Research Report
Fixed Income

2022

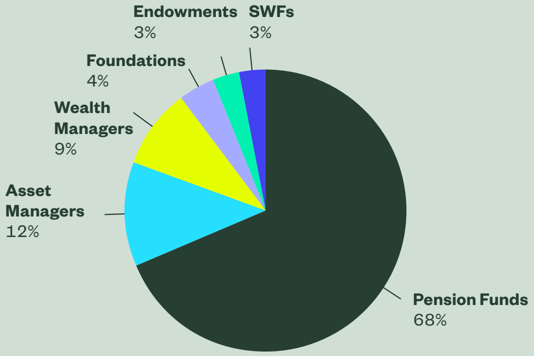
The Role of ETFs in a New Fixed Income Landscape

STATE STREET GLOBAL ADVISORS SPDR®

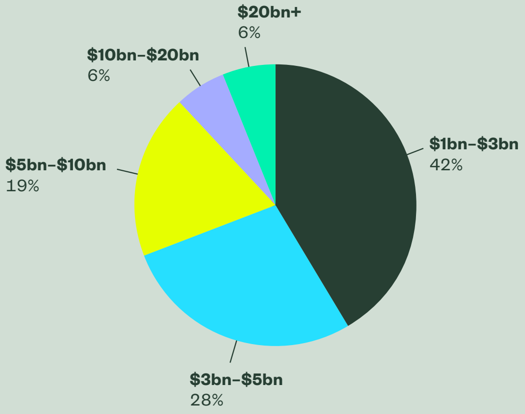
About the Survey

The 2022 State Street Global Advisors fixed income survey canvassed the views of major investors across the globe to better understand where the fixed income market is and where it is heading. The qualitative and quantitative survey was conducted in mid-2022 and was administered by an independent third-party firm not affiliated with State Street Global Advisors. State Street Global Advisors is identified as the study sponsor. A total of 700 global institutional investors responsible for asset-allocation decisions for top pension funds, wealth managers, asset managers, endowments, foundations and sovereign wealth funds participated in the study.

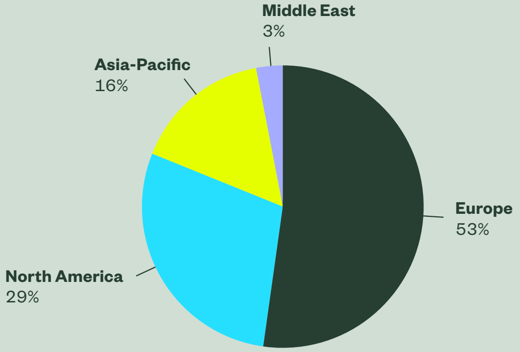
Institution Type



Assets Under Management



Region



Source: State Street Global Advisors, May 2022.

Contents

Our latest survey of investment leaders identifies deep trends shaping the future state of fixed income portfolios.

Rampant inflation and central bank interest rate increases are dominating the short-term outlook for fixed income.

But longer-term, structural forces — from challenges to traditional 60/40 portfolios, the search for new sources of returns to cost pressures and rising Environmental, Social, and Governance (ESG) demands — are changing the way investors implement and manage their fixed income allocations.

Our new global study, surveying 700 institutional investors and investment decision makers, reveals how exchange traded funds (ETFs) are an increasingly important tool in the evolving fixed income landscape.

ETFs are:

- Being utilized for portfolio construction, including non-core allocations
- Playing a liquidity role as investors increase allocations to non-liquid sources of income
- Helping to facilitate the internalization of fixed income management
- Enabling investors to implement ESG objectives with precision

