Xtrackers

FIXED INCOME ETFs – AN ASSET OF CLASS FOR YOUR ALLOCATION
THINK ETF. THINK X.

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ETFs help investors achieve their Fixed Income portfolio goals

Imagine bond pricing could be made transparent. Imagine bond trading could be brought on exchange, and that bond trading would function without reliance on increasingly constrained bank balance sheets. Imagine being able to trade indexed bond exposure in one standardised vehicle rather than hundreds of individual bonds with various product features, without losing out on diversification.

Now keep these thoughts in mind while you read the rest of this brochure.

This brochure touches on a range of fixed income exchange-traded fund (ETF) aspects, starting with the goals investors have in mind when considering fixed income ETFs — for example, improving diversification, increasing liquidity, allocating cash more efficiently, reducing costs or increasing yield. The brochure further analyses the growth of fixed income ETFs and how various ETF features resonate in different market scenarios.

The variety of bond exposures available through the Xtrackers platform is broad: it ranges from broad market exposure, sovereign bonds, inflation-linked, corporate, covered and emerging market bonds, to currency-hedged, interest rate-hedged, inverse, credit and cash ETFs. These ETFs offer a variety of yield and duration exposures to suit investors' individual needs.

In the liquidity section we discuss how fixed income ETF trading is beneficial as a transparent, on-exchange, standardised way of trading bond exposures.

Last but not least, we shed some light on how to most efficiently track a fixed income index in an ETF. We outline the tasks facing a fixed income ETF portfolio manager, showing that the goal of tracking indices requires operational excellence and precision.

We hope this brochure provides you with new insights that will help your investment process and identify how fixed income ETFs can address your investment needs today and in the future.

Julien Boulliat

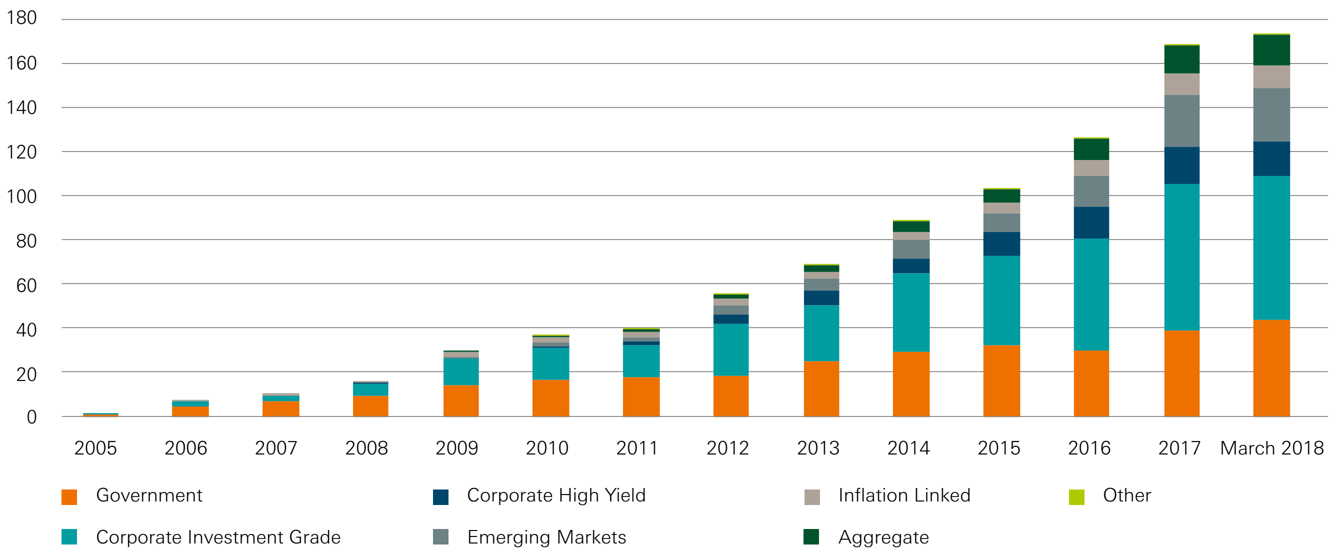
Managing Director
Head of ETF Portfolio Management Europe and Asia

Fixed Income ETF assets are growing rapidly

The first exchange-traded funds (ETFs), launched in the 1990s, aimed to track equity indices. But in the last decade fixed income ETFs have attracted growing interest from investors.

