THREE MYTHS OF FIXED INCOME ETF TRADING

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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. Fixed income exchange-traded funds (ETFs) provide the investing world with transparency in an otherwise opaque asset class. Although launched in 2002, fixed income ETFs did not become mainstream until 2008, and today these funds are often considered the growth engine for the ETF industry. However, because of the over-the-counter nature of the fixed income market and the fact that ETFs with fixed income underlying securities were adopted later than their equity-based relatives, there are still myths around the trading and liquidity profiles of these funds. I want to address these myths and explain the realities of the fixed income ETF structure. **Myth 1: Fixed income ETFs are not liquid, and on-screen volume equals ETF liquidity Reality:** ETFs are just an exchange-traded wrapper around a basket of securities. The minimum liquidity available of the ETF is defined by the liquidity of the underlying securities. With equity ETFs, the volume of the underlying securities can be measured and tracked. Implied liquidity is an industry standard metric that quantifies basket liquidity in equity-based ETFs. In the fixed income market, the over-the-counter trading nature and lack of centralized trade reporting make quantifying fixed income ETF liquidity more challenging. That being said, there is a basic industry practice that assumes 5% of an outstanding issue will turn over daily and a conservative estimate to avoid market impact is to not be more than 25% of that daily turnover. We recently discussed this subject in a separate blog post, where we quantified the potential daily liquidity in our new "Smart Beta" fixed income strategies. The bottom line remains that fixed income ETFs are designed with liquidity in mind, so they can scale, and the minimum liquidity available will always be based on the liquidity of the underlying asset class. On- screen volume only acts as an additional layer to the overall liquidity profile of the ETF. **Myth 2: Fixed income ETFs have wide spreads Reality:** The spread of an ETF is a representation of the spread in the underlying asset class, plus the costs and risks associated to the market maker. The exchange-traded and transparent nature of ETFs allows investors to see these spreads in real time. Whereas in a mutual fund, the portfolio spread would mirror that of an ETF with similar characteristics, however, the mutual fund structure does not allow for this level of intraday transparency. In fact, many fixed income ETFs actually have on-screen spreads that are tighter than the spreads in the underlying bonds. This is a distinct benefit to the exchange-traded nature of the structure, where various market participants can naturally meet on an exchange to buy and sell at prices potentially cheaper than what it costs to acquire the underlying portfolio. **Myth 3: Fixed income ETFs are broken and trade at premiums or discounts to net asset value (NAV) Reality:** Fixed income ETFs can trade at premiums or discounts relative to their NAV or intraday NAV, but this does not mean that they are broken. The problem with using NAV to compare an ETF's current price is that the NAV is based on the previous trading day's prices and is, therefore, considered stale. When comparing a fund's price to its intraday NAV, which uses a security's last traded price, investors must remember that bonds are traded over the counter and the last traded price in many bonds is not widely published (or even always known). The ETF is acting as a price discovery vehicle and gives investors real-time, actionable prices relative to where market makers know they can buy or sell the underlying portfolio or a highly correlated hedge. Given the opaque dynamics of the fixed income market and continuing adoption of ETFs with fixed income underlying securities, it is understandable that investors have questions about fixed income ETFs. Like anything that is new and not widely understood, education is a key factor along the way to broad-based adoption for these funds. We on the capital markets team at WisdomTree hope that we can put these three common myths around fixed income ETFs to rest and that this has given you more confidence in your fixed income ETF trading and investing.

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DEFINITIONS

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.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

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.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.