Benchmarking Fixed Income

KEY TAKEAWAYS

- Indices can appeal to an audience ranging from the largest institutional investment managers down to individual investors. Included in this audience is the media, which reports on the performance of bond markets and individual sectors. The ability to measure return performance and investigate the contributing components can facilitate a better understanding of an investment.

- Continuous reevaluation of benchmark indices is necessary to ensure that they meet the requirements of any particular investment objective.

- The adoption of new ETF structures in fixed income has driven demand for alternative approaches to indexing.

HISTORY & EXPERIENCE

The concept of creating indices to measure the performance of financial markets dates back to the founders of our company: S&P traces its history to Poor’s Publishing, founded by Henry Varnum Poor in 1860 in Boston. Poor’s Publishing printed both the “History of Railroads and Canals in the United States” (1860) and “Poor’s Manual of Railroads” (1868). The manual was the first investment guide to cover securities sold by railroads. The Standard in S&P was Standard Statistics Corporation, founded in 1906, which merged with Poor’s in 1941. Bond ratings began in 1922-1923.

Indices have been used to measure performance for all aspects of the equity, fixed income, commodity, volatility, real estate, and healthcare markets. The investment community needs a means by which to gauge the market in order to quantify issuance, trading, and performance measurement.

Recent scandals, such as the LIBOR scandal of 2012, have led to the introduction of the IOSCO Principles for Financial Benchmarks for index providers.

The Role of Index Providers

With the tremendous growth and broad global acceptance of index-based investing, index providers are receiving more attention. Questions regarding business structure and corporate ownership, the strength of the calculation infrastructure, access to and roles in providing market data, and other salient issues have become important elements of due diligence and regulatory conversations. Index users demand that there be a reputable service provider behind their benchmarks and investments.
As the world’s largest resource for index-based innovation, data, and research, S&P Dow Jones Indices brings independent, transparent, and cost-effective solutions to the global investment community. Changes in markets and the investment vehicles used to access those markets have driven the need for innovative index design. Our goal is to continue to anticipate and respond to how our clients see global investment opportunities.

Who Are Index Consumers?

Consumers of indices span an audience from individual investors up to the largest and most well-known institutional investment managers. The media also consumes index data and integrates it into reports on the performance of bond markets and their individual sectors. For analysts, portfolio managers, and individuals, the ability to measure return performance and gain insight on the attributing components can facilitate a better understanding of an investment.

Even hedge fund managers consume index data, not necessarily to measure the total return performance of an investment, as they tend to follow assets that can have fast turnarounds and vary among numerous products, but rather for price discovery and the time series an index can provide. An index’s past performance can be used to display historical trends, and it can feed forecasting models and other analytical tools. Indices themselves do not forecast, but instead show current and past market activity.

The advent of exchange-traded notes (ETNs) and exchange-traded funds (ETFs), together referred to as exchange-traded products (ETPs), have “democratized” bond markets by opening up avenues of investment to the general public, for whom purchasing individual bonds was often prohibitively expensive. Index-linked products have been a means for smaller investors to gain exposure to markets that might not be accessible to them otherwise.

BROAD-MARKET AND BENCHMARK INDICES

Bond indices have been used as benchmarking instruments for measuring the performance of bond and money market investment portfolios for almost 40 years. The ability to integrate complex pricing algorithms and associated terms and conditions data in an over-the-counter market has helped provide structure and transparency to the overall fixed income market.

Large series of indices have been created to cover different fixed income asset types, varying geographical regions, and numerous industries and sectors. Until recently, the methodology for weighting securities in bond indices had been mostly based on market valuation.

The basic goals of a benchmark index include the following.

- **Index Objective**: It must be clear what the index intends to measure or track.

- **Fit**: A benchmark index should represent a defined set of fixed income asset types, maturity ranges, industry sectors, credit ratings, allocation goals, or risk tolerances to measure the performance of a variety of investments.

- **Transparency**: A benchmark index should have a publically available methodology.

- **Sound Governance**: A benchmark index should have robust governance processes without conflicts of interest.

- **Robust Control Framework**: A benchmark index should have proper checks and balances to facilitate consistent calculation and conformity with its methodology.

1 Though it is important to keep in mind that past performance is no guarantee of future results.

A number of market participants have stated that some of the broad-market indices used today are flawed. Their argument is that market-value-weighted indices may not have the properties of a good benchmark, and therefore these indices may be failing to deliver their primary objectives to investors and asset managers. Market-value-weighted indices continue to measure what they were designed to measure, which is an asset-weighted depiction of the market that is similar in concept to capitalization weighting in the equity space.

Another interpretation is that the investment objectives of benchmark users have changed over time due to recent alterations in monetary and fiscal policies and with regulatory oversight. Recently developed products and newer approaches to index structures have provided the opportunity for investors to consider alternatively weighted fixed income indices and to reevaluate the way in which they benchmark their fixed income holdings.

