

BEHIND THE BOND BOOM  
ETP FLOWS QUARTERLY

JANUARY 2013

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# Behind the Bond Boom



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The advent of exchange traded products (ETPs) focused on fixed income has been swift and surprising. We take a peek behind the scenes in this new quarterly report on ETP money flows.

The debut publication includes *interactive graphics* that show three years of ETP investment flows across all asset classes. Fourth-quarter highlights include:

- ▶ ETP flows showed increased risk appetite, with emerging market equity and debt funds both attracting record inflows. Investment grade flows held steady, but investors pulled a small amount out of high yield ETPs.
- ▶ We provide ratings and industry sector breakdowns for investment grade and high yield ETPs, and highlight the 10 most commonly held individual bonds.
- ▶ For emerging market debt ETPs, we give a country breakdown that shows Brazilian, Mexican and Russian bonds are most popular.
- ▶ Inflows into fixed income ETPs typically do not reverse when rates start rising—if (limited) history is any guide.
- ▶ Volumes of bond ETPs have risen sharply, but liquidity in underlying markets is spotty. Contrary to popular belief, much of fixed income ETP trading does not necessarily trickle through to the over-the-counter (OTC) bond markets.

BlackRock collects and analyzes industry-wide data of nearly 5,000 ETPs globally in monthly *ETP Landscape* reports.

## HELICOPTER VIEW

Global ETP Trends, 2012

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Interactive Charts



	Q4 FLOWS (\$BN)	% OF Q3 ASSETS	12-MONTH FLOWS (\$BN)	CURRENT ASSETS (\$BN)	12-MONTH ASSETS CHANGE	NUMBER OF FUNDS
<b>EQUITIES</b>						
Developed	30	2.8	116	1,085.7	25%	2,077
Emerging	27.1	11.6	54.8	275.9	42.1%	710
<b>Total</b>	<b>57.1</b>	<b>4.4</b>	<b>170.7</b>	<b>1,361.6</b>	<b>28.2%</b>	<b>2,787</b>
<b>FIXED INCOME</b>						
Corporate	4.5	4	37.9	118	57.9%	147
Government	1.9	2.8	-0.63	72	0.5%	331
<b>Total</b>	<b>15.8</b>	<b>4.9</b>	<b>70</b>	<b>338.9</b>	<b>31.4%</b>	<b>714</b>
<b>COMMODITIES</b>						
Gold	4.7	3.2	15.6	141	18.9%	109
<b>Total</b>	<b>5.8</b>	<b>2.8</b>	<b>19.2</b>	<b>200.4</b>	<b>15.2%</b>	<b>898</b>
<b>OTHERS</b>	<b>-1.1</b>	<b>-3.5</b>	<b>2.7</b>	<b>32.2</b>	<b>6.9%</b>	<b>347</b>
<b>GRAND TOTAL</b>	<b>77.6</b>	<b>4.2</b>	<b>262.7</b>	<b>1,933.1</b>	<b>26.8%</b>	<b>4,746</b>

Source: BlackRock. Data as of Dec. 31, 2012.

Notes: Totals include other categories. Government bonds exclude municipal bonds and inflation protected securities.

## BLACKROCK INVESTMENT INSTITUTE

The BlackRock Investment Institute leverages the firm's expertise across asset classes, client groups and regions. The Institute's goal is to produce information that makes BlackRock's portfolio managers better investors and helps deliver positive investment results for clients.

