary sustainability – working to ensure climate change and other sustainability issues are understood and acted upon by actuaries.

Andy Cheseldine, Client Director, CCTL

Andy joined Capital Cranfield in 2017. Prior to this, Andy acted as an adviser to trustees and employers at Watson Wyatt, Hewitt Bacon & Woodrow and latterly as a partner at LCP. Using his experience of over 30 years in consulting on both DC and DB pension arrangements and liaising with regulators throughout the pension and financial services industry, he is able to use his wide knowledge and understanding for the practical benefit of trustee boards. He has served on the PLSA DC Council since 2013. He is a regular commentator in the pensions press and a popular speaker at pensions events.

Carl Hitchman, Head of Fiduciary Management Advisory (FMA), Stamford Associates

Carl is a qualified actuary with over 33 years pensions and investment experience, covering a wide range of areas including investment strategy, manager selection, transition management, derivatives, securities lending and foreign exchange. He has significant practical experience of the fiduciary management market, initially in an oversight role where he was responsible for undertaking assessments of fiduciary managers and now in the development of Stamford's FMA proposition.

Kate Hollis, Senior Investment Consultant, Willis Towers Watson

Kate joined Willis Towers Watson in September 2014 as a manager researcher on the fixed-income team. She leads traditional credit research and the exposure ASK and is a member of the credit – smart beta ASK. Kate previously spent 10 years at S&P Capital IQ, most recently as global head, fixed income/alternatives fund research. Before that she spent five years working for funds of hedge funds and 15 years in fixed income sales and trading, working for Deutsche Bank, Daiwa Securities, Scotia McLeod and Schroders.

Abhishek Kumar, Portfolio Manager, Emerging Market Debt Local Currency, SPDR ETFs

Abhishek leads the State Street Global Advisors' EMD team, managing both hard currency and local currency EM funds. He joined SSGA in September 2010. Previously Abhishek spent three years at ICICI Bank UK, managing global credit portfolios. He is a CFA charter holder. Abhishek holds a Masters in Management from ESCP Europe Paris, a post graduate diploma in Management from the Indian Institute of Management, India and a Bachelor's degree in Mechanical Engineering from the Indian Institute of Technology.

Antoine Lesne, Head of Strategy & Research EMEA, SPDR ETFs

Antoine is a vice president of State Street Global Advisors and head of SPDR ETF research & strategy for EMEA. Antoine's responsibilities include developing a strategy framework for the existing SPDR ETF range to align it with financial market developments and longer-term economic outlooks. This is delivered through research on ETFs as well as market bulletins that support the distribution of ETFs across EMEA. Prior to this, Antoine was a fixed income portfolio strategist covering Europe and global fixed income beta strategies.

Alan Pickering, Chairman, BESTrustees

Alan Pickering is chairman of BESTrustees and a trustee of a number of pension schemes. These include The Plumbing Industry Pension Scheme, which he chairs, and The People's Pension. Alan chairs the governance group of the Royal Mail Statutory Pension Scheme. He was a trustee of the Kosovo Pensions Savings Trust between 2011 and 2015. Until February 2013, he chaired the financial literacy charity, Life Academy. He has served as a non-executive director of The Pensions Regulator having previously been a member of the Occupational Pensions Board.

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Rachit Sharma, Senior Investment Manager, RPMI Railpen
Rachit manages a number of pooled funds, government bond portfolios, and overlays, in addition to leading work on macro strategy that informs management of the growth fund. Rachit also manages portfolio implementation and capital markets activities, including relationships with counterparties and overseeing the outsourced dealing desk. Before joining Railpen in 2010 Rachit worked in private wealth management advising UHNW individuals and families on asset allocation and managing global multi-asset investment portfolios.

Paul Whelan, Fixed Income Manager Researcher, Aon
Paul is UK head of fixed income manager research for Aon Hewitt and heads up the UK transition management team. He covers the full spectrum of fixed income asset classes. Paul is an active member of the UK fixed income views team, working to expand the breadth of the team's output, formulating appropriate scheme hedging levels and informing the advice given to clients on managing their liabilities. Paul also works closely with the fiduciary business, Delegated Consulting Services. He often contributes to the pensions press.