ETFs Play an Expanded Role in Portfolio Construction

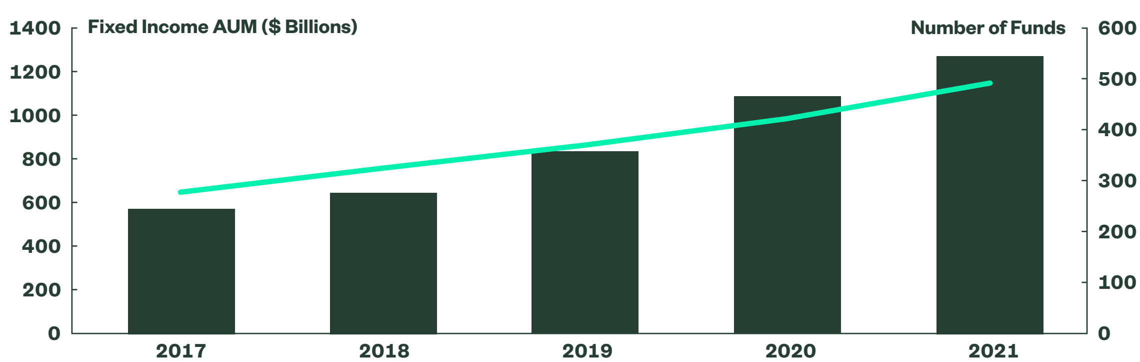
Data recorded by the New York Stock Exchange (NYSE), the world's largest exchange, shows that assets under management (AUM) in fixed income ETFs grew from $574 billion in 2017 to $1.28 trillion in 2021; the number of funds has also increased rapidly, from 278 to nearly 500 over the same time period.[1]

Our 2022 survey shows that the role of ETFs in asset allocation is expanding to non-core sectors. For example, 62% of investors who are increasing exposure to high-yield corporate credit over the next 12 months say it is likely they will use ETFs to do so, and 53% say the same for emerging-market debt.

We can see the increase in use, as compared to our 2021 fixed income survey, *Preparing for the Big Shift*.[2] In it, we found that 50% of investors were making significant use of ETFs to construct their core allocations, such as government bonds and investment-grade credit, but only 27% were doing so in their non-core allocations. The increase from just over a year ago is remarkable.

Fixed Income ETFs See Significant Increase in AUM and Number of Funds

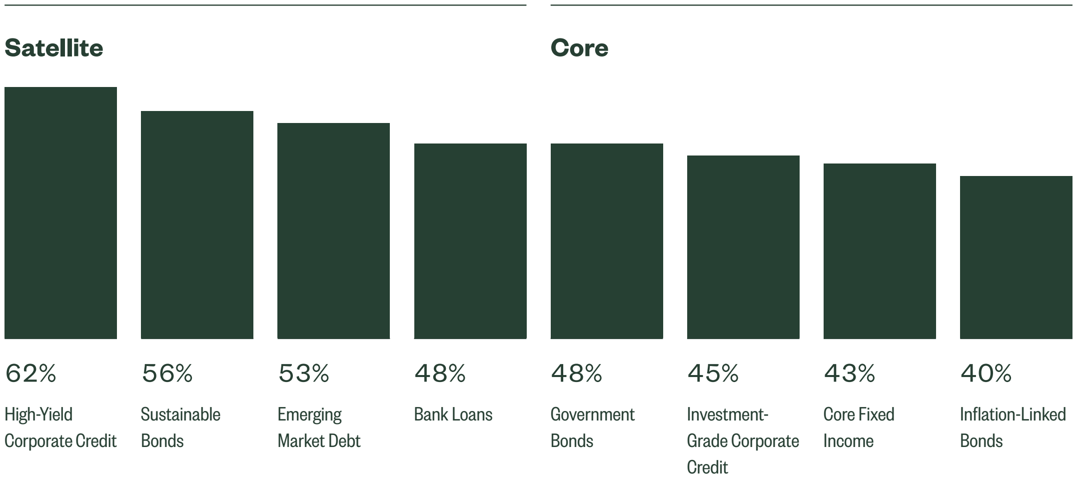
Figure 1



Source: NYSE, as of March 14, 2022. 'ETFs Rising in the Turbulence,' data from 2017–2021. Data used with permission of NYSE Group, Inc. © 2022 NYSE Groups, Inc. This chart may not contain the most up-to-date information; refer to nyse.com for the most current materials.

Investors Are Turning to ETFs to Build Core and Satellite Allocations

Figure 2
For those fixed income sectors to which you are increasing allocations over the next 12 months, how likely is it that you will use ETFs to build your exposure?



Source: State Street Global Advisors, May 2022. Chart shows percentage for somewhat/very likely to use ETFs. n=700.

This trend is more pronounced among the largest institutions in the survey: 68% of those with AUM over $10 billion are likely to use ETFs to build new exposures to high-yield corporate credit, while 88% are likely to do so within emerging-market debt.

Survey findings indicate that investors are increasingly turning to ETFs, even in less efficient sectors (see Figure 2). One driver for this is that some investors appear to be coupling broad beta exposures with more specialist active strategies in these sectors. For instance, among survey respondents who plan to increase high-yield allocations, 44% will use a mix of index and active strategies; 47% will do so for emerging-market debt allocations.