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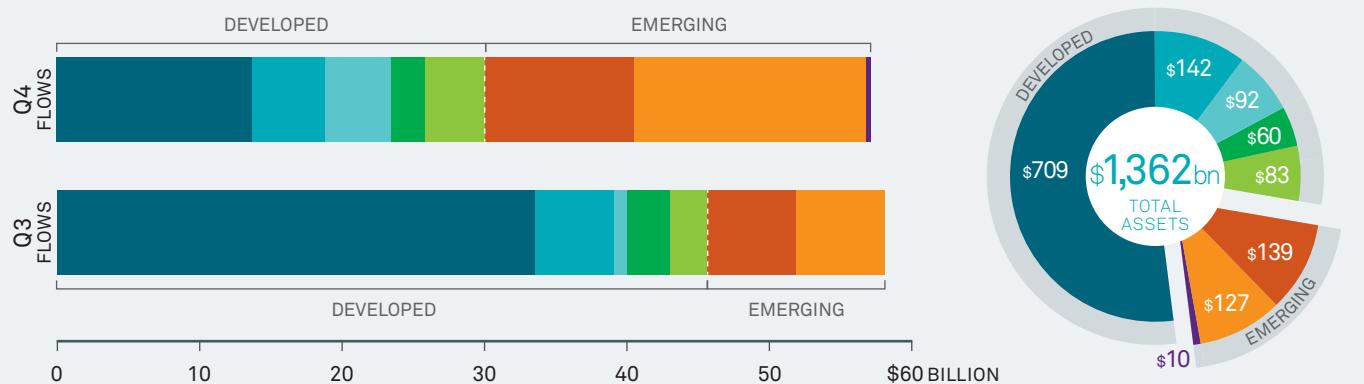
Ewen Cameron Watt

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## AN EMERGING STORY

Equity ETP Flows and Assets, 2012



Source: BlackRock. Data as of Dec. 31, 2012.

Developed Markets: North America ■ Europe ■ Other Developed ■ Global ■ Global Ex-US ■  
Emerging Markets: Broad EM ■ EM Single Country ■ Regional EM ■

## ENERGETIC IN EQUITIES

Inflows into emerging market equity funds hit a record \$27.1 billion in the fourth quarter, more than double the amount in the previous quarter. This was driven by a tripling of flows into China-focused ETPs to \$12.2 billion amid signs the country's new leadership would jumpstart economic growth. Emerging market equity ETPs now hold \$276 billion, or one fifth of the equity ETP total. See the chart above.

Flows into developed market equities fell to \$30 billion, down a third from the third quarter. Slower inflows into North America-focused ETPs drove the change. European ETPs attracted \$5 billion-plus inflows for a second quarter, a departure from the outflows in the first half. Overall equity inflows fell 1% to \$57.1 billion in the quarter.