Spotlight on fixed income ETFs

Our panel of experts looks at the various roles fixed income ETFs can and should be playing in pension fund portfolios now and into the future

Chair: We have seen significant growth in the fixed income market since the financial crisis. The size of the market has grown from $80bn in 2009 to c.$980bn today with expectations it will reach $1tr during 2019. The demand from institutional investors has also increased dramatically with most of the growth occurring across corporate, global and emerging market bonds. This rapid growth suggests that institutional investors are using fixed income ETFs not only for their tactical but also for their strategic asset allocation needs.

ETFs have also helped to modernise fixed income markets, assisting investors with liquidity and accessing niche exposures within their portfolios, as well as enhancing transparency and providing investors with low-cost execution when establishing a diversified portfolio. However, despite this growth, there remain a number of misconceptions within the fixed income ETF market, particularly around certain exposures such as emerging markets and also around liquidity.

Can I ask those of you around the table, what is your exposure to fixed income ETFs or ETFs in general, in your current roles?

Whelan: I head up the fixed income manager researcher team for Europe at Aon and, in terms of ETF usage, we directly use them within our fiduciary business, both for managing flows, more tactical exposures to markets and

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increasingly – but from a low base – more strategic allocations. In terms of clients, directly on the advisory side, both across insurance and pension funds, there is still relatively little usage of ETFs and still some nervousness around them.

Cheseldine: I am a professional trustee with CCTL, as well as a trustee of two relatively small DB schemes and half a dozen quite big DC schemes and in none of those do we currently use ETFs.

Aspinall: I'm the chief investment officer of B&CE. We sponsor The People's Pension – the largest DC master trust in the UK. We have some ETFs for our exposure to real estate and infrastructure. I would frame them as enabling us to get access to those exposures quickly. For our long-term exposures we would like to be more like the unlisted direct holdings in those pieces. I can see them managing some liquidity in that circumstance, so potentially offering proxy prices. But that's where we use them.

Hollis: At Willis Towers Watson, I am head of the traditional credit manager research team and also the exposure team, which includes indexation. We don't use ETFs at all in any fixed income asset class for our investment portfolios and very rarely for managing transitions. Our DB clients don't need the extra liquidity. They make strategic asset allocations and change them once every three to five years, and we find that ETFs are extremely expensive compared to the traditional index funds that we invest in.

Pickering: I am chairman of BESTrustees. I'm a full-time and professional trustee of both DB and DC schemes, and in both contexts, fixed income is becoming more important. It's the income aspect that's becoming more important than the underlying capital characteristics of the asset class that generates the income.

Trustees are, in DB land, grappling with a binary debate about CDI or LDI, and have come to the conclusion that it doesn't matter whether it's a C or an L prefix, it's the income which is important. Likewise, in DC land, particularly if we're regarding a defined contribution scheme as a savings product that provides an income that doesn't peg out before you do rather than a cash cow, income generating asset classes have a really important role to play.

Abrams: I'm Mercer's lead researcher for global credit and absolute return fixed income. I echo what Kate *[Hollis]* has said, in terms of the long-term nature of most of our clients, we also see very little exposure to ETFs there. On the fiduciary side, which can be a bit more dynamic over a short or medium term horizon, again, little use currently due to some of the expenses associated with ETFs.

Hitchman: I am head of Fiduciary Management Advisory at Stamford Associates. A big part of our proposition is very much around contractual cash flows from fixed income. However, to date, there's been very little use of ETFs in what we do.

Sharma: I am a fixed income and multi-asset portfolio manager at Railpen. I work in the public markets investment team. In terms of ETF usage, we use them occasionally, but it's not a big part of our portfolio.

Chair: As expected, there is a mix of uses and uptake in ETFs across a variety of exposures around the table.

Lesne: Yes and, as has been mentioned, there are a lot of misconceptions or myths around ETFs too. On average, the usage of ETFs in traditional asset allocation is growing but does not represent the largest pool of instruments used by investors. There's however a lot of coverage from a sensationalist headline perspective – a lot more coverage of ETFs than we've ever had on index funds in particular.

Hitchman: My understanding is that the use of ETFs is much greater in the US than it is this side of the Atlantic. I would like to get your perceptions on the dynamics of what's driven that.

Lesne: ETFs were launched first in the US, so they've got the first mover advantage. Also, one thing that has been driving the growth of ETFs there is the fact that there are some tax advantages to the structure in the US. Those were certainly the initial big drivers.

