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by markit

What are bond indices?

Today's bond market

The bond market is the largest securities market in the world. With \$87.2tn outstanding, it far surpasses the more popular equities market, which enjoys a greater share of the media spotlight.¹

However, bonds play a vital role in the functioning of the global financial system. They link lenders (investors) with borrowers. In buying a bond, an investor is essentially providing a loan to the bond issuer who in return will pay back the full loan with periodic interest payments. How do investors connect with the bond market to access investment opportunities globally? Enter bond indices and index investing.

What is an index?

An index is defined as a statistical measure, typically of a price or quantity, calculated from a representative set of underlying data.²

Most commonly known for its role as a benchmark, an index can be described as the standard against which the performance of a financial instrument can be measured. In this role, an index provides a way to measure the performance of a specific segment of a financial market, i.e. comparisons within a region, industry sector or other asset classes.

A bond index is used to measure the value of a section of the bond market. It can be defined by specific characteristics such as maturity or credit rating to capture a narrower slice of the market.

¹ Bank for International Settlements, Quarterly Report, June 2015

² European Commission http://ec.europa.eu/index_en.htm

How are indices used?

As a measure of performance, investors, central banks and regulators use indices to gauge market developments. Aside from acting as a barometer of market temperament, indices also play a significant role in both active and passive fund management strategies.

An actively managed fund (one that seeks to outperform the market) will use an index as a benchmark to measure performance. Passively managed funds, also known as “passive indexing” or “index tracking” funds, use indices to track a specific market (or asset class) as closely as possible in a bid to replicate the performance of the index.

Investors (active and passive alike) will invest in index funds that track specific bond indices that fulfill their investment criteria.

For example, a fund which wants access to a broad range of liquid US high yield corporate bonds may opt for the Markit iBoxx Liquid Investment Grade index.

iBoxx \$ Liquid Investment Grade Index



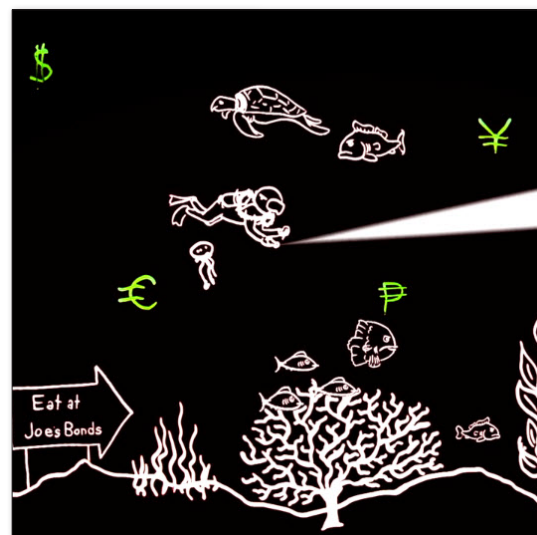
Source: Markit

Fixed income complexities

The complex nature of the fixed income markets made the emergence and initial adoption of the bond index much more gradual than its equity index cousin.

Unlike equities where shares trade on an exchange with public prices, transactions for fixed income securities take place bilaterally between two parties via a dealer network. Traded over-the-counter, transactions are off exchange.

Bonds can vary in many ways, including asset class, type (government, corporate or sovereign), tenor and coupon rates. Equities are limited to two lines of stock such as ordinary and preference shares, yet there can be multiple bonds for every issuer of debt. Bonds trade less frequently than shares, and the lengthy trade times between issues can amount to a lack of liquidity in the bond market.

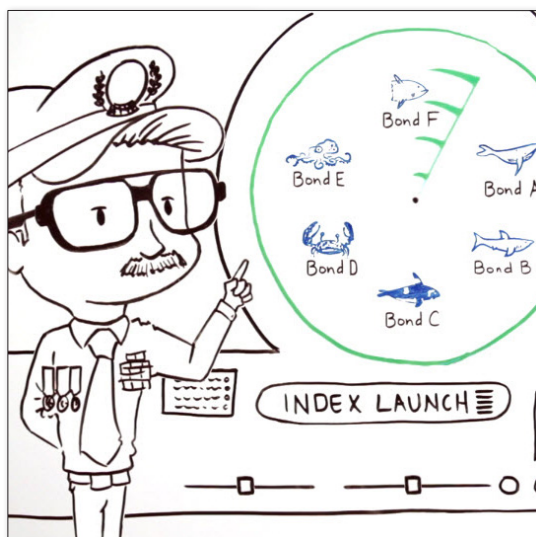


All of these factors contribute to reduced transparency of the asset class.

The role of bond indices

Bond indices provide a way to overcome the complexities of the bond market.

Since John Bogle, founder of Vanguard Group, launched the first bond index fund in the 1980s, bond indexing has evolved with indices now providing benchmarks for virtually any bond market exposure.



Investing in an index fund that tracks a bond index removes the challenge of having to select individual bonds. Bond indices provide broad exposure to segments of the bond market (taking into account the range of bond characteristics).

For instance, a bond index can offer investors an opportunity to invest in multiple liquid bonds in a single instrument. Bond indices also allow for greater risk control by affording investors the ability to tailor their potential exposure to risk and return.

An index's return will closely track that of the market, with the most effective bond indices achieving close to zero tracking error. This means that the divergence between the price behaviour of a position or a portfolio and the price behaviour of a benchmark is as narrow as possible, reducing the risk of an unexpected profit or loss.

Uptake of passive investment

A shift from active to passive investment management over the past two decades has further highlighted the importance of bond indices and the vital role they play.

Although the beginnings of the shift can be traced back to the 1990s, the sustained low yield environment created by the global financial crisis has accelerated the pace of change and provoked widespread acceptance of passive investment.

Today's investors are seeking low cost alternatives, and indices operate in a low cost environment. Lower management fees result in lower expense ratios, while lower turnover ratios (rate at which securities are bought and sold) generate lower short term capital gains.

Overall, the benefits of lower costs, greater risk control and diversification have led to mainstream acceptance of passive indexing and emphasised the significance of effective bond indices.

Conclusion

Ultimately, bond indices help investors manage the complexities of the bond market and bring greater visibility to a historically opaque and illiquid asset class.

Investors now demand a wide range of indices, and the industry will continue to adapt and evolve further to meet the changing needs of its participants.



More information

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