European fixed income ETF assets rose from €7 billion in 2006 to €173 billion in Q1 2018, a compound annual growth rate of 30 percent. By the end of 2017, a quarter of all European ETF assets were in fixed income funds, about double the market share level of 2006.

GRAPH 1:
European fixed income ETF assets by market segment (in EUR billion)



Source: DWS, Bloomberg, as of 31 March 2018. European domiciled ETFs, all providers.

Why have fixed income ETF assets grown at such a pace?

Five key characteristics of ETFs have helped boost client demand during the last decade:

Transparency

During the financial crisis of 2008-09, many investors switched out of complex, hard-to-value fixed income products and into more transparent investment vehicles, such as government bond and money market ETFs. The vast majority of ETFs track indices based on consistent, publicly available rules, while also disclosing their portfolio holdings daily.

Targeted Exposure

During 2010-2012 the increasing variety of European fixed income ETFs helped investors select the precise market, maturity and credit exposures they wanted for their portfolios. For example, government bond ETFs investing in "safe haven" countries and investment-grade corporate bond ETFs that excluded financial issuers proved popular.

Access Vehicle

Gaining immediate, diversified exposure to fixed income securities can be challenging, especially in less traded segments of the market, such as corporate bonds. ETFs act as a convenient access vehicle for indices of bonds with similar underlying characteristics.

Low Costs

In recent years record low bond yields have thrown the costs of investing into sharp focus, as asset management fees threaten to consume an increasing share of investors' overall returns. The average All-in Fee (TER) of fixed income Xtrackers ETFs is only 0.19%.[1]

Liquidity

The liquidity of an ETF reflects its underlying holdings. But in less liquid fixed income market categories, such as high-yield corporate bonds, investors increasingly use ETFs as a price discovery mechanism for the market as a whole. Secondary market trading in ETFs often enables investors to enter and exit funds at lower cost than buying or selling the whole underlying index basket. This liquidity feature has been cited as a key reason for recent investor interest in fixed income ETFs.[2]

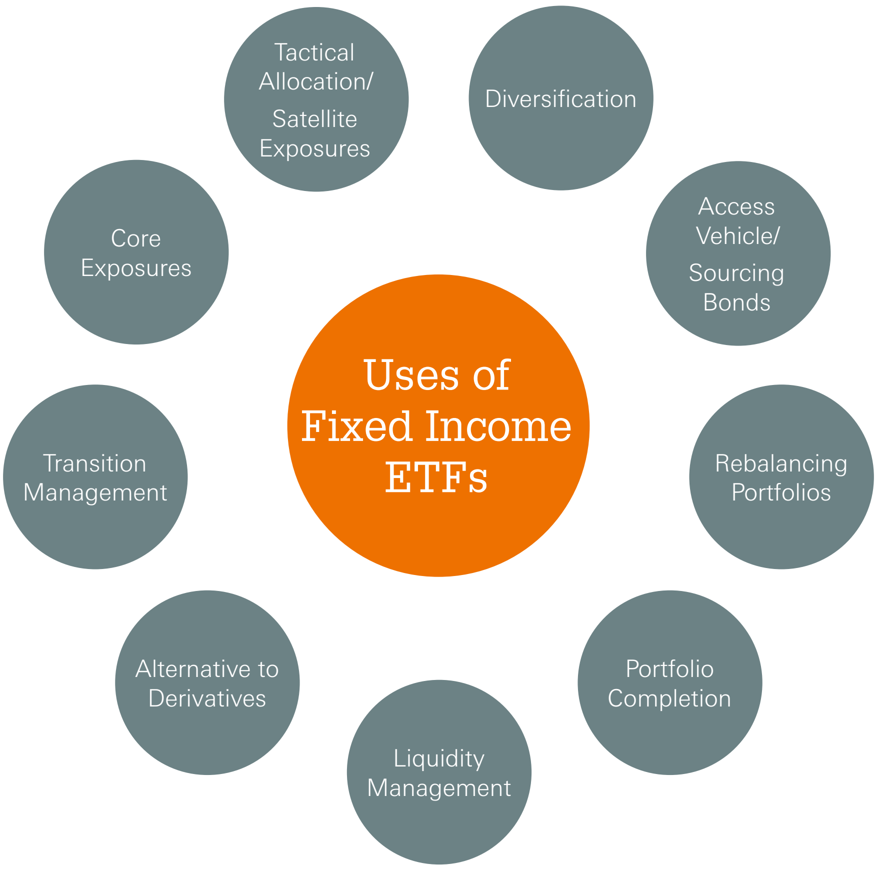
1 Source: DWS. Average TER is calculated as an asset-weighted average as of 31 May 2018.
2 For a detailed analysis of ETF liquidity, please see the passive insights paper 'ETFs: Catalyst or Mirage for Market Liquidity?' https://etf.dws.com/ - 'Downloadcenter' – 'Passive Insights'