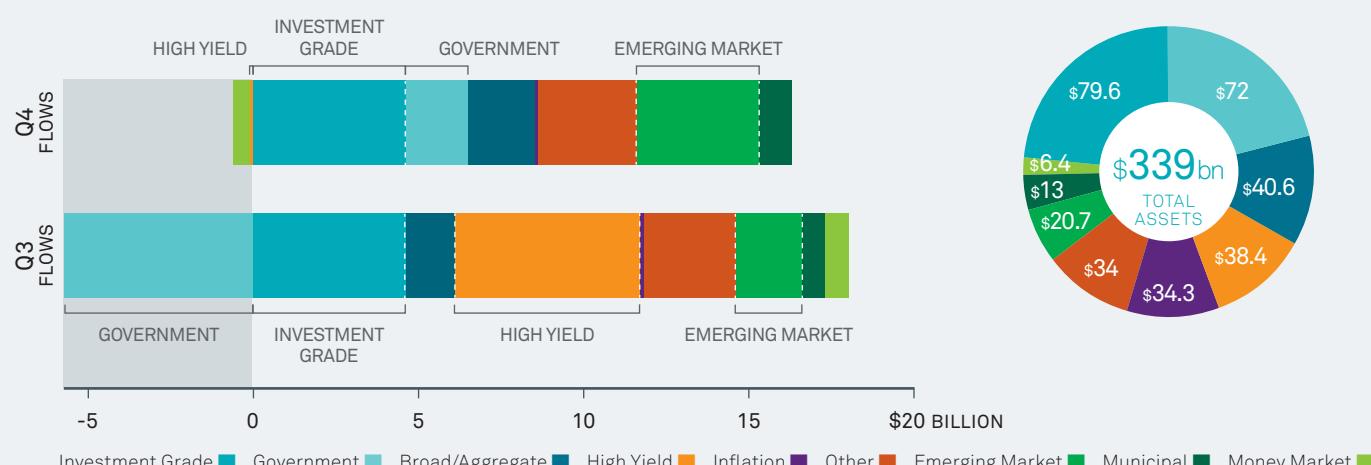
## FLUMMOXED IN FIXED INCOME

A mixed bag of fixed income ETP flows made it tough to gauge investor sentiment. There were bouts of "risk-off" behavior. Safe-haven government bond ETPs saw inflows of \$1.9 billion, in the run-up to the US elections and the countdown to the "fiscal cliff" of automatic tax increases and spending cuts. See the chart below. But US Treasury ETPs saw annual outflows for the first time since 2005.

High yield ETPs also showed risk aversion, recording a \$79 million outflow compared with bumper inflows of \$5.6 billion in the third quarter. Flows into investment grade and emerging market debt ETPs pointed to some risk appetite, with the latter raking in record inflows of \$3.7 billion. Overall, fixed income flows increased by 28% to \$15.8 billion.

## INTERNAL GYRATIONS

Fixed Income ETP Flows and Assets, 2012



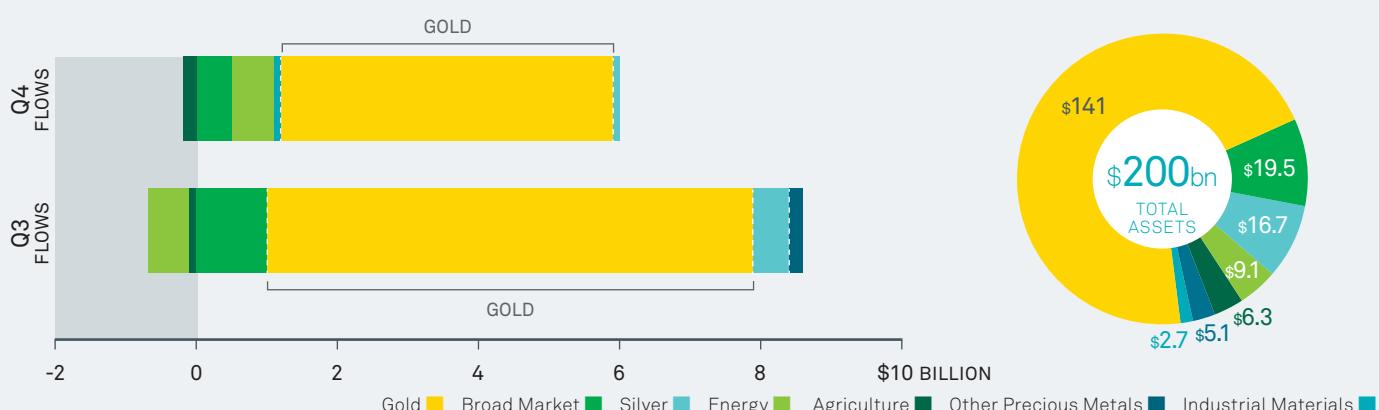
Investment Grade ■ Government ■ Broad/Aggregate ■ High Yield ■ Inflation ■ Other ■ Emerging Market ■ Municipal ■ Money Market ■

Source: BlackRock. Data as of Dec. 31, 2012.

The opinions expressed are as of January 2013 and may change as subsequent conditions vary.

## PAVED WITH GOLD

Commodities ETP Flows and Assets, 2012



Source: BlackRock. Data as of Dec. 31, 2012.

Note: Category is made up of ETPs designed to track physical commodities or commodity futures indices.

## GOLD AND OTHER NUGGETS

Gold ETPs recorded their seventh consecutive quarter of inflows, pulling in \$4.7 billion in the quarter. Demand has been underpinned by investor fears of inflation (gold as a store of value) and low interest rates (the opportunity costs of holding gold is low). Gold makes up 70% of the commodities ETP assets under management. See the chart above.