After that, I would almost disassociate the US versus Europe argument, in terms of the adoption of ETFs. ETFs in Europe are still very much used by investors like those around the table today that include large institutional investors, large asset managers, large discretionary private management/portfolio management but still very little by retail investors when compared with other fund structures. So far, the growth trajectory has thus been very different.

We believe there is going to be convergence, ultimately. In the US, we are starting to see a lot more pension fund investors and insurance companies use the wrapper; insurance has seen a slow uptake but there's been a change in regulation which means that you may be able to use an ETF at systematic value in the US. This development could help increase the use of the ETF and treat it more like a bond rather than an equity. This is something that we have not seen in Europe yet. Regulation is very often a large driver of changes in habits and instruments uses.

Chair: In terms of how we have seen UK pension funds use ETFs, one of the ways in which they have used them is to access difficult areas, some of the more esoteric asset classes. Emerging markets is a good example, global convertibles as well, where a client or an investor would like to access a certain asset class, but they don't necessarily have the in-house capabilities or expertise to do so. So, instead of spending time doing manager research in an area they have limited expertise, they'll use an ETF to access those more niche exposures. That's been a big part of what we've seen.

Secondly, we have seen ETFs used as a liquidity sleeve. We find that institutional investors allocate a small portion of their overall portfolio to ETFs, mirroring the underlying portfolio. This allows them to facilitate any tactical allocations they may have or rebalancing, and also to be more nimble if they experience any outflows.

The final way we see ETFs used is more on the transition management side. If, for some reason, they have a manager and they are looking to move away from that manager, they may want to do that immediately, but they won't necessarily want to have that drag by holding that money in cash. So, they'll use an ETF in the interim, whilst they do the research on the new manager. Then, once they come to the decision as to how they want to allocate that money, they have not lost out on performance in the interim.

That's how we've seen them used, mainly, within the UK pension fund space.

Lesne: That's not so different on the continent. The types of uses of ETFs that you mention there are also very common. The markets where I've personally seen the biggest take up have been in the Nordics and in the Netherlands, where you also have some of the biggest pension funds. But we're starting to see that also develop in Italy, for example, and in other markets where regulation has changed to allow pension investors to start using this type of instrument.

It's very much regulatory driven, and in the uptake it's very clear that such instruments are used in the 'returns' portfolio of DB pension funds. DC is very different, of course, but if you are a DB fund, in the returns part of the portfolio, high yield ETFs or emerging market ETFs, for more tactical overweights, for example – depending on the cycle – have been of great use. We have also seen the use of investment grade corporate ETFs as well, and that has been driven sometimes by the challenge to access the market since the GFC. Price is of course a very important factor. We have seen things starting to change in relation to prices in the US, and they are also starting to change in Europe, where ultimately you will find ETFs which are as inexpensive as you could find in an index fund, and sometimes actually cheaper than index funds. So, that's something that ETFs are helping, and we are starting to see smaller pension funds use ETFs.

Responsible investment

Whelan: I head up the fixed income manager researcher team for Europe at Aon and, in terms of ETF usage, we have used ETF for managing flows and more tactical exposures to markets, but usage is still relatively light.

Lesne: There's a trend towards it generally and in the ETF space there has been some proliferation of products, but of course it is not huge. Looking at Europe, across both equities and fixed income ETFs, at the end of January this year, we had around €10 billion of ESG or socially conscious ETFs listed in Europe, according to Morningstar, of which around €1.2 billion was fixed income ETFs.

On may point to the lack of agreement on some standards around ESG as an impediment to a broader adoption.

Kumar: I agree, all the clients I have spoken to do not have a uniform perception of ESG – it means different things to different investors and until we have some sort of agreement on what exactly an ESG standard would be, then things can't move forward. As a result, most investors are going down a customised ESG version.

On a separate note, people are finding more uses for ETFs every day. I see much of the flows from active to index moves, for example. We also see clients who were invested in active funds, moving to more indexed funds via ETFs. So, from holding

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a few concentrated bonds, they get the full diversified basket of the universe at a very cheap level. If they had gone in the market and bought and sold the bonds, it could have been quite expensive. Given that the bid/offers of the ETFs are pretty small, the transition would have been done cheaply for even the most expensive asset classes like high yield or EM.