THE STRUCTURE OF ETFs

The adoption of new ETF structures in fixed income has driven demand for alternative approaches to indexing. ETFs are unique in the realm of fixed income in that they are traded on a stock exchange, while bonds are generally traded over the counter. This vehicle has increased efficiency in and access to fixed income markets. A recent study of institutional investors conducted by Greenwich Associates found that 59% of U.S.-based fixed income ETF investors surveyed have increased usage of ETF’s since 2011, with many turning to ETFs as a liquidity enhancement tool.3

One challenge for ETF providers is ensuring that the representative fund tracks the performance of the underlying benchmark index. Any deviation in performance from the index is known as tracking error, which is viewed quite negatively, especially by institutions. In order to manage tracking error, the ETF provider will usually choose a representative basket of bonds that captures the overall characteristics of the index, but with fewer, larger, and more-liquid issues. Due to liquidity, the difficulty of minimizing tracking error is higher in a corporate issue than it would be in a government issue. The efficiencies of maintaining a fixed income basket supporting an ETF product have been observed in the market, showing that for every USD 8 of fixed income ETFs traded, only USD 1 of actual bonds change hands. As a result, the burden of the draw on underlying bond market liquidity is lessened, while the actual liquidity available to the market increases.4

Stricter capital reserves and costs imposed upon financial institutions by Basel III and Dodd-Frank have led to a change in market participants’ behavior. Financial institutions have been less willing to hold bond inventory and no longer provide market support through proprietary trading desks. This behavioral and structural change has led to less liquidity in the markets. Bond ETFs may provide flexible and active trading, market quote transparency, the ability to margin, short-selling capabilities, and options trading. One-third of the institutional ETF users in the Greenwich Associates study are employing ETFs as liquidity overlays to gain easy exposure, increased liquidity, and diversification.5

THE EVOLUTION OF STRATEGY INDICES

Given the increasing innovations made by ETF providers, the indices that underlie ETFs have had to provide more sophisticated features, as well. Some of the new approaches to indexing that have been developed to meet the strategic needs of investors and ETF product providers include the following.

- **Equal-Weight Indices**: This is a simple approach that assigns an equal distribution to each of the index constituents. However, this approach can require excessive holdings in thinly traded or illiquid securities.

- **Liquid Indices**: These indices are structured to increase the liquidity of the constituent holdings. The simplest approach is to increase the minimum par amount for inclusion in the index so that the larger and, presumably, more-liquid issues are included. Another approach is to incorporate a liquidity score or a trade volume measure that screens for more-liquid issues.

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3 Greenwich Associates, “Bond Market Challenges Continue to Drive Demand for Fixed Income ETFs,” April 2015, pg. 3.
Benchmarking Fixed Income  

- **Fundamentally or Factor-Weighted Indices:** The weighting methodology of this style of index incorporates a measure of the issuer’s ability to service its debt. Publicly available accounting measures, such as sales, issuer cash flows, book value of assets, or the level of dividends, are some of the factors that can be incorporated into the approach.

- **GDP-Weighted Indices:** The weighting methodology of these indices relies on a country’s GDP in comparison with the total GDP amount for all the countries in the index. The weight of each constituent is dependent on its GDP level, rather than the market price, so a rising GDP will increase the weight of holdings, even if interest rates or inflation have reduced the price of those holdings. In a market-value-weighted index, the weight of an issuer increases (or decreases) with an increase (or decrease) in its price.

- **Liability Indices:** These indices typically have highly customized designs in order to match the long-dated liabilities of insurance companies, pension funds, and institutional money managers. The methodology of this type of index can be fairly complex, and the available investments can be quite specific for bonds that may be limited in supply.

- **Synthetic Product Indices:** These indices have become more popular with the general adoption of credit default swaps (CDS) for hedging credit risk. The methodology of these indices focuses on the most-liquid and most-actively traded CDS, and it provides broad coverage of a market segment. Synthetic indices may offer more liquidity and tighter price spreads than individual cash bonds or single-name CDS.

**CONCLUSION**

Global fixed income markets are continually changing, requiring investors to constantly adapt in order to achieve their financial goals and objectives. The ever-changing needs of investors create a need for new, innovative, and accessible index services. No matter what environment the global economy provides, investors will continue to seek ways to generate sustainable returns, while also managing risk.

Benchmarks will continue to be an important tool for providing effective measures of performance and risk evaluation. There may be a greater urgency for alternatively weighted products in comparison to those currently offered, but decisions will need to be considered at the investor level. Changes in the economy and product offerings make it necessary to frequently reevaluate the indices used as benchmarks in order to determine if they continue to meet the requirements of the specific objectives of each investment.
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