Vanguard

Vanguard Perspective

February 2023

Picking a corporate bond ETF that's ready for 2023

Investors looking for corporate bond ETFs to complete their asset allocation should identify the funds that potentially are best suited to weather whatever the economy does in the new year. Finding the right ETF means deepening your bond ETF expertise to make sure you're exercising due diligence.

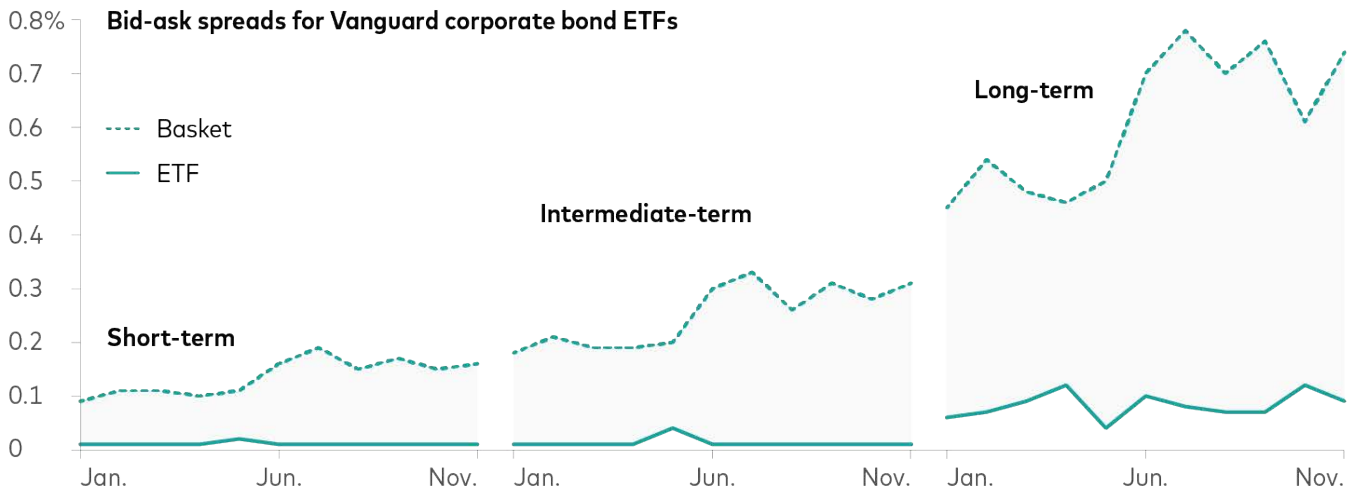
Whether the economy falls into recession in 2023 matters not in the end. What always matters is that you should choose bond ETFs based on rigorous due diligence no matter what underlying markets are doing.

The vast universe of individual corporate bonds and the decentralized nature of the marketplace can make such bonds relatively illiquid and difficult to trade, especially compared with trading a ready-made basket of bonds through an ETF. Corporate bond ETFs now loom large as liquidity providers, lowering the cost for investors to add corporate credit into their portfolios in a scalable and diversified way.

As initial proof points, investors need only look at how corporate bond ETF trading held up during periods of serious and protracted market turmoil—notably in 2018, in 2020 during the COVID-19 lockdown, and in 2022 as the Federal Reserve, to fight inflation, has raised interest rates more quickly than it has in more than 40 years.

As the chart below shows, while the cost to trade underlying corporate bonds increased during periods of volatility, ETF spreads in 2022 remained tight and allowed investors to cheaply take advantage of tactical or strategic allocation opportunities.

Vanguard corporate bond ETFs' tradability stayed virtually unchanged throughout 2022 drawdown



Note: The ETFs represented in the figure are Vanguard Short-Term Corporate Bond ETF (VCSH), Vanguard Intermediate-Term Corporate Bond ETF (VCIT), and Vanguard Long-Term Corporate Bond ETF (VCLT).
Source: Vanguard, based on year-to-date Bloomberg data as of November 30, 2022.

Given all these complexities, it's worth checking three due diligence boxes before choosing and using corporate bond ETFs on behalf of clients: optimization capabilities, ability to minimize transaction costs, and liquidity of the ETF.

