Fixed Income ETFs Pass the Test...Again

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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.

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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.