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Better (And More!) Bond ETF Choices

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Last week was a busy one for launches of new ETFs tracking bond indexes. Barclays' iShares continued to expand its bond offerings (which now number 16) by introducing the first high-yield (or "junk") bond ETF, and Vanguard finally entered the fixed-income ETF arena by launching four products tied to its existing bond index funds. Heretofore, Barclays had been the only ETF manager providing bond ETFs, so this is a welcome development for ETF investors, especially since Vanguard's bond ETFs are superior to iShares' bond ETFs with respect to fund expenses and the strategy employed to replicate the underlying bond index.

To illustrate why we believe that Vanguard's bond ETFs offer formidable competition to bond ETFs from Barclays, it is well to consider funds from the two companies that track the same underlying index. In this case, we will examine the two firms' ETFs that track the Lehman Aggregate Index (symbol: AGG in the case of iShares and symbol: BND in the case of Vanguard).

First, BND has an annual expense ratio of just 11 basis points, whereas AGG is priced at 20 basis points. This difference in expenses may seem small, but it is meaningful in the context of today's low interest rates; as Vanguard is fond of reminding us, these savings add up over time. Second, and as important, is the methodology used to replicate the underlying index. The Lehman Aggregate is a very large index containing several thousand individual bond issues. Barclays uses a representative sampling technique, in which it seeks to capture the vast majority of the returns of the index by holding a relatively small (i.e., 140 bonds) subset of the index. Vanguard, in contrast, provides much broader coverage of the index, holding over 2,500 bonds in its fund. This more complete representation of the index, combined with lower expenses, appears to have produced better performance. Over the past five years, investors in Vanguard's Lehman Aggregate fund (from which the ETF is now derived) would have enjoyed annualized returns approximately 30 basis points higher than investors in iShares Lehman Aggregate ETF (symbol: AGG).

Another noteworthy development occurred last week in that a new asset class was opened up for ETF investors. Barclays last week brought to market the first ETF tracking high-yield corporate bonds --- the iShares iBoxx High Yield Corporate Bond Fund (symbol: HYG). A junk bond ETF is a significant and long-awaited addition to the ETF arsenal, and the asset class has been an outstanding one over the past five years. High yield bonds have delivered 10 percent annualized returns over this period with volatility of only about 60 percent of the S&P 500. However, we do not expect to be adding this security to our portfolios any time soon, given our judgment that the risk/reward on the junk bond asset class is currently unattractive.

The high yield corporate bond asset class currently offers yields of approximately 7.5 percent, or about 280 basis points above 10 year Treasuries. Junk bond yields and credit spreads (spreads over Treasuries) have narrowed dramatically over the past five years, and are at or near the lowest levels we have seen in the past 20 years. Since 2002, junk bond yields have declined from 14 percent to under 8 percent, and spreads have contracted from over 10 percent to below 3 percent. Since 1990, the average spread between junk bonds and comparable maturity Treasury bonds has been 460 basis points.

Default rates on high yield bonds are the key variable which determines their spreads to Treasury bonds. The high yield default rate at present is 1.8 percent, which is very close to a record low. Low current default rates and credit spreads reflect an environment where junk bonds appear to be priced for perfection, and the financial markets are supporting higher and higher amounts of leverage to support record LBO activity, which, if history is a guide, may be signaling a peak in the credit cycle.

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based portfolios.

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