Energy ETPs rebounded with inflows of \$567 million, almost offsetting the outflows in the third quarter. Silver ETPs enjoyed a sixth quarter of inflows, netting \$123 million. But agriculture ETPs suffered their seventh consecutive quarter of outflows as investors pulled \$202 million. This leaves the sector with just \$6.3 billion in assets, or 3% of the commodities ETP total.

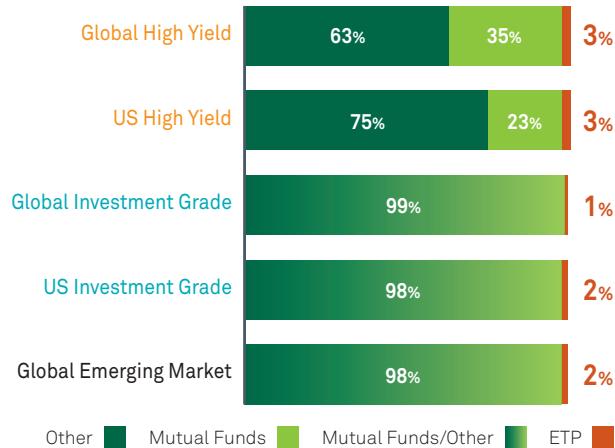
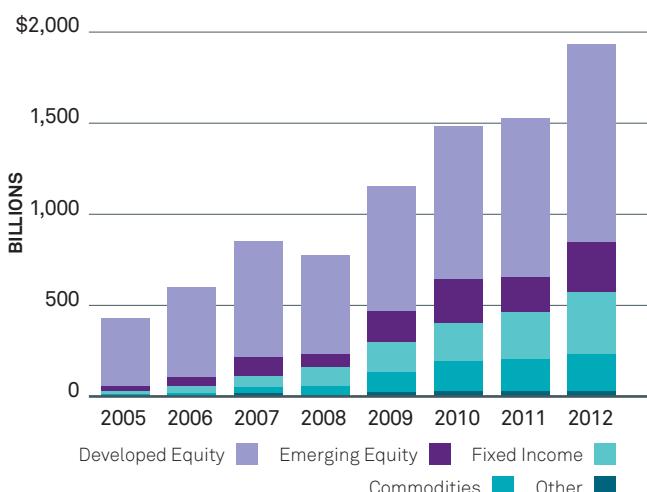
## SENTIMENT VS. MARKET FORCE

Global ETP assets have spiraled upward, crossing the \$2 trillion mark in late January. ETPs tracking developed market indices still make up a majority of assets. See the left chart below. The big story of the past year? Record inflows into emerging market equity and fixed income ETPs. Assets in the first category jumped 42% while fixed income assets rose 31%.

ETP fixed income assets are a drop in the bucket compared with the total value of bonds outstanding—or even compared with mutual fund bond holdings. Of our three focus areas, high yield ETPs make up the biggest share of the total with ... a whole 3%. See the right chart below. This is one reason why fixed income ETP flows should be viewed as investor sentiment indicators rather than market forces at this time.

