FIXED INCOME ETFS PASS THE TEST...AGAIN

Michael Barrer — Director of Capital Markets
10/06/2021

The COVID-19-induced market volatility of March 2020 brought unprecedented stress to almost all financial asset classes. ETF critics have been saying for years that fixed income ETFs operating in an equity market structure may not hold up, given an underlying asset class that trades mostly over the counter (OTC). What we observed was that not only did fixed income ETFs operate exactly as designed during the extreme volatility of March 2020, but they added liquidity and helped avoid some of the price action the underlying market could have seen. To us, this was no surprise, as we have seen ETFs behave as intended during similar events of smaller scale.

In August 2021, the International Organization of Securities Commissions (IOSCO) published a report on their ETF observations during this period. Their view plays into exactly the conversations we on the Capital Markets team had with dozens of clients in the weeks after March 2020. Below is a summary of IOSCO's observations of the fixed income asset class for ETFs:

1. **Bid/Ask Spreads:** For any ETF, B/A spreads are a function of costs and risks. In times of higher volatility, spreads in ETFs widen in keeping with their underlying securities and the risk in the market. ETFs are unique in that they are exchange-traded, where buyers and sellers can meet on a venue to exchange risk, never causing a trade in the underlying market. Because of this technological feature of ETFs, many fixed income funds traded tighter from a spread perspective than the underlying bonds they are designed to track.

2. **Secondary Market Turnover:** ETFs are designed to be traded and they proved that in March 2020, when ETF trading increased 100% to over 40% of the total equity volume, on average. In fixed income ETFs over this period, funds traded $720 billion in turnover, but there was only $20 billion in fund outflows, or 2% of total AUM. The volatility shock of March 2020 saw fixed income ETFs trade 36 dollars to every 1 dollar of outflow. Not only is this astounding, but it shows that ETFs helped absorb the shock to the overall system and underlying bond markets. The ETF itself is a liquidity buffer! In comparison, mutual funds saw $250 billion of net outflows, or 6% of total AUM. Those outflows required portfolio managers to mostly sell bonds to raise cash, putting increased pressure on the primary market.

3. **Premiums/Discounts:** Many ETFs, especially fixed income ETFs, saw end of day premiums and discounts of closing market price to net asset value (NAV). One main reason for this is the imperfect pricing of the fixed income market structure. Because bonds do not always trade, some daily closing prices of cash bonds are estimates or models of what the vendor believes the price to be. ETF market makers price the fund where they are confident the fair value of the bonds is at that time, thus causing a disconnect that can be magnified in times of higher volatility. Furthermore, market makers price in other costs besides the price of the bonds to provide liquidity in the ETF. In times when there is not a lot of liquidity in the underlying market, like we saw in many segments of the fixed income market in March 2020, a liquidity premium in the ETF is being priced in. Investors should embrace this cost as the ETF is providing liquidity that is not present in the asset class they are gaining exposure to.

4. **Custom Baskets:** With the adoption of the ETF rule in December 2019, all ETFs became eligible to create and redeem using custom baskets. For fixed income especially, this was a welcome addition and perfect timing for the volatility storm of March 2020. Because market makers could deliver and receive highly correlated subsets of the full ETF portfolio, they were able to provide much more liquidity than if they were dealing in small lots of thousands of fixed income CUSIPs.

We have long preached the benefits of the ETF structure, especially for the fixed income market. The added layer of liquidity of the exchange-traded wrapper, the liquidity buffer to the underlying market and the access to liquidity in closed or illiquid markets was on full display during the market events of March 2020. We commend IOSCO for their research and putting on paper what we have known for some time.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. 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.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Funds

+ WisdomTree Yield Enhanced U.S. Aggregate Bond Fund
+ WisdomTree Interest Rate Hedged High Yield Bond Fund
+ WisdomTree Floating Rate Treasury Fund

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Over-the-Counter (OTC) : A security traded in some context other than on a formal exchange such as the NYSE, TSX, AMEX, etc.

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.

Bid/Ask Spread : This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

Secondary market : A market where investors purchase or sell securities or assets from or to other investors, rather than from issuing companies themselves—exchanges such as the New York Stock Exchange and the NASDAQ—are secondary markets.

Mutual Funds : An investment vehicle made up of a pool of moneys collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and other assets.

Premium : When the price of an ETF is higher than its NAV.

Discount : When the price of an ETF is lower than its NAV.

Net Asset Value (NAV) : The calculated assets minus liabilities divided by shares outstanding. NAV is the straightforward account of the actual assets in the fun.

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

Baskets : The composition of an ETF in terms one creation/redemption unit.

CUSIP : CUSIP stands for Committee on Uniform Securities Identification Procedures. A CUSIP number identifies most securities, including: stocks of all registered U.S. and Canadian companies, and U.S. government and municipal bonds.