VanEck: Bond ETFs Offer Fresh Takes

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THE NEWEST ETFS FROM VANECK OFFER A FRESH ANGLE ON THE WELL-TROD INVESTMENT-GRADE CORPORATE BOND SPACE

VanEck is known for offering differentiated exposure across the asset classes it covers. It recently expanded its fixed income offering by launching the VanEck Vectors Moody's Analytics IG Corporate Bond ETF (MIG) and the VanEck Vectors Moody's Analytics BBB Corporate Bond ETF (MBBB), which rely on indexes that draw on Moody's proprietary research to construct bond portfolios. Here, VanEck Director of ETF Product Management William Sokol discusses what sets these funds apart and their underlying investment case.

- VanEck Vectors Moody's Analytics IG Corporate Bond ETF (MIG), 0.20%
- VanEck Vectors Moody's Analytics BBB Corporate Bond ETF (MBBB), 0.25%

Tell me about VanEck's first launches in more than a year.

We launched the VanEck Vectors Moody's Analytics IG Corporate Bond ETF (MIG) and the VanEck Vectors Moody's Analytics BBB Corporate Bond ETF (MBBB) in early December. Essentially, both of these funds track indices that comprise attractively valued, dollar-denominated, investment-grade corporate bonds, which provide excess compensation relative to their risk. Excess spread means the excess of market spread versus "fair value," which is based on proprietary credit risk metrics developed by Moody's Analytics.

The two funds are very similar in their approach. The difference is that MIG focuses on the broad investment-grade market and the most attractively valued bonds out of the broad investment-grade universe. Meanwhile, MBBB, as the name implies, focuses on the BBB segment of the corporate bond universe, which, in itself, is a very large segment of the corporate bonds part of it—approximately 50%. It's a very similar methodology, but with a different starting universe.

The Moody's Analytics credit model is very well-known among credit practitioners. It's been out in the market for several decades. It has a very large team of researchers who support the credit model. So it's really relied on by many institutions around the world, for credit risk management and portfolio management.

The model calculates what's called the "expected default frequency." It's essentially a forward-looking measure of the probability of default, from which fair value can be derived, as well as other credit risk metrics, including the probability of experiencing a ratings downgrade. It's very much a quantitatively driven strategy, with a large number of inputs incorporated by the model.

Talk a little more about the model.

One of the key inputs is a firm's stock price. The model uses a firm's stock price and a company's assets from its balance sheet to model out the probability of default, over several different paths based on volatility assumptions to determine the forward-looking probability of default.

That's very different from just taking a credit rating to make that determination, because credit ratings can tell you things like historical probabilities of default. They could tell you, relative to other ratings, which is more risky. But they don't tell you, on an absolute basis, what you can expect with a particular bond, over the next year or some other period, in terms of its probability of default. It only provides historical information.

For instance, if you want to build a strategy around security selection—and considering that 50% of the corporate bond market is BBB—just knowing that a bond is rated BBB doesn't really tell you anything in terms of assessing whether a bond currently provides attractive value. You need to be issuer-specific and bond-specific when you're assessing whether a bond has value.

Further, these estimates need to have a higher frequency to capture market opportunities as they come up. That's why we like the Moody's Analytics credit model, because it's based on nearly real-time market data. Credit ratings are useful, but we felt you need granular, responsive and forward-looking metrics to identify individual bonds that provide attractive value based on current market pricing.

The methodology ranks every bond in the universe by excess spread. What we mean by that is that the model determines a fair value spread based on its expected default frequency, or expected probability of default. The fair value spread is a model-determined spread that an investor should be earning as compensation for the risk of the bond.

The index provider compares that fair value spread, calculated by Moody's Analytics, to the actual spread that can be achieved based on current market prices. If the bond provides you more spread than what's needed to compensate you for the risk that's embedded in that bond, then that may be attractive.

Essentially, you end up with an index comprising bonds that have attractive value, in the sense that they're providing an attractive level of spread for the amount of risk you're taking.

Could MBBB and MIG replace a standard, plain vanilla corporate bond exposure in a regular portfolio?

I think MIG could certainly be an attractive option to replace a broad corporate bond exposure within your core bond portfolio. Investment-grade corporates can play an important role within a core bond portfolio. This could be a good option to get that exposure.

It's selecting the most attractively valued bonds from within the entire U.S. corporate bond market to build a very diversified portfolio, but one that only focuses on the most attractively valued securities, and one that avoids bonds where you're not earning enough compensation for the risk you're taking.

MBBB might be an attractive complement to a broader exposure or to increase corporate exposure within a core bond portfolio for investors who are able to assume a little more risk and volatility for the enhanced yield and total return potential.

Both funds allow you to maintain that corporate exposure without taking on too much risk relative to spread you're earning. And what we've found in our research is that bonds that have high excess spread have provided consistent outperformance over time, versus bonds that have low excess spread, or versus the broad corporate bond market.

This seems to be very on-brand for VanEck. The firm doesn't really do plain vanilla, at least not in the income space. How do these funds fit in with the wider field?

We definitely think that, in some markets, a broad beta exposure is not always the best way to approach investing, depending on what your goals are. If you're looking for outperformance, if you're looking to enhance yield, or maintain yield and reduce risk, you need to be selective and target the individual securities that can provide the characteristics you're looking for, so you can achieve the desired outcomes.

For example, that's what the VanEck Vectors Fallen Angel High Yield Bond ETF (ANGL) does, by targeting a specific segment of the high yield universe that has delivered very attractive performance, and what we believe to be superior outcomes, versus a broad-based high yield bond exposure.

That's what we're trying to do here with MBBB and MIG: Select a unique segment of bonds from a very broad universe—meaning, the most attractively valued investment-grade corporate bonds—so that investors can achieve their desired outcomes. In this case, that means maintaining an attractive level of yield without having to take on too much risk within a core bond portfolio.

Again, the way we do that, in the investment-grade space, is by focusing on the most attractively valued bonds. What makes this a little bit different is that the methodology relies on credit metrics developed by Moody's Analytics. It has an industry-leading credit risk model that has been around for several decades. It's built on an established methodology supported by extensive research, and an extensive data set that is proprietary to Moody's.

MIG and MBBB are the first U.S. ETFs that deliver rules-based strategies that use data from the Moody's Analytics credit model to select bonds, the same platform relied on by hundreds of the world's largest institutions. That's a very attractive feature of these strategies.

They're also completely quantitatively driven strategies. The credit model and the index selection process don't rely on stale data. It doesn't rely on backward-looking data. It's not influenced by the way companies report their financials. It's a completely rules-based methodology, so you remove any subjectivity and apply a very disciplined process.

And it's more forward-looking. Bonds are selected based on forward-looking measures of credit risk. And because equity prices really help to drive some of these credit risk metrics, it gives you these signals that have sufficient frequency to allow investors to capture market opportunities. For a performance-oriented strategy that relies on security selection, we think that's important.