## HEADY GROWTH—FROM A LOW BASE

ETP Asset Growth and ETP Share of Bond Markets

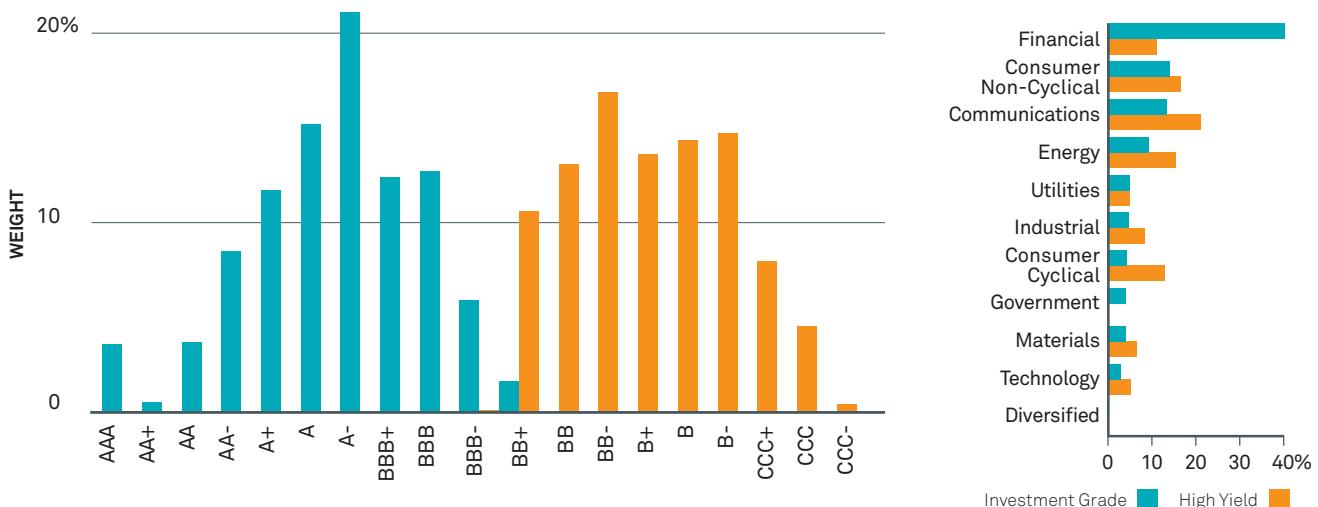


Sources: BlackRock and Barclays. Data as of Dec. 31, 2012.

Notes: Other ETP assets include alternative and currency funds. Mutual fund holdings are not available for investment grade and emerging market debt. Percentages may not add up due to rounding.

## PEERING UNDER THE HOOD ...

Ratings and Sector Breakdown of Corporate Bond ETPs, 2012



Sources: BlackRock and Bloomberg. Data as of Dec. 31, 2012.

Notes: Based on the top 15 investment grade and top 10 high yield ETPs by assets. These make up more than 85% of assets in each area.

## RATE YOUR ETP

The ratings breakdowns of ETPs broadly reflect their indices and bond issuance patterns, with a concentration around the middle of the quality range. Ratings cluster around A- for investment grade and B+ for high yield. See the left chart above.

The global hunt for yield has narrowed valuations between quality and not-so-great income assets, as detailed in our *2013 Investment Outlook* in December 2012. We highlighted how spreads of CCC bonds were zeroing in on Bs, and argued it may make sense to “trade up.” In the ETP high yield space, bonds rated CCC and below made up 16% of total assets.

## BAGS OF BONDS

Financials dominate investment grade ETPs with a 39% share. This is almost triple the level of the next biggest group, consumer non-cyclicals. See the right chart above. Six of the top 10 bonds held by investment grade ETPs are financial issues.

High yield ETPs hold a more diverse—or colorful—bag of bonds. Bonds of communications firms take up slightly more than a fifth, followed by consumer non-cyclical and energy companies. For both ETP groups, the top 100 most commonly held bonds made up 58% of the \$105 billion in total assets under management. See the table below.

## ... AND EXAMINING THE PARTS

Top Issues Held by Corporate Bond ETPs, 2012

INVESTMENT GRADE	\$ MILLIONS	% OF ETP TOTAL
Citigroup	1,645	2.4%
Morgan Stanley	1,416	2.1%
Goldman Sachs	1,402	2%
General Electric	1,373	2%
JPMorgan Chase	1,334	1.9%
AT&T	1,078	1.6%
Bank of America	1,015	1.5%
Verizon	790	1.1%
Wal-Mart	745	1.1%
European Investment Bank	731	1.1%
<b>Top 10 Total</b>	<b>11,531</b>	<b>16.7%</b>
<b>Next 90 Issuers</b>	<b>28,250</b>	<b>40.9%</b>
<b>Other</b>	<b>29,304</b>	<b>42.4%</b>
<b>Grand Total</b>	<b>69,085</b>	<b>100%</b>