Active Bond ETFs Gaining Traction

It is not just index ETFs that are attracting greater interest in fixed income, however. Net flows into actively managed bond ETFs last year were the largest on record, according to EPFR data.[3]

More frequent — in some cases, daily — holdings disclosure, combined with greater liquidity than that provided by active mutual funds, could prove increasingly attractive for investors seeking efficient ways to rebalance their portfolios while retaining the benefits of active strategies.

> **I think in high-volatility markets, you need to have more active management. And when you see things in the ETF prospectus that allow an actively managed ETF to really respond to volatility and sudden, large changes in the market, that should help with performance."**
>
> —A fixed income manager at a US asset owner.

Our survey results suggest that asset owners who already manage part of their fixed income portfolio in-house, or are in the process of internalizing it, may be driving active ETF adoption — particularly in Asia Pacific and Europe.

Active ETFs Highly Important for Asset Owners Managing Fixed Income In-House

Figure 3
For those assets where you plan to increase in-house management, how important will active fixed income ETFs be in building your exposure?

Source: State Street Global Advisors, May 2022. Chart shows percentage rating as moderate to very high importance. Note: Respondents selected the level of importance for each asset. n=530.

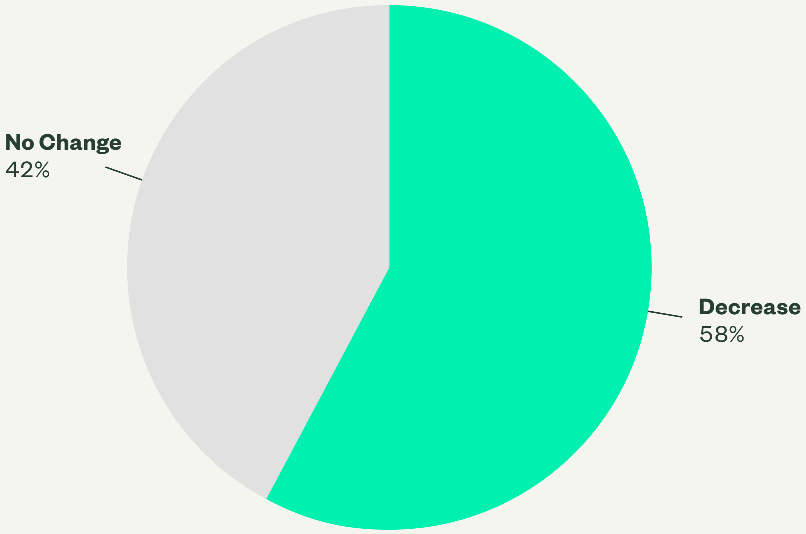
Harnessing ETFs for Targeted Duration Plays

Fixed income markets saw significant volatility in the first half of 2022. With inflation climbing to 40-year highs in the US,[4] the US Federal Reserve (Fed) and other central banks shifted to tighter monetary policies and implemented rate hikes.

Given this environment, our survey found a significant number of investors were planning to, or had already, shortened the duration of their portfolios.

Many Investors Are Shortening Portfolio Duration

Figure 4
Over the next 12 months, what changes will you make to the duration of your fixed income portfolio?



Source: State Street Global Advisors, May 2022. Note: Respondents were allowed to select one option. n=700.

The wide range of bond ETFs available to investors and ease of access the funds provide make it easy for investors to adjust duration in a targeted way.

A fund manager at a UK-headquartered wealth management company says his firm has been shortening the duration of its funds over the past 18 months. "We have a very long preferred list of funds that enables us to make sector and duration plays — whether it's ultra-shorts, 1–3 year, 0–5 year, or 10-year, we've got a vehicle at all of those different points to help us rebalance," he says:

> **"With ETFs, you can be very targeted in your fixed income via passive strategies. It used to be the case that you got stuck with all maturities in a broad-based exposure. Now, there's a vehicle for pretty much any duration you're looking for."**

