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Alternative Bond ETF Strategies to Diversify Risk, Maintain Yields.

Fixed income investors should consider the risks of traditional market cap-weighted bond indexing and look to alternative exchange traded fund methodologies to help diversify their risks and maintain income.

In the recent webcast, *The Quest for Income: Smarter Approaches to Meet Client Income and Stability Needs*, Katherine Nuss, vice president and fixed income client portfolio manager at Columbia Threadneedle Investments, touched upon the current economic environment, with labor markets progressing but still below their peak and core inflation decelerating. The Federal Reserve is still waiting on the labor markets to make a full rebound and insists that inflation remains transitory.

Nuss argued that investors should consider the value in diversification rather than further upside potential, especially with the markets more at risk of rising interest rates. However, credit valuations leave little room for error with tight spreads reflecting high valuations in the credit markets already.

Marc Zeitoun, head of strategic beta and private client advisory at Columbia Threadneedle Investments, argued that there may be room for fixed income investors to find value, but people will have to go beyond their comfort zones or away from traditional bond benchmarks like the Bloomberg U.S. Aggregate Bond Index.

"Bloomberg U.S. Aggregate Bond Index investors are taking more risk to generate less income than ever before," Zeitoun said.

Zeitoun warned that investors need more credit exposure or even 80% in high yield in today's low-rate environment to generate a 4% yield, but this would expose them to risks that many may not be comfortable with. Income is a driver of total return, and its contribution is magnified in short duration. On the other hand, Zeitoun argued that investors need to consider a diversified, flexible portfolio that can better balance today's market risks.

For example, Jay McAndrew, vice president and national sales manager at Columbia Threadneedle Investments, highlighted the Columbia Diversified Fixed Income Allocation ETF (NYSEArca: DIAL), the Columbia Short Duration Bond ETF (SBND) and the Columbia Multi-Sector Municipal Income ETF (MUST).

McAndrew underscored the improving income and diversification through a broader opportunity set. For example, high yield and emerging market debt produce the most yield relative to duration. They also exhibit low correlation with the Bloomberg 1-5 Government/Credit Index.

DIAL provides convenient access to six sectors attractively priced and managed by senior fixed income portfolio managers. For instance, the ETF focuses on BBB- and BB-rated sovereign EM bonds that have provided income at a reasonable volatility. McAndrew noted that DIAL's indexing methodology provides a more differentiated country and currency exposure, investing in higher-yielding countries and a modestly shorter duration.

DIAL helps investors focus on areas that have been largely ignored by traditional bond benchmarks. The typical short-term bond fund lacks meaningful exposure to higher income-producing sectors, according to McAndrew. Meanwhile, with short-term rates so low, fees can even negate the impact on effective yield.

Additionally, SBND, which tracks the Beta Advantage® Short Term Bond Index, provides convenient, diversified access to four sectors, managed by senior fixed income portfolio managers at a competitive price. The thoughtfully constructed, diversified portfolio can mitigate duration risk while capturing higher current income opportunities. In order to maximize the potential for risk-adjusted returns and income, the underlying Beta Advantage Multi-Sector Municipal Bond Index is designed to exploit inefficiencies inherent in traditional passive approaches.

Lastly, MUST broadens the opportunity set by providing thoughtful access to municipal sectors at an attractive price and is designed by senior municipal fixed income portfolio managers.

ETF TRENDS

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