

Fixed-Maturity Bond Exchange-Traded Funds

Drawbacks of investing in single bonds include the time and effort required for bond portfolio management as well as the possible challenge of achieving sufficient diversification. Drawbacks of investing in active bond funds include high fees, a high probability of significant underperformance over time and the fact that investors are always exposed to what is called “duration” and “credit-spread” risks (addressed below), even when buying the safest and shortest-maturity bonds. The latter drawback also applies to investing in the standard passive bond exchange-traded funds (ETFs). Fixed-Maturity ETFs provide a potential sweet spot.

Characteristics of fixed-maturity ETFs

Fixed-maturity ETFs are ETFs that **expire** or redeem (with all proceeds returned to investors) at a predetermined date, such as 5 years into the future. The fixed-maturity ETF itself in turn purchases bonds maturing within and close to its own maturity date.

A second characteristic is the **passive management** of the ETF. The fund purchases a set of bonds with predefined characteristics. There is no or minimal trading activity once the bonds are initially purchased.

Another characteristic is that, with a high degree of confidence, the **yield is known** at the time of purchase. Further, in the event of no defaults, the yield approximates the end return. With a continuous or ongoing bond fund or ETF, even with no defaults, the return at the end of the investor’s holding period is not known in advance.

Finally, along with the passivity of the fund, comes low management **fees** as well as lower “drag” from any bond buying and selling (due to the differences between the bond bid and ask prices as well as any commissions paid by the ETF to its broker for executing the transactions). The cost burden of an active retail bond fund may be 10 times greater than that of a passive fixed-maturity ETF (for example, 1.5% vs. 0.15%)

Duration risk

Duration risk can be thought of as the risk of receiving lower proceeds from the sale of a bond fund or ETF simply because the general level of interest rates have risen. A standard bond ETF or fund will always be subject to this (as they are continuous) while this risk will be eliminated at the *end* of the life of fixed-maturity ETF or single bond.

To illustrate duration, consider the US Treasury bond paying coupon of 4% and expiring in November 2035 (ISIN US91282CPJ44), currently trading at USD 98.2. If the general level of interest rates and yield rises by one percentage point tomorrow, the price of our bond would decline to around USD 90.7, a drop of nearly 8%.

Credit-spread risk

The yield of a bond (which generally approximates its coupon at issuance) has two components. A risk-free component and an additional premium to reflect the riskiness of the specific bond issue.

The latter is the credit-spread component. During the life of the bond, the credit-spread component is variable. Only at maturity of the bond, assuming no default, is this risk eliminated.

Credit-spread risk is similar in concept to duration risk but in this case the price change of the bond is not due to a general change in interest rates but rather due to a change in the perceived risk of our specific bond. To illustrate, consider the UBS 3.875% 2037 bond in Euros, currently trading at EUR 100.2 and yielding 3.8% per annum. This yield is approximately 1% higher than the yield of a German government bond (the risk-free yield) of similar maturity. If suddenly, the perception of risk of UBS changed and investors demanded a 1.5% higher yield instead of 1%, the price of our bond would decline to around EUR 96.3 or a decline of nearly 4%.

To be clear, the duration and credit-spread risks, may also work in the investor’s favor should interest rates and credit-spread turn lower.

Taxation

A word on taxation is appropriate. For tax purposes, direct coupon income of a bond may be treated differently from the cash distributions or dividends of a bond fund. In addition, the domicile of a fund may influence the tax treatment of payments.

In the **United States**, for example, dividend distributions and coupons payments are treated differently for withholding tax purposes. Generally, coupons are not subject to withholding while dividends are. Further, distributions of a US bond ETF (whether fixed-maturity or not) are treated as dividends. If you are a Swiss resident, the US withholding tax is generally mitigated due to the double-tax treaty with the US. If you are a Dubai resident, however, where no double-tax treaty exists, withholding tax would be a significant disadvantage and income-distributing US bond ETFs would be discouraged.

What about **European** fixed-maturity bond ETFs? Many EU countries do distinguish between dividend income and coupon income. However, the fixed-maturity European-listed bond funds in our ETF collections are domiciled in Luxembourg or Ireland (even though they are exchange-listed elsewhere) where no withholding tax is expected in dividend payments.

Opinion

While institutional investors may have a different view, the fixed-maturity character of a bond ETF is a significant and understated benefit to individual investors.

The universe of available fixed-maturity funds is relatively small. Take advantage of what is available.

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