Pickering: Can you say a few words about the role of an ETF wrapper as a mainstream wrapper rather than a complementary wrapper? You did mention earlier the liquidity associated with ETFs. In DB land, those of us who are on a journey know that we may well get to risk transfer more quickly than we originally anticipated. Many schemes have got tailwinds rather than headwinds, and whenever we go into an asset class, or a wrapper, we want to know how easy it is to get out of it without being a forced seller. Likewise, we're trying to deploy the brainpower that was traditionally utilised in DB land, in the DC world.

One of the difficulties there is that, notwithstanding the long-term nature of the pension, we do have to provide daily liquidity. Again, can you comment on the role of an ETF as a mainstream wrapper, bringing together good ideas in a market that puts a premium on liquidity?

Liquidity

Chair: Absolutely. When we think about fixed income ETFs, the one element that is important to consider are the two areas of liquidity. So, there's both the primary market and the secondary market. The secondary market is where we see the fixed income ETFs trade intraday on exchange. This is, in times of increased volatility, a useful tool, because you can use the secondary market to match buyers and sellers, so it provides a tool for investors to trade relatively easily throughout the day.

The primary market is what comes into play when you're trading, for example, larger sizes of the underlying fixed income, and also when you perhaps need to redeem, and you don't see what you need on the secondary market.

So, the fixed income ETF market has this unique feature where there's both the primary and the secondary, and they both have the ability to provide liquidity.

What we find in stressed market environments is that ETFs could potentially offer additional liquidity compared to direct bonds. And, because you have this ability to trade on the secondary market, we see increased volumes, which results in fixed income ETFs trading more efficiently than the underlying bonds they represent.

Abrams: I can see how that secondary market liquidity is a nice feature for instant access, accessibility, transparency. ETFs are another menu option as a trading tool, but when it comes to a long-term allocation as part of an investment strategy, I think it's only fair to hold up those ETFs versus the broad market beta that exists.

What we see, for example, is high-yield ETFs fall short in terms of performance over the past few years, and you can explore the reasons why that is. It may be time-variant in nature, but as a starting point, high-yield ETFs track a subset of the most liquid bonds in the marketplace, hence they might be lower yielding, and they omit the less liquid, smaller part of the market – I think there are often good opportunities within that part of the market for making additional return.

Secondly, one of the things that I think is worthy of further exploration – and I think investors are right to ask questions about this – is around that primary market liquidity piece: when conditions change and if the market participants/the market makers decide to step away from trading in the market, that could move the price of an ETF away from its NAV. In this respect, you may be unlucky enough to buy an ETF at a significant premium and sell it at a significant discount – of course, it might be the other way around. But if you were after a long-term beta allocation to a market, I don't think it's easy to hold ETFs up as a panacea for access to that market, in terms of the beta. What we see in terms of our active managers, is that alpha can be variable as well. But if we take, say, the median statistic of our active manager universe, they have tended to outperform high-yield ETFs over the years.

Hollis: A related question for Abhishek *[Kumar]* – what do you do when part of your beta suddenly becomes totally illiquid – I'm thinking here of Venezuela, where since the sanctions went on, I understand the trading is essentially non-existent. J.P. Morgan is still pricing it within the index, but if they decide to take it out of the index, what will you do? How will you manage that exposure?

Kumar: We are lucky to have very little of Venezuela.

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As an ETF provider, one of our main points of focus is liquidity – that's why we have liquidity constraints in our funds. You have to think about the possibility that at a point in time, your universe will not be liquid enough and you should be willing to sacrifice a bit of the value for liquidity. Venezuela this year – at least in January – has been the best performing country though it can't be crystallised now due to sanctions.

You may have to sacrifice a bit of your return for liquidity. The bonds rated CCC and below are not that liquid so whenever a country gets rated as CCC by any one rating agency, we remove it. In doing so, we do sacrifice a bit of potential upward swing in price movement if they were to quickly bounce back.

For example, in Venezuela, if there's a change of regime and it bounces back, the rating agencies will likely upgrade it. There may be a delay in this review and we may lose a bit of initial rally.

Hitchman: But what if you have material exposure?