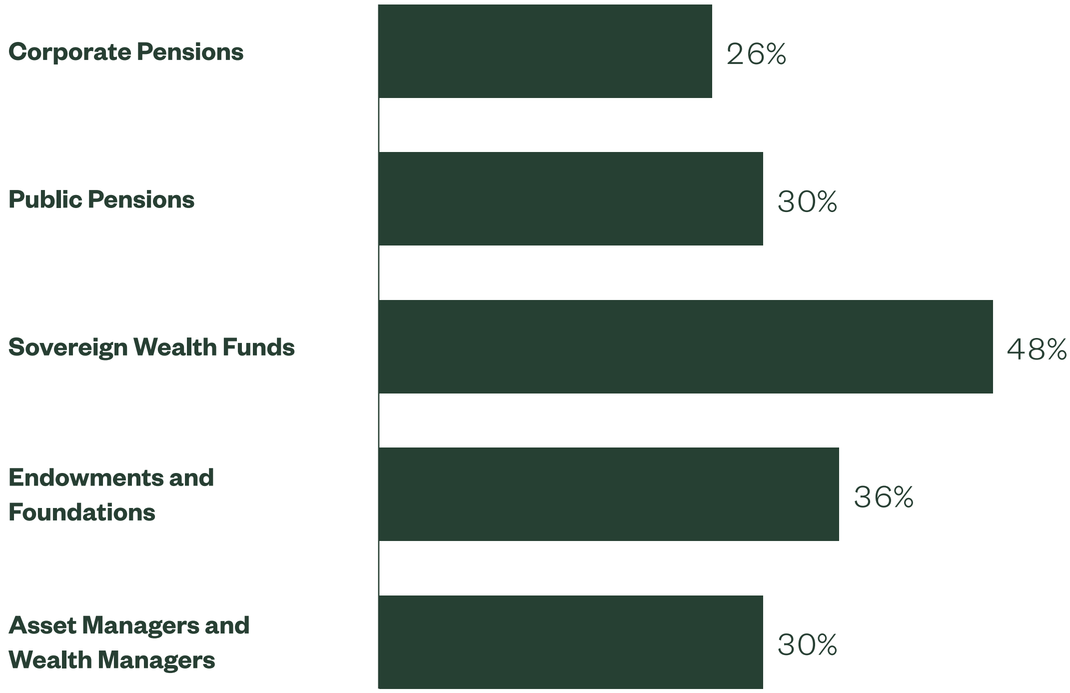
Meet Evolving Liquidity Demands with ETFs

In response to the pressures of the previous low interest rate environment, many institutional investors had increased allocations to non-liquid sources of income, such as private credit.

AUM in private debt is forecast to reach US$2.69 trillion by 2026, overtaking real estate, according to alternatives data provider Preqin.[5] This has reached a point where increasing portfolio liquidity is a top concern across all global survey participants.

Increasing Portfolio Liquidity Is a Priority Across All Survey Participants

Figure 5
Which of the following priorities will be most important for you to address through your fixed income allocation over the next 12 months?

