

Bonds, Jammed Bonds

WILL RISING ILLIQUIDITY IN BOND MARKETS GIVE ETFs LICENSE TO THRILL?

By Ed McCarthy

The bond market is experiencing a dichotomy that's challenging investors. Post-Financial Crisis, the volume of outstanding bonds has grown. At the same time, however, consolidation among banks and broker/dealers has cut the number of market makers, and new regulations have reduced the capital these companies can commit to fixed-income inventories. Matthew Tucker, CFA, managing director, head of Fixed-Income iShares Strategy at BlackRock in the San Francisco Bay Area, cites New York Federal Reserve Bank stats that these institutions currently hold 20% of their pre-Crisis bond inventories. These conditions have "caused a shift in liquidity in the bond market where many investors have to reevaluate how they source liquidity [and] where they source liquidity," says Tucker.

The illiquidity is greatest in markets with large numbers of outstanding securities. Tucker notes that there are approximately 250 Treasury notes and bonds with maturities of one year or

greater. That relatively small (by number of issues) market has remained liquid. In contrast, BlackRock estimates that less than 20% of investment-grade corporate bonds in the US trade every day. Consequently, corporate bond investors are less likely "to be successful in finding someone to trade with and finding a price at which [they] want to transact," he says.

A third-quarter 2016 report from Stamford, Connecticut-based Greenwich Associates, "Institutional Investors Embrace Bond ETFs," examined the changing bond market. Per the report: "Seventy-one percent of the institutions participating in Greenwich Associates 2016 US Bond ETF Study say the trading and sourcing of securities have become more difficult in the past three years"—up from 34% the previous year. In addition, 60% of study participants reported it was more difficult to complete large-sized bond trades in 2016.

FROM OTC TO ETF

Andrew McCollum, managing director with Greenwich Associates and the report's author, says the liquidity problem is causing prospective investors to consider how they will sell a position before completing the buy transaction. "We have

investors in our research that will say to us, 'Today, I think very carefully not about just getting into a fixed-income security but how I'm going to get out of the fixed-income security,'" says McCollum. "And for some of these bonds that aren't terribly liquid, they consider that when making their decision about what the right vehicle is. I don't think that was a big consideration five years ago."

Tucker says that illiquidity is leading bond investors to seek alternatives to the dominant over-the-counter (OTC) market structure. He estimates that the leading electronic trading platforms now handle about 20% of all corporate bond trades, and that percentage is increasing each year. Fixed-income exchange-traded funds (ETFs) are also attracting more investors. As of late 2016, the average daily trading volume in fixed-income ETFs was roughly \$7 billion, and in some instances, fixed-income ETFs can supplement the corporate bond OTC market and provide additional liquidity for investors, Tucker maintains.

A SMALL BUT GROWING ROLE

Assets held in ETFs are still a tiny slice of the overall bond market—less than 1%, says Tucker. But the Greenwich Associates survey points to rapidly growing ETF adoption:

- Sixty-eight percent of survey participants have increased their bond ETF usage over the past three years.
- Institutions are executing larger bond ETF trades. In 2016, 31% reported executing a trade of \$50 million or more, up from 19% in 2015.
- Thirty percent of investors surveyed are considering investing with bond ETFs rather than individual bond positions in the next year.
- Eighty-eight percent of institutions using fixed-income derivatives are considering or have considered using bond ETFs as an alternative.

Institutions' ETF usage serves a purpose, and even though bond ETFs are generally passively linked to an index, institutions are using the funds to take active positions, says McCollum. It can be a short-term tactical purpose, such as when an investor is changing managers but wants to maintain exposure to an asset class during the transition, but the uses go beyond those scenarios. "They're taking active positions by thinking, 'There's a real opportunity here in this category or in this asset class, and I want to get in quickly and get out quickly, and I'm going to use an ETF to do that.' Or, 'I'm going to hedge my portfolio for a long period of time, and an ETF could be a good tool to do that,'" says McCollum.

The loss of liquidity has also affected investment managers working with private clients. About five years ago,

KEY POINTS

Illiquidity in bond markets is driving investors to seek alternatives to the dominant over-the-counter (OTC) market structure.

Although assets held in exchange-traded funds (ETFs) account for a tiny share of the bond market, ETF adoption appears to be growing rapidly.

The trend is expected to accelerate, with assets in bond ETFs doubling or tripling over the next two years.