Kumar: If you have material exposure, then it can be slightly difficult. We have been in difficult situations before in EM, for example, we had problems in Malaysia in November-December 2016. Just after the US elections, the markets panicked and started to sell EM assets. Central Bank in Malaysia took an extreme measure and clamped down on currency repatriations and that created even more problems. So, we've had situations like that, where the market was difficult, and the trading costs were slightly elevated. But we haven't been in any very difficult situations in the past, at least in past seven years.

Lesne: An ETF is, to some extent, a tool that is used to express what the market price would be, if you were to do it. You can exchange shares of the ETF without having to trade the underlying. You're transferring the risk, and you have to pay for that action of course.

Sharma: It's also worth noting that ETFs aren't creating liquidity in the underlying asset class. If Venezuela is illiquid, it's illiquid for all portfolios, whether the exposure is through an ETF or through a segregated portfolio. Even in a segregated portfolio, as a manager, sometimes you would end up with securities that have become illiquid, and you end up holding them for a long time. So, as an investor, that risk doesn't necessarily go away if the structure is not an ETF.

Lesne: I think the risk is the same, as you said, for the ETF. From a liquidity standpoint, I'd say that it's either better for the ETF, because of the secondary market layer, where you exchange blocks instead of exchanging many, many bonds. Or it's as bad as what everybody would face – active, passive, any type of instrument. I cannot believe that an active manager would be any better of – we've got exactly the same trading desks. We've got very strong trading capabilities. If we face the issue, they will face it, unless ETFs are the only instrument being sold that day – and this is not what we experienced in previous volatility bursts.

Hitchman: A lot of this, for me, is about investors understanding the nature of the risks and the potential consequences. It's fair enough to say that with ETFs liquidity might be better, but that liquidity potentially comes at a price. My question is, what is that price? That price could diverge both positively and negatively relative to the underlying assets. So I come back to the question about what happens if you have a big chunk of assets in, for example, Venezuela.

How does that start unravelling over time and what do people see as the downside risks – because if you're a large pension fund and you're sitting on a bond portfolio, then what you're really worried about is default risk, and may be well placed to sit and ride through the volatility. But if there's a market event with an ETF and that forces the ETF to unwind, forces it to sell, that is a dynamic that might be a concern for a pension fund holding ETFs.

There are a lot of people who are positive about ETFs but there are also a lot of concerns out there, and until we've got over that, and there's complete transparency around what they are and the nature of the embedded risks, there's going to be nervousness around them.

Cheseldine: This links back also to Alan *[Pickering's]* point earlier – that pension trustees are investing predominantly for income.

Sharma: Within the ETF structure itself, are there mechanisms to deal with part of the portfolio becoming illiquid?

Kumar: There is. We explored that option when Malaysia started to seize up. You create a sub-fund, which is just a buy and hold account, and the ETF gets a share of that sub-fund. Then, as and when that sub-fund is liquidated, the ETF is paid back.

Sharma: What happens to

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redemptions from the ETF?

Kumar: The investors get a share in that sub fund and cash.

Lesne: There's a price there that someone will be willing to pay on that – it might not be a nice price. But that's a cost of liquidity, and that's very well known. If you're trying to sell your Venezuelan bonds today, for example, there is a market for it, but you might just not like the price. However that's the current market price. That's what you will see being reflected in the ETF. So, the same thing would happen for an active fund or any type of fund, which gives the potential to investors to be trading, at least every day or every week.

Sharma: But there are securities that sometimes just don't have a price for a period of time.

Kumar: As an ETF manager, I want my investors to challenge me on the liquidity of the ETFs. That's what I think is missing. If you look at the biggest ETFs in Europe, they continue to hold defaulted bonds, because it is an allowed investment. Then you should question – is this liquid enough, and you should be holding it?

Sharma: What happens if there are large redemptions? Does the last holder get left basically with an illiquid portfolio?

Kumar: No, every investor is treated fairly. As long as you think there is a price, it is continues to be in the main pool; if it's deemed that a price is no longer available, that it can't be sold, then it has to be carved out, and it's put in a sub fund and each investor gets a share, so that every investor is treated fairly. The last one out doesn't suffer.

Aspinall: But who is this for? Ultimately, I fully understand creating a new layer for retail, to enable me to put a pound into a broad market. That's great. As a buy and hold investor, I give up a lot to go through any pool, so is this just the next competitor for UCITS, for example? Is that the positioning? In which case, it's a scale thing for trusts. They'll go through this phase, some of us might be lucky enough to get out the other side. Even in that tier, why would I put the retail guys in, because their panics become mine. I'm sharing panic. Why would I put liquidity between those two groups – the market does that already for me?

