FIXED INCOME ETF LIQUIDITY: CAN IT BE QUANTIFIED?

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This blog post is relevant to institutional investors interested in trading exchange-traded funds (ETFs) in significant volume. Individual investors do not always have access to liquidity providers to trade ETFs as referenced below. Most investors are familiar with the idea that exchange-traded funds (ETFs) are simply a wrapper of securities and that they are at least as liquid as their underlying basket. In regards to quantifying underlyings of ETFs with equity underlyings, investors can reference implied liquidity as a benchmark for how many ETF shares can be traded through the underlying basket. Equity markets are extremely transparent, automated and competitive, allowing for clarity. In contrast, bond markets are much more opaque, are unautomated for the most part and lack transparency in regards to reporting. Fixed income ETFs allow investors to gain exposure to a wide variety of bond portfolios in an inexpensive and efficient manner by benefiting from the equity market structure as they are exchange listed. As their popularity continues to increase, we often are asked, how can the liquidity of an ETF with fixed income underlying be quantified? Before diving into assessing the liquidity of a fixed income ETF, it is important to discuss the dynamics of the fixed income market and why it poses such a challenge. Bonds are primarily an over-the-counter-, dealer-based market with no integrated trading and reporting facility. There are some reporting mechanisms for corporate, agency and municipal bonds, but they are by no means comprehensive or real time. The lack of transparency and reporting highlights the importance of understanding fixed income liquidity, not only when assessing an ETF, but also when structuring the product. WisdomTree recently launched four smart beta fixed income ETFs. Liquidity structure was of the utmost importance in creating the WisdomTree Fundamental U.S. Corporate Bond Fund (WFIG) the WisdomTree Fundamental U.S. Short-Term Corporate Bond Fund (SFIG) the WisdomTree Fundamental U.S. High Yield Corporate Bond Fund (WFHY) and the WisdomTree Fundamental U.S. Short-Term High Yield Corporate Bond Fund (SFHY). Here are some of the key liquidity screens we took into consideration when we created the Indexes that our four new Funds track: • First, a liquidity screen was applied to the U.S. fixed income universe for these Funds to only include public issuers. This allows us to have consistent access to the issuer's fundamentals and be able to better assess issuer health compared to the private sector. Additionally, bonds of publicly traded companies are generally considered more liquid than those of private companies. • The second screen applied was to the amount outstanding of the issues in the Index. A number of fixed income indexes require a minimum of $100 million in par outstanding, whereas we have applied screens of $350 million outstanding, with a $500 million screen applied to WFHY. Larger amount outstanding is also usually a sign of higher liquidity. • Last, we applied an issuer cap; we would not include more than 5% of outstanding issues for investment grade and 2% for high yield. • For our two high-yield Funds, WFHY and SFHY, we also removed the bottom 5% of the universe based upon a liquidity score comprising seasoning (length of time since issuance) and issue size. The more seasoned a bond is, the less liquid it is considered. How do investors quantify potential liquidity in any fixed income fund? We canvassed many fixed income market makers to get a sense of how they assess the liquidity of bonds. A basic industry practice is to take the size of an outstanding issue and assume that 5% of that turns over daily. A conservative estimate of how much an investor can trade over the day without impact is 25% of that daily turnover. So what does that mean? Let's take a look at WFIG. If an investor were to sum the outstanding issues in WFIG, the outstanding amount would total $81.86 billion.[1] Next, 5% of the outstanding amount is close to $4.1 billion, and 25% of that is roughly $1.02 billion. Based on our very basic calculation, an investor could potentially trade $1.02 billion of WFIG when transacting in the underlying bonds without market impact in one day. That being said, it is important to remember that fixed income liquidity is subjective, and the market makers are taking into account duration, credit quality and issue size when evaluating the underlying securities.

Potential **Liquidity** **Estimates**

	Daily Turnover Estimate	Market Impact Estimate
WFIG	$4 billion	$1 billion
SFIG	$4 billion	$1 billion
WFHY	$2.5 billion	$600 million
SFHY	$2.2 billion	$550 million

Source: Bloomberg, 4/27/16.

Although it is not obvious to the naked eye, there is ample potential for daily liquidity in fixed income ETFs. The key is knowing how to access it by utilizing your trading desk or the capital markets desks at the various issuers. Fixed Income ETFs allow investors to economically gain access to a range of fixed income strategies that they may not have the resources or tools to invest in on a per-bond basis. Fixed income ETFs have seen tremendous growth over the past several years as they have allowed investors to bridge the gap between an opaque bond market and a transparent exchange-listed security. What is paramount to remember is that the underlying securities still reside in the fixed income world, so the utilization of trading resources is crucial in order to tap into the potential liquidity. [1]Source: Bloomberg, 4/27/16.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond 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.

High-yield or "junk" bonds have lower credit ratings and involve a greater risk to principal.

While the Funds attempt to limit credit and counterparty exposure, the value of an investment in the Funds may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of each Fund's portfolio investments. Please read each Fund's prospectus for specific details regarding each Fund's risk profile.

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Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Underlying basket : Securities held by a fund to replicate an investment strategy or index.

Implied/Underlying Liquidity : Implied liquidity or implied daily tradable shares (IDTS) is a representation of how many shares can potentially be traded daily in an ETF as portrayed by the creation unit. The formula is: (30 day average daily volumes * variable percentage) / shares per creation unit) * creation unit siz.

Municipal Bond : A debt security issued by a state, municipality or county to finance its capital expenditure.

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Investment Grade : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Market maker : Someone who quotes a buy and a sell price in a financial instrument.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Credit quality : A measure of a borrowers potential risk of default.