HIGH YIELD	\$ MILLIONS	% OF ETP TOTAL
HCA	687	1.9%
Sprint Nextel	644	1.8%
ILFC	631	1.8%
First Data	591	1.6%
Ally Financial	587	1.6%
Reynolds Group	529	1.5%
CIT	491	1.4%
DISH	458	1.3%
MGM Resorts	406	1.1%
CCO Holdings	361	1%
<b>Top 10 Total</b>	<b>5,384</b>	<b>15%</b>
<b>Next 90 Issuers</b>	<b>15,328</b>	<b>42.8%</b>
<b>Other</b>	<b>15,140</b>	<b>42.2%</b>
<b>Grand Total</b>	<b>35,853</b>	<b>100%</b>

Source: BlackRock. Data as of Dec. 31, 2012.

Notes: Based on the top 15 investment grade and top 10 high yield ETPs by assets. Percentages represent the total share of ETP assets, not the ETP share in each individual issue. Totals may not add up due to rounding.

## TRAVEL NOTES

### Emerging Market Debt ETP Assets by Country, 2012

COUNTRY	TOP TEN (58%)																			Grand Total	
	Brazil	Mexico	Russia	Turkey	Indonesia	Poland	Philippines	South Africa	South Korea	Colombia	Venezuela	Peru	Malaysia	Hungary	Ukraine	Lithuania	Croatia	Uruguay	Chile		
ASSETS (MN)	\$1,280	1,202	1,090	1,083	1,082	963	911	882	792	694	676	608	576	562	395	386	360	328	292	3,027	17,189
% OF ETP TOTAL	7.4	7	6.3	6.3	6.3	5.6	5.3	5.1	4.6	4	3.9	3.5	3.4	3.3	2.3	2.2	2.1	1.9	1.7	17.6	100

Source: BlackRock. Data as of Dec. 31, 2012.

Notes: Based on the top 10 emerging market debt ETPs by assets. These make up more than 85% of assets. Percentages represent the total share of ETP assets not the ETP share of each country's debt. Totals may not add up due to rounding.

## EMERGING POWERS

Brazil, Mexico and Russia are the top three countries held by emerging market debt ETPs. See the table above. Inflows are powered by an appreciation for the emerging world's improving fiscal, governmental and economic conditions.

For example, 11 emerging markets rank in the top 25 countries of the BlackRock Sovereign Risk Index (BSRI), as detailed in *Mapping Sovereign Risk* in January 2013. But only three of those—South Korea, Russia and the Philippines—feature in the ETP top 10 list. Index membership is the determining factor for ETPs—not an assessment of the debt itself.