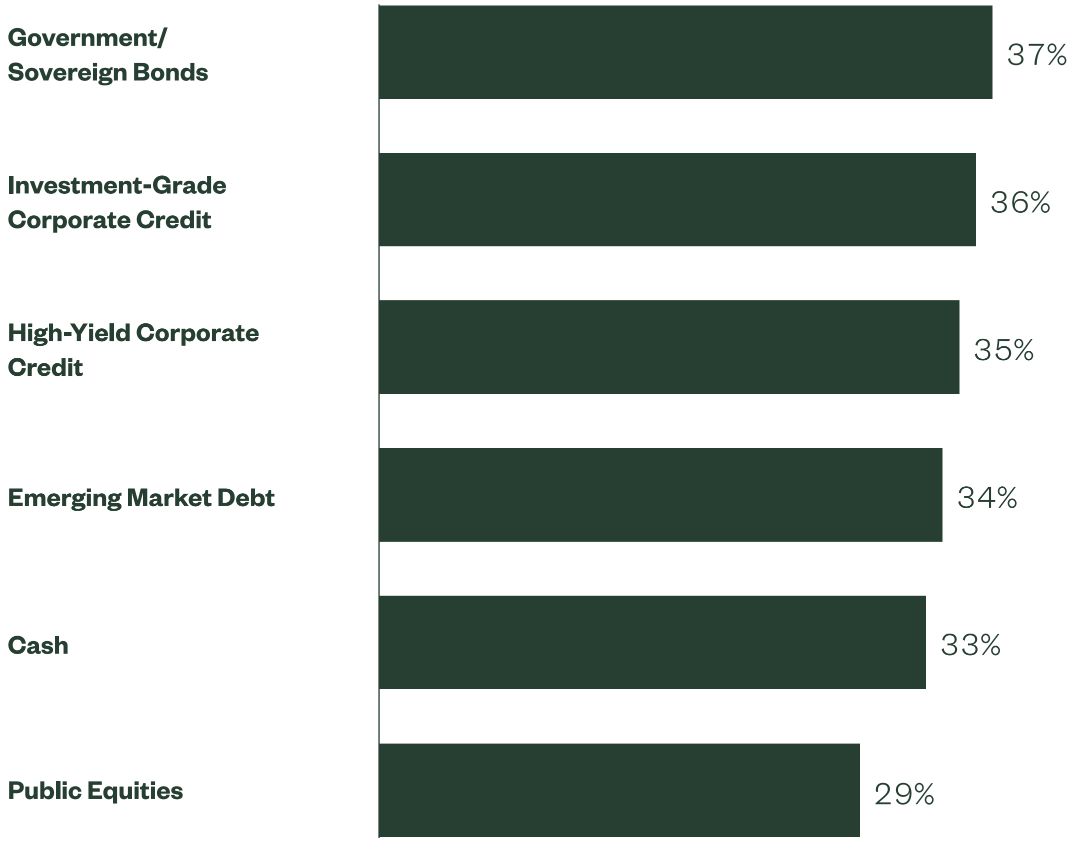


Source: State Street Global Advisors, May 2022. Response options included: Integrate ESG considerations; manage effects of inflation/rising rates; greater portfolio liquidity; produce higher portfolio returns; generate reliable, low-risk income; diversify equity/risk exposures. Note: Respondents were allowed to select up to two options. n=700.

Investors in our survey have been largely funding their privately placed allocations from liquid sources such as public fixed income and cash over the past three years (see Figure 6).

Investors Are Predominantly Funding Private Placements From Liquid Allocations

Figure 6
If your organization has increased its overall allocation to private credit over the last three years, which asset class(es) have you reallocated from in order to fund it?



Source: State Street Global Advisors, May 2022. Note: Respondents were allowed to select all that apply.

However, while the increase in private allocations may have improved investors' yield and income profiles, it offers much less liquidity compared to a combination of more conventional fixed income, cash, and equities.

Investors in our survey are deploying a range of strategies to manage the increased liquidity risk associated with larger private credit exposure, including the use of fixed income ETFs.

> **"There are ETFs in the marketplace that have a higher yielding profile as well as the liquidity to act as a funding pool, or that can be paired with an allocation to private credit."**
>
> — Bill Ahmuty, Head of SPDR ETF Fixed Income Group at State Street Global Advisors.

ETFs Play a Critical Role in Maintaining Liquidity Profiles

Figure 7
If your organization has increased its overall allocation to private credit, what actions have you taken, if any, to manage the accompanying increase in liquidity risk?

Source: State Street Global Advisors, May 2022. Note: Respondents were allowed to select all that apply. n=473.

For pension funds in particular, it is essential to assess the implications of any rebalancing between public fixed income and private credit in the context of the scheme's total liquidity requirements. ETF allocations can help schemes ensure they have the flexibility to meet short-term pension liabilities while seeking to maximize long-term returns.

A fixed income manager at a US asset owner says enhanced liquidity is one of the key benefits of using ETFs as portfolio building blocks:

> **"ETFs can be a great vehicle if you want to allocate to a certain sector. They're great for liquidity, they're easy to use and you're not going to get hit on transaction costs as that's straightforward to monitor," he says. "But if you're trying to generate alpha, then you also have to include some active strategies as you can't just rely on being overweight in the right sector."**

ETFs Support the Shift to In-house Fixed Income Management

The Global Financial Crisis brought about an extended period of historically low interest rates, which lasted more than a decade and pushed investors to improve efficiencies within fixed income portfolios.

This remains a priority today: 46% of our survey respondents said their organizations are under a lot of pressure to make more efficient use of the fee budgets within their fixed income allocations.

This pressure has led some asset owners to build in-house investment teams instead of relying predominantly on external managers. Our survey found that, among asset owners facing pressure to be more efficient in fixed income, 46% are planning to bring some part of their portfolio management in-house over the next 12 months, compared with 31% of those not experiencing the same pressure over fees.

The move toward internalization varies significantly across regions.

64%

of asset owners plan to bring part of their fixed income portfolio in-house over the next 12 months, versus 45% in Europe and just 8% in North America.