Uses of Fixed Income ETFs

ETFs are best understood as building blocks, designed to be used in portfolio construction. The performance of most fixed income ETFs is linked to that of an underlying index, which follows consistent, publicly available rules. This ensures that investors are exposed to targeted risk/ return measures such as yield, duration or credit spreads.

The modular nature of fixed income ETFs makes them suitable for a wide range of uses.

Examples of uses of fixed income ETFs



Source: DWS – For illustrative purposes only

Imagine, for example, that a fixed income portfolio manager has the following goals:

Scenario 1: Diversification

A manager has core holdings of individual fixed income securities from the domestic market but is looking to diversify into foreign currency-denominated, higher-yielding or emerging market bonds. Individual ETFs provide instantly accessible, broad exposure within these market categories.

Scenario 2: Core and satellite (tactical) exposure

A portfolio manager may use fixed income ETFs on core market segments to reduce overall portfolio costs, and complement these exposures with more tactical 'satellite' allocations for example to specific maturity buckets or high-yielding bonds.

Scenario 3: Access Vehicle/Sourcing Bonds

The portfolio manager regularly receives cash inflows of unpredictable size into the portfolio and needs to allocate the money quickly and efficiently. Rather than constructing a purchasing programme of individual bonds, which can take time, threatening a drag on portfolio performance, the investor can use large and liquid fixed income ETFs to gain exposure immediately. Further, since ETF shares can be created or redeemed in-kind[3], via an exchange of the ETF units for the bonds in the underlying portfolio, the investor can acquire the ETF units and then request a redemption, receiving the bonds in return.

Scenario 4: Transition Management

Following the termination of an active mandate, a portfolio manager wishes to retain market exposure during the interim period before appointing a replacement manager. ETFs offer index-based returns within a variety of individual market segments, allowing the investor to maintain the desired exposure during the transition.

Scenario 5: Investing on an FX-Hedged Basis

The portfolio manager wishes to buy bonds in a particular foreign market while reducing the risk of a fall in the foreign currency. Currency-hedged fixed income ETFs offer this market exposure in a pre-packaged format, based upon systematic rules and transparent pricing of the hedge transaction.

