UNDER THE SPOTLIGHT:

Fixed income ETF liquidity

ETFs force price integrity in fixed income during times of crises
Daniel Izzo, CEO of GHCO

Mutual fund liquidity mismatch pushing investors to ETFs
Tom Eckett, Deputy Editor of ETF Stream

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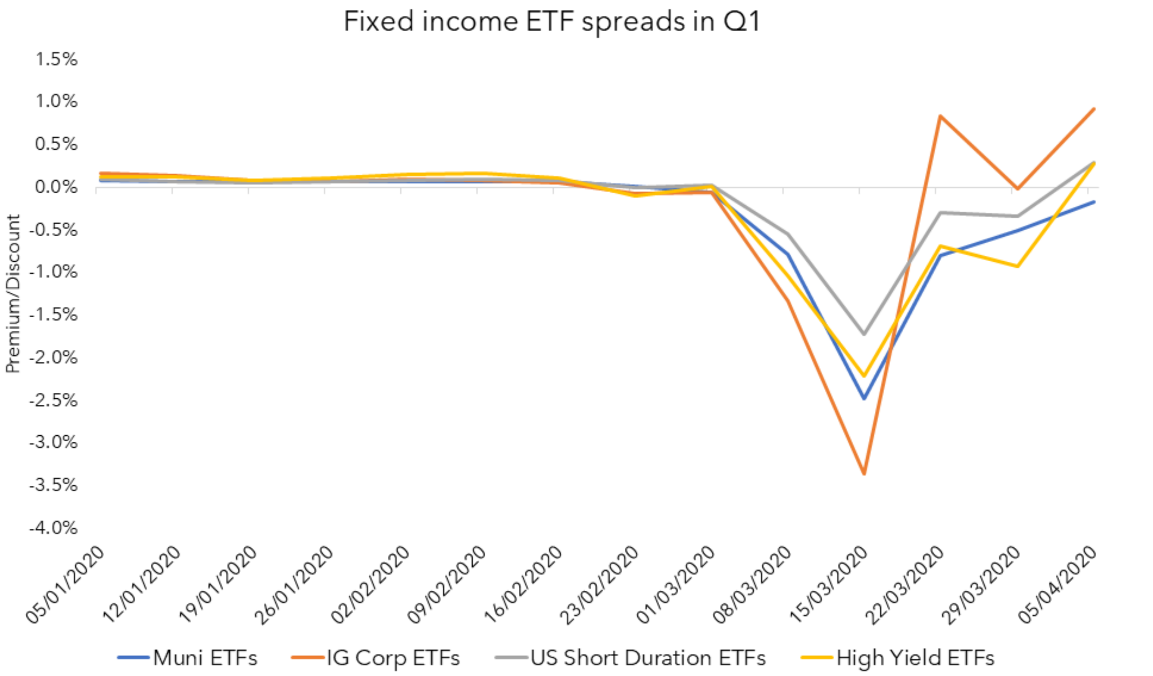
ETFs force price integrity in fixed income during times of crises

I have witnessed four fixed income crises in my career. On each occasion, in the wake of the crisis, Fixed Income ETFs were both heralded for their relative liquidity and demonised for their discounts to NAV. In reality, the perceived discount of the ETF is overstated in times of market stress. This is due to the simple fact that bonds are not traded and bond mutual funds are omitting the implied value change in their holdings because they are able to hide behind the stale prices of the bonds. The status quo for fixed income traders during a crisis is something akin to a soldier in a foxhole waiting for the income barrage of artillery, duck down, hope for the best and wait for it to pass.

ETFs reflect a more accurate risk-adjusted price of the bonds than comparable mutual funds or even the bonds themselves. While it is painful to see your positions mark down, at least you definitively know what the ETF is worth. The reality is, in periods of market stress, people want, or have, to sell. With an ETF, the market price is a measurable absolute and there is a bid. If you want to sell, you know the level and you can make an informed decision. You might not want to sell at the market price, but at least you have the option. If you own a mutual fund, you cannot sell, at least not in size or in a timely way. Pretending your mutual fund has not depreciated because its underlying bonds have not traded for two weeks is not only inaccurate reporting, it is also a tremendous blind spot in the decision-making process for investment managers. In my experience, the only thing scarier than a loss, is an unknown and immeasurable loss.

Market making does not happen by chance. Quotes are the product of continuous refinement of absolute math due to the competitive landscape. While many market makers in and around Europe are maintaining an illusion of mystique in the business, it is really not that mysterious. Market makers each have their own special recipe but the fundamentals hold true. For those of us on the inside, the margin differential is a single digit integer of basis points driven by cost structures and scale. Every time a request for a quote receives three similar quotes from competing market makers you have indisputable proof the math is consistent.