The size of the organization factors into this decision too: 64% of the largest asset owners surveyed ($10 billion+ in AUM) are bringing part of the portfolio in-house, compared with 34% for those with less than $3 billion in AUM.

As they take decisions to move money in-house, asset owners will need to think about efficient ways to build fixed income exposures with the resources they have at their disposal. Our survey found that those asset owners moving fixed income in-house over the next 12 months expect ETFs to be an important tool for building their exposure.

Active and Index ETFs Rank High For Asset Owners as Internal Fixed Income Management Tools

Figure 8
For those assets where you plan to increase in-house management, how important will the following approaches be in building your exposure?

Source: State Street Global Advisors, May 2022. Chart shows percentage rating as high importance. Note: Respondents selected the level of importance for each asset. n=211.

ETFs can enable investors to implement their allocation models without requiring large internal teams to manage them.

> **“If you don’t have the resources, but you need exposure to that asset class, an ETF is the way to go. You’re going to have someone who’s an expert that’s managing it, but you don’t need all the different systems internally to run the portfolio. It’s easy to scale up and, depending on the ETF, you’ll have diversification as well.”**
>
> —A fixed income manager at a US asset owner.

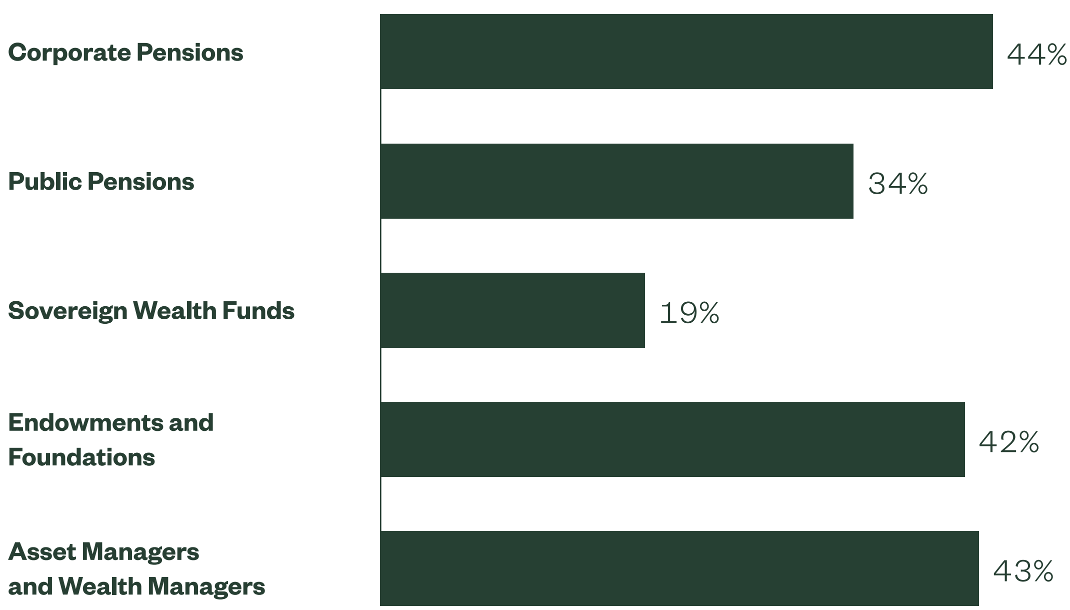
Implementing ESG Objectives Within Fixed Income

Investors are under increasing pressure — from a risk, performance, and regulatory perspective — to ensure their fixed income portfolios take ESG issues into account.

Our survey found that integrating ESG considerations is the top priority for asset managers, wealth managers, and corporate pension funds to address through their fixed income allocations over the next 12 months.

ESG Integration Is a Key Priority in Fixed Income Portfolios

Figure 9
Which of the following priorities will be most important for you to address through your fixed income allocation over the next 12 months?



Source: State Street Global Advisors, May 2022. Response options included: Integrate ESG considerations; manage effects of inflation/rising rates; greater portfolio liquidity; produce higher portfolio returns; generate reliable, low-risk income; diversify equity/risk exposures. Note: Respondents were allowed to select up to two options. n=700.

There is some variance by geography in the survey, with 44% of North American respondents citing ESG integration as a top priority, versus 38% in Europe, and 36% in APAC. We believe this may be an indication that North America respondents are in the early stages of ESG integration, developing policy frameworks, and are more likely to make ESG a priority over the next 12 months, while European respondents have already done more in terms of ESG integration.