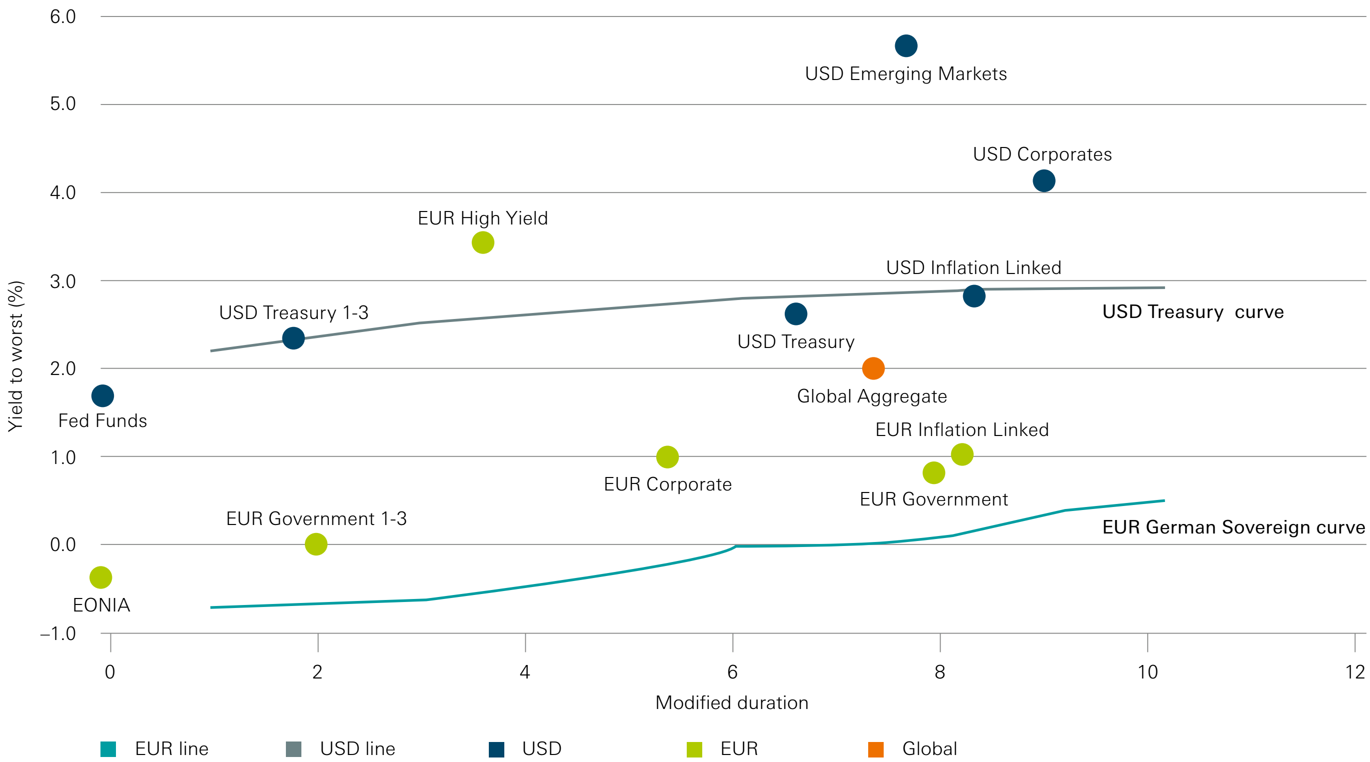
[3] Via the services of an "Authorised Participant" or "AP".

Which Fixed Income market segments do ETFs cover?

DWS Xtrackers range offers investors exposure to a wide variety of fixed income market segments, helping them to find the right solution for their portfolio requirements. The approximately 50 fixed income ETFs currently offered cover segments from government bonds to emerging market bonds, from investment-grade to high-yield corporates and from single country exposure with maturity focus to global aggregate bonds in a currency hedged format.

The indices underlying these ETFs can be categorised by geography, issuer type, currency of denomination, income stream, levels of diversification, index methodology, credit spread, duration and issuer quality. In the table we illustrate key characteristics of fixed income ETFs, showing the range of options potentially available for investors.

GRAPH 2:
Examples of bond segments offered by Xtrackers ETFs



Source: Bloomberg Barclays, Markit iBoxx, DWS. As of May 2018.

Features of Fixed Income ETFs

Characteristic

Global	Geographical Coverage	Regional/Single Country
Government/Agency	Issuer Type/Market Sector	Corporate/Covered
Multi-currency	Currency of Denomination	Single-currency
Fixed	Income Stream	Variable/Inflation-Linked
Diversified/Aggregate	Diversification	Concentrated/Liquid
Capitalisation-Weighted	Index Methodology	Alternatively-Weighted
AAA or Investment Grade	Credit Quality	High Yield
Short duration/cash-like	Maturity/Duration	Long Duration
Unhedged	Currency Risk	FX-hedged

Source: DWS. For illustrative purposes only.