Mariann Montagne, CFA, a senior investment analyst at Gradient Investments in Arden Hills, Minnesota, began to experience increased difficulty buying bonds for individual investors. Many clients had bond allocations ranging from \$50,000 to \$200,000 that she would ladder across a range of maturities. Her usual practice was to monitor the OTC markets for investment-grade bonds, with specified parameters to buy for individual clients' accounts. She expected the price mark-ups for small retail positions to be higher than those charged against institutional lots, but between 2011 and 2013, the bid/ask spreads became "onerous, extremely onerous," she says. "You could have a 1% or 2% differential between the bid and the offer in a 2% [rate] environment. I had a devil of a time trying to get good names in the years that I needed and where the client wouldn't automatically get this 1% or 2% haircut."

OBSTACLES TO INCREASED ADOPTION

There are potential roadblocks to the further adoption of ETFs. McCollum says some institutional investors' internal guidelines include restrictions that limit their use of the funds. But those restrictions are becoming less common: Only 24% of the 2016 survey respondents still had such policies, down from about 50% in 2015.

ETF analytics are another challenge. Investors know a specific bond's cash flows and provisions, but an ETF can hold a thousand bonds, making such calculations as yield and duration more difficult. To standardize analytics, BlackRock, State Street Global Advisors, and Bloomberg, among others, jointly developed the aggregated cash flow methodology and the Fixed Income ETF Metrics Convention. "If you're an investor and you receive information from a broker/dealer about the yield or duration of an ETF, and it's calculated according to the standard, you know how the calculation is done, and you'd be able to replicate it yourself," says Tucker. "And the same thing applies if I go in and look at a provider website and see information about yield or duration or I go onto an analytics platform like Bloomberg and see information about yield and duration."

A third concern has been ETFs' performance during exceptionally volatile or disrupted markets. Specifically, do ETFs experience liquidity and price disruptions during these periods? Fixed-income ETFs have been in the market since 2002, which means they have gone through the Financial Crisis of 2008, the Taper Tantrum of 2013, and the high-yield market sell-off in December 2015. During these periods, bond ETF prices have reflected their underlying markets, and their trading volumes have increased, says Tucker. The ETF creation and redemption process with authorized market makers helps maintain the value relationship between the fund and the underlying bonds, he adds, and investors have an option to trade ETFs on an exchange versus going to the OTC market, providing them with an incremental source of liquidity.

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A December 2015 BlackRock report, "High Yield ETFs in Stressed Markets," examined the iShares iBoxx \$ High Yield Corporate Bond ETF's (symbol HYG) performance for the volatile period of 2 December through 25 December 2015. Secondary market trading in HYG increased significantly during that month to an average of \$1.5 billion per day versus \$640 million per day for the year's first 11 months. The report states: "Nearly 95% of all HYG investor trading activity during this period occurred on exchange rather than the OTC bond market. High-yield investors were able to execute transactions more efficiently by using HYG, which typically trades at a bid/offer spread of less than 1 basis point, [rather] than by using individual cash bonds, which typically trade at a bid/offer of 50–100 basis points."

A BRIGHT OUTLOOK

Observers believe bond ETF usage will continue to grow. Greenwich Associates found that one-third of institutions plan to increase their use of bond ETFs in the coming year. Of those, 30% expect to boost ETF usage by more than 10%. Insurance companies' increased use of ETFs is another positive indicator. Among the insurance companies that participated in the 2016 Greenwich Associates study, about half started investing in ETFs within the past two years, and nearly a quarter were using ETFs for 12 months or less. More than half of the surveyed insurers (52%) planned to increase their use of ETFs in the next year.

The development of fixed-term ETFs could also spur usage among institutions looking to match liabilities and among private investors seeking laddered portfolios. The fixed-term ETFs are catching on, says Tucker. The fixed-term corporate and municipal funds from iShares held \$1.4 billion at year-end 2015, an amount that grew to \$2.6 billion by November 2016. Montagne says her firm uses the Guggenheim dated fixed-term ETFs to create bond ladders in the three- to five-year range for private clients. In a rising rate environment, which the firm expects, the funds allow her to have a predictable series of rolling maturities that can capture higher prevailing rates.

These factors bode well, says Tucker, who believes that it's still the early days for the funds. "I think the ETFs have a long way to go in terms of growth," he says. "I can see assets doubling or tripling easy from here over the next couple of years."

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KEEP GOING

"Fundamental Indexing in Global Bond Markets: The Risk Exposure Explains It All," *Financial Analysts Journal* (posted online 5 December 2016) [www.cfapubs.org]

"Global Inflation-Linked Bonds: A Primer," *Enterprising Investor* (4 November 2016) [blogs.cfainstitute.org/investor]

"Should Bonds Trade More Like Equities?" *CFA Institute Magazine* (September 2016) [www.cfapubs.org]