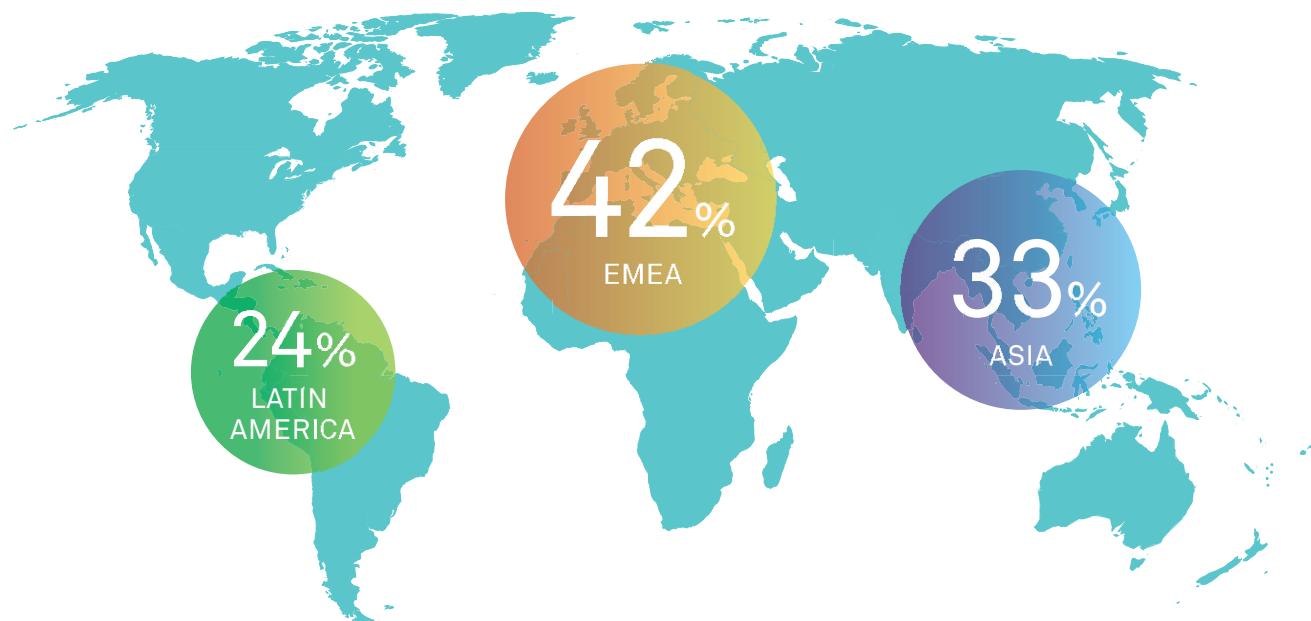
## GOING LOCAL

Emerging market debt ETPs hold about one third in local currency bonds and the remainder in US dollar debt. This differs by country. ETP holdings of Brazilian and Mexican debt have average ratios, with 33% and 37% in local currency debt.

ETP holdings of Russian and Philippine debt, by contrast, are 23% and 13% local currency. Foreign exchange fluctuations make all the difference in total investment return. Foreign currency appreciation furnished 60% of total returns of emerging market debt in the past eight years, as shown in our *2013 Investment Outlook*, but contributed 75% of the risk.

## A WORLD OF (DESIRABLE) DEBT

### Regional Spread of ETP Emerging Market Debt, 2012



Source: BlackRock. Data as of Dec. 31, 2012.

Note: Percentages represent the share of total ETP assets, not the ETP share of each region's debt. Total does not add up due to rounding.

## WHEN RATES BACK UP

Monthly Bond ETP Flows and US Treasury Yields, 2008–2012



Source: BlackRock. Data as of Dec. 31, 2012.

Note: Chart only shows selected fixed income categories. Shaded areas represent time periods when US Treasury yields rose 1% or more from trough to peak.

## PULLING THE PLUG?

What happens to ETP fixed income flows when yields rise? If history is any guide, not a heck of a lot. The impact on overall ETP flows was scant, although inflows slowed in the most recent period. See the chart above.

Yield spikes do influence interest rate-sensitive sectors such as US Treasury ETPs, which recorded some monthly outflows in both periods. Inflation-protected ETPs saw inflows of \$12.9 billion during the first period, but recorded some outflows in the second. Credit sensitive ETPs such as high yield have been less affected—so far.