Liquidity and trading

In the past, bond investors may often have wanted to trade fixed income securities as easily as trading equities. That is, instead of seeking prices in the OTC market for hundreds of bonds with varying features, there could be a single security that bundles the available liquidity in the fixed income markets and also offers transparent pricing.

Fixed income ETFs make this wish less unrealistic than it sounds.

Fixed income ETFs are regulated, open-ended mutual funds. Each ETF tracks a bond index that can contain hundreds or thousands of bonds. But in contrast to traditional mutual funds, which are usually priced and traded once a day, ETFs trade continuously. This trading takes place on stock exchanges during the trading day, as well as in the OTC market, where many investment institutions, banks and professional market makers interact.

By bringing the trading of the bond basket onto an exchange, the ETF promotes price transparency and price discovery. In turn, the exchange order book, which discloses potential ETF buyers and sellers and their preferred prices, helps create an additional layer of liquidity, from which all market participants can potentially benefit.

The larger and more liquid a fixed income ETF, the greater the proportion of trading that is likely to take place in the secondary market (either on-exchange or OTC) and the more significant this secondary layer of liquidity.

The layers of ETF liquidity

Secondary market trading offers an additional layer of liquidity:

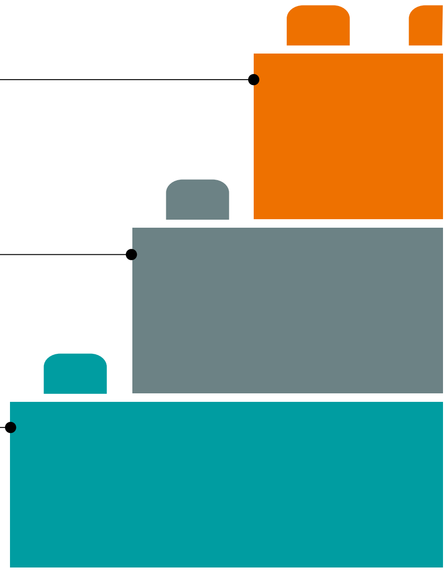
It reflects the trading volume that is exchanged between investors and market makers without resulting in creations or redemptions of ETF units. It is the flow that is 'absorbed' by the market.

In practice:

The liquidity (costs) of creations and redemptions is determined by the basket of bonds needed to create or redeem ETF units.

Base case:

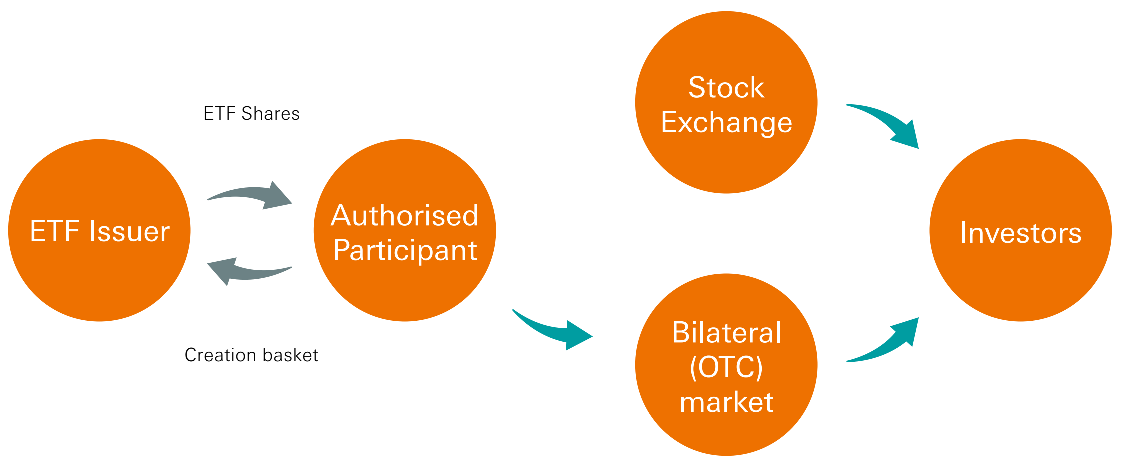
ETFs are index tracking funds. In theory a fixed income ETF should be as liquid as the single bond components in the benchmark. This assumes all bonds are traded when the ETF is traded.