Lesne: In answer to your question, who is this for, it's meant for everyone. Do you want to share your risk with others? That's the question you've got to ask yourself in your position.

Aspinall: It's a subtly different question – I already share my risk with others, through the price mechanism of the underlying market. Everyone trades in the same place but if I divide those trades between five or 10 pools, then I must be in a lower liquidity environment overall, even if fundamentally it's simpler because there's aggregated trading at the top level. So, you're not creating any more liquidity at any part of the system, just moving it around.

Also, I get all the transition arguments that are made around ETFs, that they can help us go from A to B a lot smoother. I'm not quite clear as to how they save transaction costs.

Lesne: It's the secondary market – it's where the intermediary is doing this. They may hold, actually, some of the paper, and then deliver this. That's where this mechanism of creation is not necessarily always for cash, it can be for bonds, and someone may be holding bonds as in inventory, and making that market. Ultimately, you're going to pay for the risk you're taking, but everybody is.

Abrams: There's also opportunity cost to consider. This is maybe a side argument, but we're also talking about passive versus active management in some of these more volatile or less liquid markets. If you need to use a stratified sampling technique to replicate, for example, high-yield markets in the first instance, that involves an active decision. If you're applying that active decision in a naïve or systematic way, my view is that if you're in a more volatile and less liquid market, you can generate a better outcome using an active approach. Opportunity cost also needs to come into the equation, as well as the transaction cost element.

Lesne: We are facing the same issues as any active manager. Afterwards, you've got to find the right active manager in terms of doing the trade-off in terms of sampling, or trying to replicate beta. Then if the active manager has got to sell, because there's a redemption, they would be facing the same issue that everybody does.

So, the point for us is, in order to mitigate some of that risk (we cannot eliminate that risk completely), we're looking for diversified indices. I agree that high yield is maybe a less liquid universe, but if you're thinking about the high-yield liquid index of 10 years ago, and the high-yield liquid index of today, it's a very different animal. You had 80-100 bonds 10 years ago, maybe 200 in the US. Today, you're talking about close to 1,000 bonds. It's a really important point for us, because in order to dilute that specific idiosyncratic risk at issue or at bond level, we need to have this diversification.

It comes back again to the question of how you define the index that you're going to track. That is investable and diversified enough so that one can replicate its characteristics and returns patterns. That is what we provide you with: the best possible beta in that context.

To your point, you might want to have a beta that is also including the illiquid premium. That maybe is something different.

But ultimately, an ETF is becoming a financial instrument like other types of instruments – it's the secondary market layer that is helping it. If there are big enough funds that can trade easily, like you would add futures on some exposures, then you can have a global aggregate ETF for example, which is cheap enough, and at least trading day in, day out, because of this liquidity element. That's a way for you to get beta on the cheap, that you can't really do or replicate with futures and derivatives as they do not provide a similar level of granularity.

Abrams: What we're talking about here, in the main, is 'context'. Everybody has a different situation, a different objective. I can see these as part of the menu options as implementation tools, I can see how ETFs fit, even though I have some concerns on the long-term investment side. So, it's really got to come down to what suits each individual investor, and what the situation is.

Lesne: And the constraints that you have in your trustee or in your fiduciary position.

Cheseldine: It also depends on the market context as well, because it's liquid until it isn't, and some of us still have the bruises from 2008.

Chair: One liquidity element which is important to note is, as banks have been forced to reduce their balance sheets, they're now holding less risk. So, as a result, it has become more difficult for investors to trade direct bonds due to the reduced liquidity offered by the banks.

A useful tool

Hollis: All of this discussion is great, if you want liquidity. Our clients however don't have the governance to trade very often. So, therefore, we find ETFs extremely expensive, compared to conventional index trackers. Why would we buy them?

Lesne: That's where the cost of ownership, is clearly coming into play. ETFs have different applications for different types of investors. For example, smaller pension funds might not actually be able to get such low fees on an index fund or on a segregated mandate from large managers. That's the first point.