Optimization capabilities

When managing bond index portfolios composed of corporate bonds, fully replicating the benchmark is often impossible. For example, some bonds will be purchased by institutional investors at the time of issuance to be held to maturity. They'll never trade on the secondary market and thus would not be available for purchase. Also, many corporate bonds have poor liquidity and may be overly expensive to add to a portfolio. For that reason, optimization capabilities are crucial for successfully managing corporate bond ETFs in terms of closely tracking their benchmarks.

As part of the optimization process, asset managers have the opportunity to take advantage of their experience, resources, and scale, finding ways to add value back to the portfolio through intelligent trading and security selection.

Vanguard Fixed Income Group uses proprietary tools developed in-house to leverage the expertise of our Global Credit Research group when making optimization decisions. This has resulted in strong benchmark-relative performance and low volatility during 2022's heightened market volatility.

Ability to minimize transaction costs

Managing liquidity and transaction costs is important to do as much as possible to maximize client experience. Unlike an ETF's benchmark, asset managers incur transaction costs, which creates a meaningful headwind to close tracking of the benchmark. In the investment-grade corporate bond market, bid-ask spreads for the 12 months ended November 30, 2022, averaged 32 basis points.[1] (A basis point is one-hundredth of a percentage point.)

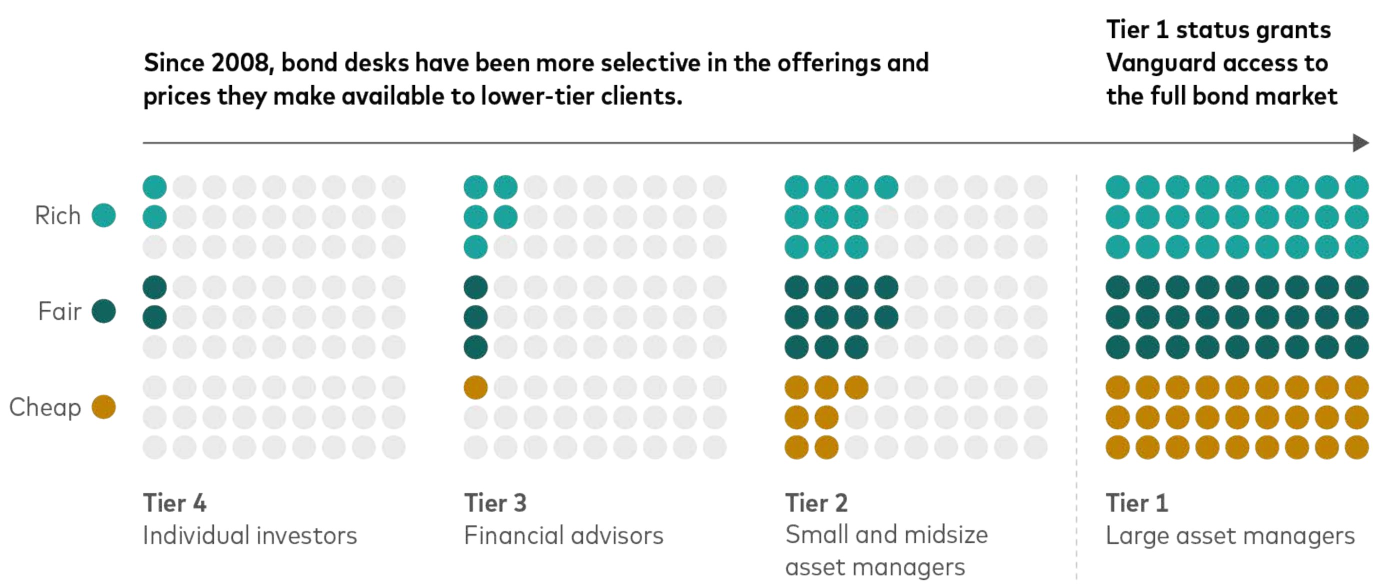
To avoid trailing our benchmark to this degree, asset managers like Vanguard have developed sophisticated trading techniques to mitigate these costs.