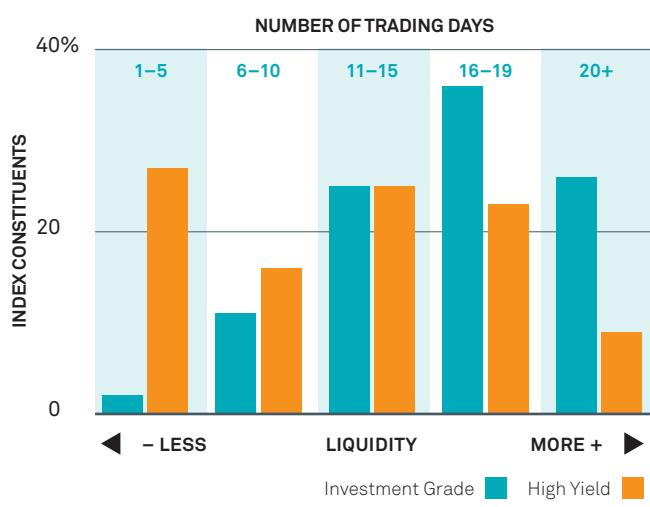
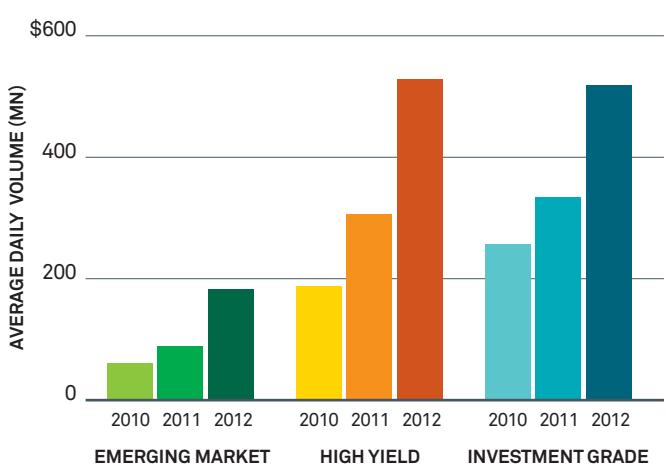
## VARIETY OF VOLUME

The growing popularity of fixed income ETPs has lit a fire under ETP volumes. Exchange trading about tripled in emerging market debt and high yield, and doubled in investment grade. See the left chart below.

ETP volumes are small compared with the overall value of trade in the underlying bond markets. But they are more vibrant than the trading in many individual issues. A quarter of high yield bonds trade just one to five days a month. See the right chart below. The OTC market is easy to enter, but may be tough to exit, as detailed in *Got Liquidity?* in September 2012.

## TALE OF TWO MARKETS

ETP Volumes and Corporate Bond Trading



Sources: BlackRock and Trade Reporting And Compliance Engine (TRACE). Data as of Dec. 31, 2012.

Notes: Right chart shows the average number of days bonds traded monthly in 2012.

## TRICKLE-DOWN ECONOMICS

Suppose high yield bonds were to sell off. Would high yield ETPs be forced sellers, and create a vicious circle of ever lower bond prices? Not to a greater extent than other market participants—and maybe to a lesser, according to *High Yield ETF Behavior in Stressed Markets* by BlackRock's iShares team in November 2012. Highlights include:

- ▶ Fixed income ETPs make up a minuscule slice of the market, and pale in comparison with mutual fund bond holdings.
- ▶ ETPs do not have a clumsy "sell" button that is triggered when prices go south. The redemption (and creation) of ETP shares is done by actual people (dealers)—and they likely only sell when there is a real market and arbitrage opportunity. Until then, chances are dealers will just mark down the price of the ETP (making it a tool for price discovery in the OTC market).
- ▶ This means the ETP will likely start trading at a discount to the (slower moving) underlying market. This may attract ETP buyers because investors can assess and exploit the opportunity in real time. It also may lessen the pressure on dealers to redeem shares and sell into the OTC market.

All this creates a (partial) decoupling of ETP exchange volumes and activity in underlying markets. One way to measure this is to compare ETP exchange volume with gross flows, which give a good indication of creation/redemption activity. The first is a multiple of the second. See the chart above right.

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## DANCING TO A DIFFERENT BEAT

### Bond ETP Exchange Volumes and Gross Flows



Sources: BlackRock.  
Data as of Dec. 31, 2012.

Another method is to analyze data from BlackRock iShares, which accounted for around two thirds of the overall US fixed income ETP market in 2012. iShares ETP volumes were on average four times greater than gross creations/redemptions in those funds last year.

Conclusion: Fixed income ETP price and volume changes do not necessarily trickle down to the underlying bond market.

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