When it comes to incorporating ESG, the top priority for pension funds (35%) and asset managers (47%) over the next 12 months is to ensure all fixed income strategies meet the ESG threshold criteria set out in their policy frameworks. Respondents from endowments and foundations (based in North America) are more likely to be focused on creating these policies as a first step.

Investors are starting to think about how they can achieve more targeted ESG objectives in fixed income portfolios too. For instance, Paris alignment has become the most favored approach to ESG integration, with 46% of survey respondents looking to benchmark portfolios against Paris-aligned benchmarks. Science-based transition targets (34%) and ESG tilting (34%) — which involves incorporating ESG risks and opportunities into traditional financial analysis using a weighting scheme — are also favored approaches.

Notably, we see that as investors pursue their ESG objectives over the next 12 months, ETFs are viewed as important tools, particularly for pension funds and asset managers.

Targeting ESG Objectives in Fixed Income Portfolios

46%

Benchmark portfolios against Paris-aligned benchmarks

34%

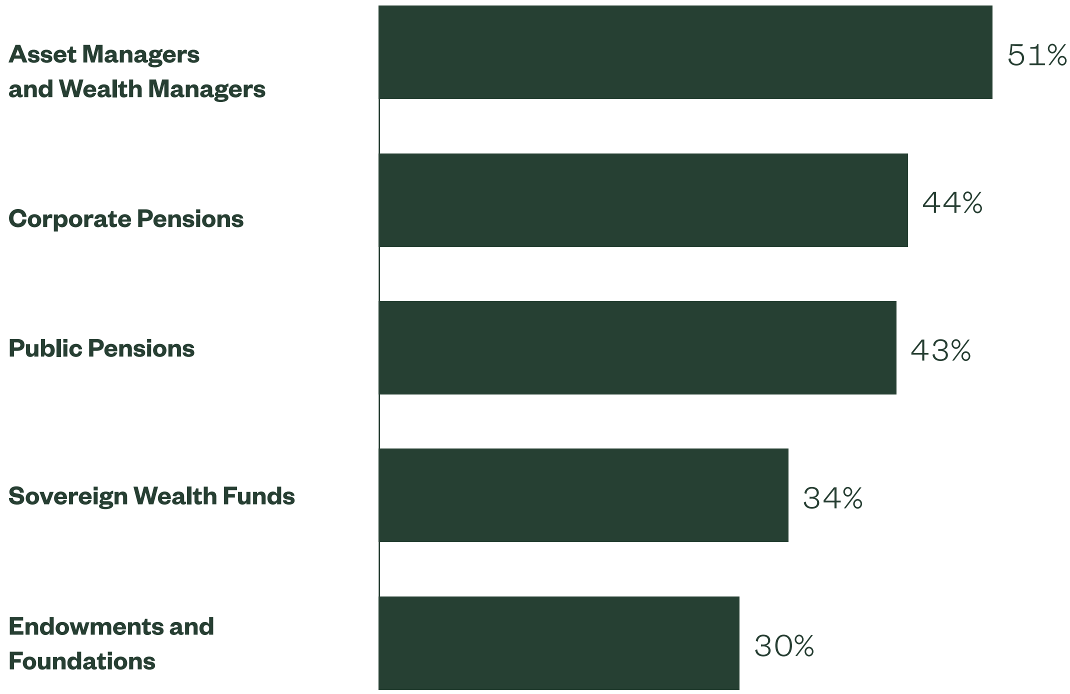
Science-based transition targets

34%

ESG Tilting

Investors See Index ETFs As Important ESG Integration Tools

Figure 10
How important will the following approaches be to your institution's ESG integration within fixed income over the next 12 months?



Source: State Street Global Advisors, May 2022. Chart shows percentage rating index ESG ETFs as high importance. n=700.

For investors seeking to bring ESG standards in fixed income portfolios up to levels set within their policy frameworks, ESG ETFs can provide building blocks to replicate existing asset allocation models while maintaining a similar risk-return profile for the portfolio.

Index ETFs can be a useful tool to support more specific ESG goals, too. For example, where investors are committing to align with the goals of the Paris Agreement, ETFs can help to maintain diversification while applying a rules-based approach to re-weight issuers according to different emissions metrics.