The accurate secondary market pricing of an ETF depends on the primary market, where dealers called Authorised Participants (or "APs") are authorised to create and redeem ETF shares directly with the ETF issuer. The existence of the primary market helps ensure that any significant deviations between the market price of the ETF and the value of its underlying assets are ironed out using the mechanism of supply and demand.

The diagram shows how an ETF creation works: ETF shares are distributed from the ETF issuer to the Authorised Participant (in the primary market, shown by the grey arrows) and onwards (via the secondary market, shown by the turquoise arrows) to investors.

How an ETF creation works



Source: DWS

In order to facilitate the liquid trading of Xtrackers ETFs we address liquidity in our ETF construction, portfolio management and trading functions:

_ We select fixed income indices for our ETFs that include liquidity screens, such as a minimum amount outstanding per bond and per issuer, or ratings cut-offs
_ We choose the replication methodology to suit the index type, allowing for physical sampling (optimisation) or synthetic replication approach where full physical replication might involve the inclusion of too many illiquid securities
_ By allowing ETF creations and redemption to take place both in-kind and in cash, as well as in relatively small minimum basket sizes, we encourage APs to participate in our ETFs' primary market, thereby supporting liquidity

The behaviour of any fund cannot be divorced from the behaviour of its underlying assets. At times, liquidity concerns may affect different types of market. However, ETFs have "lines of defence" in mitigating potential liquidity risks.

Tracking a Fixed Income index

Managing a passive (index-tracking) fixed income portfolio sounds simple: in theory, the portfolio manager just buys all the bonds in the index. In practice, this is often a suboptimal way of running an index fund. Why? It comes down to the way the bond market works.

Secondary market trading activity in bonds can be concentrated, usually in large and recently issued individual securities. That is true in the government bond markets and even more so in corporate bonds and other sectors. This doesn't mean that bonds which are less actively traded do not have a price – just that it's usually more expensive to buy and sell them.

As a result, buying the index bonds in their full weightings usually makes sense only for concentrated indices of relatively more liquid securities, such as high-quality government bonds. For other types of indices, full index replication is likely to generate an undesired level of trading costs, threatening to defeat the objective of tracking the index.

An alternative is to replicate the index via a process called stratified sampling: this means selecting a sample of the benchmark's securities that will closely match the benchmark's risk profile within multiple predetermined buckets. This approach helps keep the overall risk/return exposures of the portfolio (such as yield, duration and credit spread) close to those of the benchmark, based on a smaller number of portfolio holdings. In turn, turnover costs can be reduced when compared to a policy of full replication.

Another type of index replication methodology is derivatives-based or "synthetic". The manager of the passive fixed income portfolio outsources the responsibility for tracking the index to a third party, usually a bank, which guarantees to provide the return on the index under a bilateral derivatives contract. The third party also hands over a basket of collateral to back its promise. Synthetic replication is used to track less liquid fixed income indices.

Full physical, sampled physical and synthetic replication index-tracking techniques all have pros and cons – see the table. At DWS we use both physical and synthetic replication in our Xtrackers ETF range.

TRACKING TECHNIQUES

Methodology	Definition	Advantages	Disadvantages
Full Physical	All index constituents purchased at full index weighting	Very low tracking error Easy to understand	High transaction costs Not feasible for less liquid indices
Sampling Physical	Portfolio holdings selected matching benchmark risk profile across key risk buckets	Efficient for broad, less liquid indices Lower transaction costs	Higher tracking error Requires specialist skills and infrastructure
Synthetic	Counterparty provides benchmark return via a derivative contract	Very low tracking error Lower transaction costs	Credit exposure to swap counterparty (can be offset by collateral)

Source: DWS

A Fixed Income ETF manager is far from passive

Index-tracking ETFs are passive by name, but not by nature. The sampling process requires high levels of specialist industry knowledge, a robust operational infrastructure and precision in implementation. Together, these qualities help ensure success in meeting a fixed income ETF’s primary objective – to track its index.