The second point is, you are starting to see interesting products in Europe. As an example at SPDR, we've have a global agg ETF at 10 basis points TER, for example. How much money do you need to get on the table to get a TER (so not only the management fees, but all the fees bundled into that), to manage a global aggregate? It's likely to be pretty high. You're talking several hundreds of million dollars to get a well-diversified global aggregate portfolio, at a TER of 10 basis points.

Whelan: You can also end up getting paid if you are willing to lend units in certain asset classes, which can increase

the attraction of holding ETF.

Lesne: Yes it's clearly about how to use it, what you should use it for, and maybe it's better for DC than for DB in some cases. It has an application because it's a financial instrument. Our task is to make sure that we provide a sufficient diversification of exposures that you can use at your leisure in the construction of the portfolio.

Whelan: It's almost analogous to the debate over how one accesses credit. Do you buy the physical bonds, or do you do it synthetically? There are pros and cons in both. People will point to historic examples where CDSs have better liquidity, but there's always the other issues. Lots of clients don't like trading CDS because they fear for when it comes off the run which is contradictory to the argument of they don't need all assets to be immediately liquid. So, there's not a right way or wrong way, it just depends on what you're trying to achieve and how to do it.

Hitchman: What proportion of bond ETFs or credit ETFs are passive as opposed to active?

Lesne: Most ETFs in the credit space are index tracking. There are a few which are managed actively with proper active management and they often use derivatives to manage duration, or to manage credit risk and so on.

Abrams: Do you lose that transparency you get with passive, with active?

ETF roundtable

Lesne: You might lose some of the transparency, but it's a choice from the issuer really whether you give transparency or not. For our ETFs in EMEA we give transparency every day. Some providers decide to delay the information, however this may evolve as regulation in EMEA is become tighter, especially in Ireland.

Hitchman: A key issue here for me in considering this is the active/passive debate. If an investor believes these asset classes should be actively managed, then from my perspective there's probably limited scope for the use of ETFs, other than perhaps to help with transitions.

Emerging markets

Chair: That's an interesting point, because one of the trends that we are seeing is an increase in usage of ETFs within emerging markets, which is traditionally an area where investors believe that it benefits to go active.

Kumar: I agree. However, if you look at the top 30 largest active managers in Morningstar, only one outperformed the benchmark in the local currency space last year. The performance in hard currency was something similar, but a large majority of them underperformed the benchmark. This was net of fees and this underperformance was material.

EM is an inefficient asset class and the perception is, the more inefficient it is, the better chance active managers have. But EM is just so inefficient that active managers actually do not have a chance. Sometimes you absolutely do what you should do be doing, what the most sensible person would do, but the market is just too irrational, and it reacts too quickly.

The perception is that the market is illiquid, it's inefficient, so it possibly means that you have to better hedge your risk. You have to diversify exposure far more which active managers tend not to do. As indexed managers we too have to make active decisions. Every bond that we buy is an active decision, because we simply can't fully replicate the index and buy every single bond in the same proportion. However, given that we are so well diversified, our expected loss from unexpected market movements is a lot lower.

Lesne: When you look at the industry in emerging markets, in most volatile periods, when the active manager is supposed to have the right security selection, and promises you that it will actually smooth the drawdown, that's actually when they underperform the most. So, that's why we believe in the diversification element. Whether you like active or passive, diversification will be a key attribute.

Aspinall: There are lots of wrinkles in financial data that I don't think ETFs iron out, but they may well start to address. Down the line though, they may create more wrinkles. That would be my observation. So, does the benchmark have any relevance to my members' objectives? No. Inflation is relevant to their objectives. Their own longevity is relevant to their objectives. Their own job is relevant. So, if the active management and passive management industry want to go off and sniff around meaningless benchmarks, then they're not selling to the needs.

Also, the ownership of a security – and this is probably more of an equity concern – is a key piece of leverage for an institutional investor, because I can now walk into the boardroom and make demands. What does the ETF universe do with that?

Lesne: In the equity space, State Street Global Advisors takes its role in this area very seriously and we are big on stewardship and have a dedicated voting approach that we report on. It's part of the ETF package, that you go with the way State Street Global Advisors will vote on that.

Abrams: In terms of active management in EMD, I would challenge the notion that the benchmark is the best diversified way to access the opportunities there, as a starting point.