One such technique is to participate in new issues. The benchmark doesn't add new issues until each month-end rebalance. However, we often trade in advance of the benchmark by participating in new issues if we can receive favorable price concessions. Our size and volume of fixed income trades—in 2021, our bond indexing team traded about $1.1 trillion in bonds—allows us to be treated as a Tier 1 client for big bond desks, generating benefits that can improve outcomes for our clients.

Having Tier 1 status means:

- Getting a first look at trade lists for both primary and secondary markets.
- Having access to banks' balance sheets for instant and continuous liquidity.
- Obtaining access to large trading lots and lower transaction costs.
- Accessing the most experienced research and trading coverage from sell-side firms.

Vanguard Fixed Income Group's bond expertise is beneficial to investors



Notes: Rich, fair, and cheap refer to the asking prices of financial assets compared with the perceived fair value of those assets given market conditions. From the perception of the bond buyer, rich implies an overpriced bond, fair implies a fairly priced bond, and cheap implies an underpriced bond.
Source: Vanguard, as of December 31, 2021.

[1] Source: Vanguard, based on data from Bloomberg.

Liquidity of the ETF

A strong capital markets team and meaningful scale and trading volumes, along with investor-friendly product design, have resulted in our products offering competitive trading spreads. Many investors don't realize it, but Vanguard Short-Term Corporate Bond ETF (VCSH) and Vanguard Intermediate-Term Corporate Bond ETF (VCIT) are the two largest corporate bond ETFs in the world[2].

Vanguard Fixed Income Investment Group manages over $1 trillion in indexed fixed income, $347 billion of that through ETFs, including the world's largest bond ETF, Vanguard Total Bond Market ETF (BND)[3]. Operational efficiency and prudent benchmark selection can help lead to positive outcomes for bond ETF investors.

Trading details for Vanguard corporate bond ETFs

		-------------------------- Year-to-date	--------------------				
		Tracking difference	**Tracking error**	**Average premium or discount**	**Average daily bid-ask spread**	**Average daily volume**	**ETF AUM**
VCSH	Vanguard Short-Term Corporate Bond ETF	0.01%	0.04%	0.02%	0.01%	$466 M	$41.4 B
VCIT	Vanguard Intermediate-Term Corporate Bond ETF	0.04%	0.08%	0.02%	0.01%	$555 M	$39.7 B
VCLT	Vanguard Long-Term Corporate Bond ETF	0.17%	0.27%	0.08%	0.09%	$109 M	$4.7 B

Notes: Tracking difference measures the ETF's year-to-date (YTD) total net asset value (NAV) return versus its benchmark. Tracking error measures the YTD annualized standard deviation of the monthly tracking difference between the ETF and its benchmark. Average premium or discount measures the YTD average of daily premiums or discounts (the difference between the ETF's daily closing market price—the price at which a security trades in the secondary market—and its NAV). Market price is the midpoint between the bid and asked prices as of the New York Stock Exchange's closing time (typically 4 p.m., Eastern time) on business days. Average daily bid-ask spread is the YTD daily average spread of each ETF. AUM is each ETF's assets under management.
Source: Vanguard, as of November 30, 2022. Average daily bid-ask spread and average daily volume are based on Bloomberg data.

[2] Source: Morningstar, Inc., as of November 30, 2022.
[3] Source: Morningstar, Inc., as of November 30, 2022.

Legal notices

For more information about Vanguard funds or ETF Shares, contact your financial advisor to obtain a prospectus or, if available, a summary prospectus. Investment objectives, risks, charges, expenses, and other important information are contained in the prospectus; read and consider it carefully before investing.

Vanguard ETF Shares are not redeemable with the issuing Fund other than in very large aggregations worth millions of dollars. Instead, investors must buy and sell Vanguard ETF Shares in the secondary market and hold those shares in a brokerage account. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

All investing is subject to risk, including possible loss of principal. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. Diversification does not ensure a profit or protect against a loss.

Bond funds are subject to interest rate risk, which is the chance bond prices overall will decline because of rising interest rates, and credit risk, which is the chance a bond issuer will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

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