Julien Boulliat,
Managing Director, Head of ETF Portfolio Management Europe and Asia explains:

In recent years we have built up a team of fixed income specialist portfolio managers and assistant portfolio managers. We run physical as well as synthetic fixed income Xtrackers ETFs. The main objective of each ETF is to track the performance of the underlying index as closely as possible, we have two main focus areas that enable us to deliver high quality replication:

1 Portfolio construction and risk monitoring

The key challenge is to minimise the active risk of a portfolio by choosing bonds that will better match the benchmark's risk profile within various identified risk buckets, still favouring assets with higher liquidity to lower transaction costs. Ensuring the quality of replication in our portfolios is a continuous process that relies on two key systems:

_ Our centralised portfolio management system (Aladdin by Blackrock) which allows portfolio managers to monitor and adjust funds ex-ante active exposures versus a multitude of internal tolerance levels across various risk buckets (country, maturity, sectors...) and risk metrics (duration, spread duration, credit spread...) while still focusing on liquidity thanks to multiple live data feeds flowing automatically in the portfolio construction module (continuous evaluated prices, brokers inventories...)
_ Some proprietary tools providing very detailed ex-post performance attribution analysis

Primary flows another key method of continuously improving the quality of replication: With every cash flow we can ‘fine-tune’ the tracking of the index by buying or selling bonds. This means we can use inflows into the ETFs to fill gaps in a physical sampled portfolio. The bond lists for creations/redemptions by our Authorised Participants are put together by our team in such a way that they maintain - or in some cases enhance - the tracking quality while also focusing on the more liquid bonds in order to decrease transaction costs where possible.

2 Performance enhancement

Although most bond indices only rebalance monthly, we don’t necessarily wait until month end to adjust the portfolios for market events such as new issues, corporate actions or rating changes as this wouldn’t always achieve best trade timing for the bonds we trade and there are opportunities to lower the rebalance cost. That is why we are active throughout the month and continuously monitor all market events to understand their impact on month end rebalance. Each trading opportunity is then compared to the active risk it represents and if this risk remains within internal pre-determined tolerance levels, we sometimes trade the index changes ahead of the effective rebalance date to benefit from potential premiums.

Lowering transaction costs is the other key driver of performance enhancement. In addition to the liquidity focus when choosing the bonds to trade, the experience of our in-house trading desk offers lower transaction costs. We benefit from a global trading desk with experienced specialists based in several locations (Frankfurt, New York and Hong Kong) who ensure not only best execution for clients but also allow us to leverage the power of being part of one of the largest asset managers in Europe.

Why choose Xtrackers Fixed Income ETFs?

Passive portfolio management is a highly competitive business. Why should investors select DWS as their fixed income ETF manager?

We believe our firm is well-positioned for this role for the following reasons:

- Clients benefit from a comprehensive range of fixed income index exposures.
  - Our Core fixed income ETF range offers physical, cost-efficient exposure for investors' core allocations: EUR and USD government bonds, EUR and USD investment grade corporate bonds and EUR and USD high yield corporate bonds. For USD exposures FX hedged share classes are available.
  - More than 45 additional ETFs complement the Core range to address varying investor requirements, including for example cash ETFs, maturity band government bond ETFs, emerging market bonds, ESG or strategic beta ETFs.
  - The Xtrackers share class structure offers distributing or accumulating options as well as currency hedging (more than 25 share classes available).
  - Through the open architecture trading platform, investors can buy and sell Xtrackers ETFs via a broad range of banks and brokers as well as fund platforms. Our Capital Markets team can assist investors to achieve efficient execution for ETF trades at no additional charge.

- DWS Xtrackers has pioneered a variety of fixed income exposures for the region's investors and we continue to demonstrate flexibility and innovation in meeting clients' fixed income portfolio management needs.

- Our Xtrackers clients benefit from a clearly articulated and efficient investment process, with robust risk, compliance and performance monitoring. Our ongoing investments in operational and dealing infrastructure help ensure that ETF investors enjoy economies of scale and low dealing costs.

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Netherlands

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