ASCENT Investment Partners

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The Risks in Passive Bond Mutual Funds and ETFs

Exchange traded funds (ETFs) continue to proliferate throughout financial markets because the structures allow individuals to invest with lower fees than traditional asset managers or mutual funds, or to buy products and structures that could not otherwise be easily purchased (equity indexes, volatility products, leveraged products, etc.). Though they are most prominent in equity markets, ETFs have gained some popularity in the fixed-income markets as an alternative to owning individual bonds or bond mutual funds.

Fixed-income ETFs are typically passively managed. Like passive mutual funds (e.g., index funds), they seek to replicate the results of a benchmark index rather than being actively managed to maximize returns. Passive bond investments have an appeal like that of an equity index fund: an investor should achieve a return that is approximately the same as "the market" while holding an investment that has excellent liquidity and lower fees than an actively managed mutual fund. While these features may be appealing, there are risks to owning passive bond investments for investors seeking safety of principal, a competitive total return and the ability to adapt to changing market environments. Passive bond investments are susceptible to poor price performance in volatile financial markets and rising interest rate environments. They also introduce credit risk and index matching issues. For these reasons, passive bond investments are not equivalent to a well-structured portfolio of bonds and they may not be suitable for investors seeking a stable and secure core fixed-income holding.

Ascent Investment Partners' approach to bond portfolio management provides investors with all the benefits of active portfolio management – a top-down strategy based on our economic and interest rate outlook; bottom-up investment selection rooted in fundamental research and diligent credit selection; and the ability to custom-tailor portfolios for an individual's specific investment needs (risk tolerance, income needs, tax considerations, etc.). Because safety and stability are the primary reasons investors include a fixed income allocation in their portfolios, we carefully balance risk and after-tax return in every investment decision. However, Ascent also provides investors with some of the benefits usually associated with passive bond investments like ETFs or passive funds:

- Ascent's fees are equal to or lower than the management fees charged by ETFs and passive bond funds. Ascent offers investors the benefits of active portfolio management without the cost usually associated with such managers.
- Ascent's client portfolios are very liquid because they are invested in only high quality, highly marketable fixed income securities.

Moreover, Ascent's approach to portfolio management minimizes seeks to minimize the most significant risks facing investors in passive bond ETFs:

1. **Price performance in changing market environments.**
   Passive bond mutual funds and ETFs can show price performance that underperforms their benchmark indexes or actively managed funds in an environment of market volatility and/or rapidly rising interest rates. ETFs and passive funds are structured to operate indefinitely, without maturity dates. The portfolios are managed to maintain a composition and relatively constant duration that mirrors the reference index. (Duration is the price sensitivity of the fund to changes in interest rates; that is, how much the price of the portfolio will fall if interest rates rise.) Individual bonds eventually mature at par regardless of price fluctuations during the holding period, and individuals typically buy bonds with the intention of holding them until maturity. ETFs are typically shorter-term investments that see a great deal of selling pressure as their market prices decline, and funds and ETFs can trade at prices that are below their net asset value (NAV, the market value of all of the bonds held in the fund divided by the number of shares outstanding).

   In a rising rate environment, all bonds will have price declines as market yields increase. An active portfolio manager like Ascent will adjust our portfolio holdings and buying strategies to best position clients as the market changes. This could mean adjusting duration, raising cash, adjusting sector or geographic weightings or other changes. In a passive fund, investors are forced to maintain a constant duration and weighting, regardless of how that mix might position them. Should investors want to lower their exposure to bonds, they will be forced to sell ETF or fund shares at the market value, which guarantees that they take a loss on the holding. In contrast, Ascent's portfolio managers can use bonds maturing at par to generate cash or can selectively sell bonds to limit losses in a way that is impossible to achieve in a passive fund.

2. **Concentration of credit risk.**

   Bond ETFs and indexed mutual funds tend to have concentrated credit risk that may be unsuitable for conservative fixed-income investors. Like equity indexes, most bond indexes are capitalization weighted. In the fixed-income space, this means that indexed funds and ETFs are most heavily invested in the issuers with the most bonds outstanding in their market segment. In many cases, the largest issuers may be mid-grade or weaker in credit quality and heavily dependent on debt financing to support their capital structure or ongoing operations. While this type of weighting may be advantageous in a declining rate environment, in a rising rate environment it introduces significant risks to investors.

   When rates rise, credit pressures rise most significantly on lower rated issuers. Companies and municipalities that are rated in the low 'A' or 'BBB' rating categories face greater financial difficulties as their costs of refinancing and servicing their debt grow with rate increases. Since indexes tend to be more heavily weighted in these mid-grade and lower-quality credits, they are disproportionately at risk for rating downgrades in rising rate environments as compared to higher grade portfolios.

   Additionally, as rates rise, credit spreads widen – the difference in yields between different rating grades gets bigger. For example, the yield on 'A' rated corporate industrials might increase from 80 basis points (80 bps, or 0.80%) higher than comparable maturity Treasuries to 110 bps (1.10%) higher than Treasuries. The lower the rating, the more credit spreads tend to increase as rates rise. A fund or ETF heavily weighted toward lower quality bonds will perform worse than one comprised of higher rated bonds as rates increase because of this feature.

   A dynamic unique to municipal ETFs is concentration of credit risk in related entities. While a fund may hold a variety of different issues that it considers as separate issuers- from a state and that state's agencies, for example - in reality all of the ratings are linked and will move in tandem if there is a rating change. The most popular tax-exempt ETF (MUB/NYSE; the iShares S&P National AMT-Free Municipal Bond Fund), for example, holds 23.12% of its portfolio in California, which is annually the largest single issuer of municipal bonds and is currently the lowest-rated state in the nation (A1/A-/A). While the fund holds a variety of different bonds issued within California, which would appear to provide diversification, the majority of the exposure is either in bonds issued by the State or in some way supported by revenues from the State. As a result, any change in credit quality on the state level will drive rating changes for most of the California holdings that are in the portfolio.

Ascent's approach to credit selection is designed to avoid concentration risk while maximizing credit quality. Ascent builds portfolios comprised of high quality issuers with a concentration of no more than 5% in any one issuer.

3. **Index performance matching.**
   ETFs and indexed mutual funds can achieve results that differ substantially from the reference index. Unlike an equity index that may contain a few hundred securities, bond indexes may contain many thousands of individual securities. This makes it impossible for a manager to replicate the index – instead they use a "sampling" strategy to build a portfolio that contains many of the same issues as the index, with similar aggregate state and sector weights, and that exhibits a duration that is equivalent to the reference index. Because it is hard to replicate a bond index, it is hard to match the index performance through every market cycle and the concentration risks mentioned above can magnify the impact of price changes due to rating downgrades or credit spread changes.

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