> **"The transparency element of index ETFs is a real advantage. Implementing ESG scores and/or climate targets is complex, and so having an index that guarantees, by its construct, that it will meet specific objectives of ESG score improvement, or year-on-year CO_2 emission reductions, can be valuable to investors committing to such a trajectory."**
>
> —Antoine Lesne, Head of SPDR ETFs EMEA Strategy and Research at State Street Global Advisors.

Navigating the Transition: An Evolving Role for ETFs

The fixed income landscape is changing as investors rethink traditional approaches to building balanced portfolios, ESG considerations gain greater prominence, and product innovation creates new routes for implementing strategies.

ETFs are an important part of this transition. The number of funds available and assets under management in index fixed income ETFs have grown over the past few years — and more recently in active ETFs too — providing investors with a wider range of tools to meet their portfolio objectives.

Our survey finds that increasing numbers of institutional investors are using ETFs to allocate efficiently to fixed income sectors, incorporate active management, and balance the liquidity profiles of portfolios.

Reflecting on the trends shaping the future of fixed income, we believe the utility of ETFs will continue to grow.

Endnotes

1 ETFs Rising in the Turbulence, NYSE, March 2022.

2 *Fixed Income: Preparing for the Big Shift,* State Street Global Advisors, July 2021.

3 EPFR, December 31, 2021.

4 US Bureau of Labor Statistics, July 2022.

5 2022 Preqin Global Private Debt Report.

About State Street Global Advisors

State Street Global Advisors serves governments, institutions and financial advisors with a rigorous approach, breadth of capabilities and belief that good stewardship is good investing for the long term. Pioneers in index, ETF, and ESG investing and the world's fourth-largest asset manager*, we are always inventing new ways to invest.

* Pensions & Investments Research Center, as of December 31, 2021.

ssga.com/etfs

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O Box 76404, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services License (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600. F: +612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 185, 1170 Brussels, Belgium. T: +32 2 663 2036. State Street Global Advisors Belgium is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900. **France:** State Street Global Advisors Europe Limited, France Branch ("State Street Global Advisors France") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors France is registered in France with company number RCS Nanterre 899 183 289, and its office is located at Coeur Défense — Tour A — La Défense 4, 33e étage, 100, Esplanade du Général de Gaulle, 92 931 Paris La Défense Cedex, France. T: +33 1 44 45 40 00. F: +33 1 44 45 41 92. **Germany:** State Street Global Advisors Europe Limited, Branch in Germany, Brienner Strasse 59, D-80333 Munich, Germany ("State Street Global Advisors Germany"). T: +49 (0)89 55878 400. State Street Global Advisors Germany is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Europe Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 49934. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Europe Limited, Italy Branch ("State Street Global Advisors Italy") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Italy is registered in Italy with company number 11871450968 — REA: 2628603 and VAT number 11871450968, and its office is located at Via Ferrante Aporti, 10 - 20125 Milan, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building 7th floor, Herikerbergweg 29, 1101 CN Amsterdam, Netherlands. T: +31 20 7181 000. State Street Global Advisors Netherlands is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.

In partnership with FT Longitude, a Financial Times company. This survey was conducted in May of 2022 via an online survey instrument (n=700) and telephone interviews (n=5). Respondents were limited to senior leaders and senior portfolio managers who are directly involved in fixed income portfolio construction and investment decisions at pension funds, wealth managers, asset managers, endowments, foundations and sovereign wealth funds.

Important Risk Information

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without State Street Global Advisors' express written consent.

Investing involves risk including the risk of loss of principal.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the Markets in Financial Instruments Directive (2014/65/EU) or applicable Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

International Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

Investing in high yield fixed income securities, otherwise known as "junk bonds", is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

The returns on a portfolio of securities which exclude companies that do not meet the portfolio's specified ESG criteria may trail the returns on a portfolio of securities which include such companies. A portfolio's ESG criteria may result in the portfolio investing in industry sectors or securities which underperform the market as a whole.

ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

Standard & Poor's®, S&P® and SPDR® are registered trademarks of Standard & Poor's Financial Services LLC (S&P); Dow Jones is a registered trademark of Dow Jones Trademark Holding LLC (Dow Jones); and these trademarks have been licensed for use by S&P Dow Jones Indices LLC (SPDJI) and sublicensed for certain purposes by State Street Corporation. State Street Corporation's financial products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates and third party licensors and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability in relation thereto, including for any errors, omissions, or interruptions of any index.

ID1178148-4928464.1.1.GBL.RTL 0822
Exp. Date: 09/30/2023