If you're doing a good job, as a passive-tracker, you've got to match the index, and all the idiosyncratic risks that come with it. You don't necessarily need to select a particular bond that witnessed that experienced a market jump, versus the other bond. But you do need to track the risk factors of the index in a fairly sufficiently granular manner in order to get your overall exposure. So, perhaps you will tend to own the 'Venezuelas' on the way down, whereas an active manager does not have to do the same thing. In terms of the benchmark itself, weights are capped at 10 per cent. There are some very large constituents, there are some very small constituents, but an active manager – granted, they may hold themselves up versus the benchmark – don't need to have those exact weights.

I will concede the last year was a disappointing year for active management versus the benchmark. Over the last five years or so, what we've seen is active managers in the EM space have tended to be long of the asset class in general, certainly EM FX, long the high carry of the asset class looking for value opportunities. I don't believe that's necessarily done in a naïve way, but it hasn't served asset managers well, particularly in an environment where EM as a whole has not performed well. I do believe going forward that active management will prevail in this market place, because it is a market with its idiosyncrasies and you don't need to be exposed to some of the tail risk on the way down.

Chair: Abhishek *[Kumar]*, one of State Street's strengths in the passive space is fixed income and in particular, emerging markets. Why is that?

Kumar: Investors need to remember that EM is an expensive asset class because buying and selling bonds and FX is expensive. There are taxes to be paid. Most of the market, or a big part of the bonds in the market, are not that liquid.

If you go for an active manager, sometimes you might win but most often you might underperform the index. If you go for pure, fully replicated indexing, you are guaranteed to lose a lot more. For a fully replicating fund tracking the J.P. Morgan Index in 2018, you would have lost about 60 basis points versus the index. In the year before, you would have lost about 95 basis points. The cost of full replication is expensive in EM, local currencies, especially.

Given the costs, we are careful about what we buy and sell and how we buy and sell. If you can do that, the cost of replication, or the performance versus your benchmark, can be a lot better. In EM, more so than in other sectors, by making informed choices about the bonds you buy, you can bring in a lot of value and reduce underperformance vs. the benchmark.

We do take active positions in trying to choose the bonds, but they are a lot smaller, and they are much thoughtful, we're careful about the bonds we choose, based on the tax profile, careful about the bonds we sell, if they're too expensive to sell. We spend a lot of time trying to improve the trading capabilities, so that the bid offer that we give to the ETF investors is 15 basis points. All of that has come from being invested in this business and spending a lot of time in improving and what we do.

Whelan: Are you able to try and mitigate things like withholding taxes further, where possible?

Kumar: The cheapest and the easiest way to do this would be to buy the low coupon bonds. But many countries try to create structures which force you not to, in which case we do different things to keep the costs down.

Chair: What sort of flows are we seeing now into the emerging market fixed income space?

Kumar: We have gone from investors shying away from EM exposures, to EM now becoming a consensus trade. Everyone is long EM, or that's what the perception is. We started to see this trend way back in December 2018, from the research that we have done – the State Street Global Advisors Bond Compass report, which shows bond flows and holdings indicators, taken from a data set that represents $10 trillion of assets under custody with State Street.

Lesne: From this report, we are trying to demonstrate what investors like those around the table today are doing; what the long-term pension, insurance, sovereign wealth or central bank money is doing. In order to look at that, however, you can't really put a dollar number on that and compare EM versus US Treasuries. The holdings are very different. Those patterns are very different. So, we use the percentile distribution of where the holdings of this book of investors is, versus its five-year average.

We take five years rolling period every quarter. We do the same for the average buying or selling activity and we rank them in percentiles. For example, according to the underlying universe, investors were in the third percentile of holdings when it came to emerging market debt. So, they have only 3 per cent of the time over the past five years have they been less invested in emerging markets debt than what we see today.

In the period of the fourth quarter of 2018, they had only sold more bonds 17 per cent of the time. So, they were still selling. In short investors were being quite underweight.

Saying that, while we see that investors were mostly selling emerging market debt over that period, they actually – and we're talking local currency – started to buy back at the end of the year on a more tactical basis.

That's an interesting pattern which we have also started to see in ETFs, and which we are expecting to see follow through in ETFs and possibly in the active funds universe too.

For a copy of the latest State Street Global Advisors Bond Compass, please visit www.spdrs.com/fixedincome