At GHCO, our goal is to build transparent and accessible markets. The liquidity of an ETF is not derived by the liquidity of its underlying index, rather by the liquidity of its most suitable hedge. This is a fundamental premise of all market making, regardless of the instrument or asset class being quoted. For fixed income ETFs, the most suitable liquid hedge can be any combination of Treasury futures, credit default swaps, or other correlated securities. At its core, market making is an exchange of liquidity risk for relative value premium. During normal market conditions, the underlying index of the bonds and the liquid hedges all maintain relative price alignment. In a fixed income crisis, market makers keep the ETF price aligned with the liquid hedges even though there is no bid for the underlying bonds. The implied basis risk between the ETF and hedge increases



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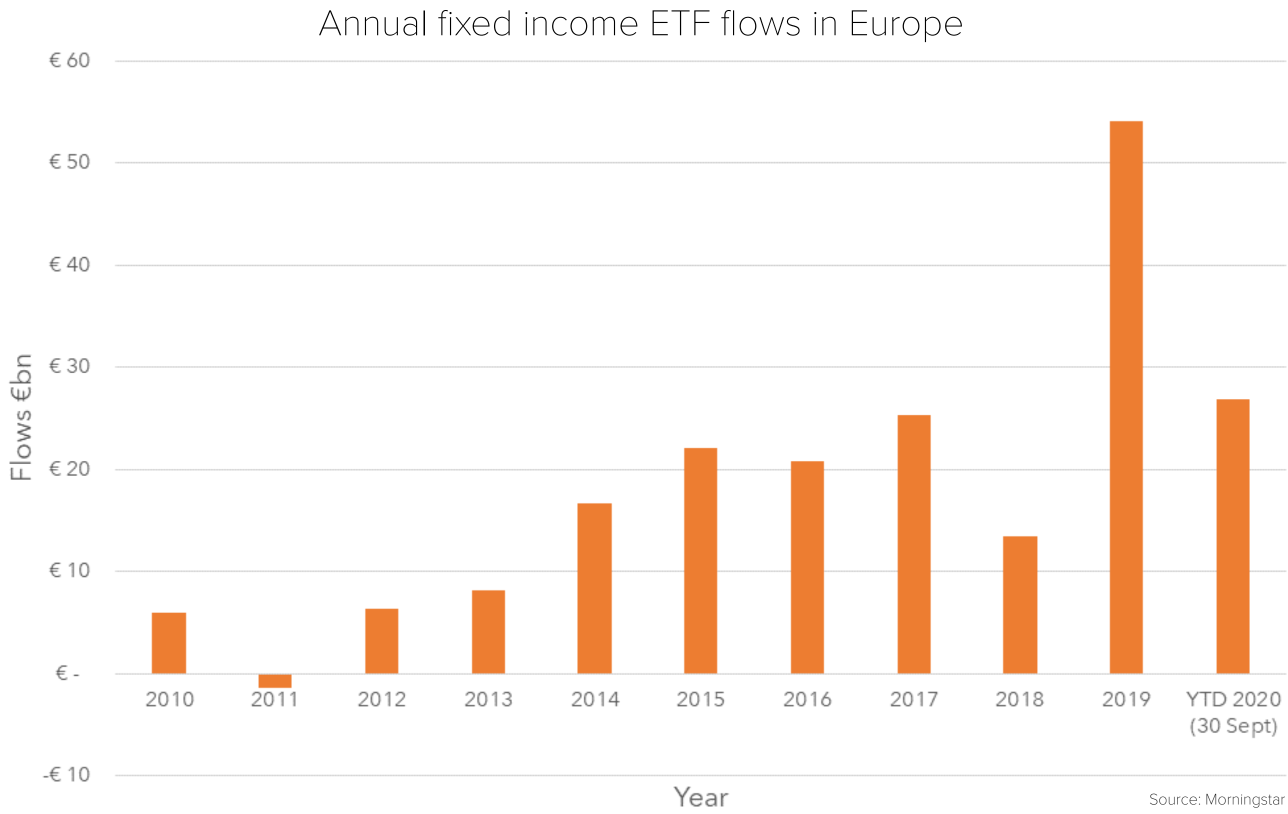

with the duration of our holding period, however long it takes to find a bid in the bonds. We, therefore, require a greater discount in exchange for the risk.

To simplify a lot: the bonds do not trade. And since bonds do not trade, the index does not change and, therefore, the NAV of the ETF does not change. Does that mean the value of the ETF has not changed? Not according to all those other more liquid products -- the futures, default swaps and correlated securities. And yet there is no outcry that the CDS are mispriced. If you measured the ETF discounts relative to the other liquid securities, you will find a significantly smaller discount than measured against the ETFs NAV. Certainly there is a discount, and I acknowledge that the discount is larger in a crisis than it is during stable market conditions, however, the discounts are grossly overstated. The NAV used to measure discounting is not an achievable NAV in redemption. That is not a critique of ETF NAVs or the NAV calculation process, rather it is a symptom of the bonds and index maintaining that fixed income status quo: If the bond has not traded, then it has not gone down.

The irony is that the achievable discount of ETFs during market stress may be the catalyst that finally forces the bond market to evolve. As market makers, like GHCO, execute the arbitrage, they act as relatively new participants in the bond market, willing to trade the bonds when others will not. The traded volume of the ETF, correctly reflecting a risk-adjusted price of the bonds, drives the need for redemption. Redemption forces the bonds to trade, therefore updating stale prices in the bond market and the bond index. When the index updates, the new NAV of the ETF is in line with the market price of the ETF and the alleged discount disappears.

An age-old adage that rings as true today as it did in its first day and any foreseeable day in the future and an irrefutable statement that is undeniably correct, regardless of the number of computations, permutations or insinuations: Whatever you are selling is only worth what someone else is willing to pay for it.

Daniel Izzo
CEO
GHCO

About GHCO

GHCO is one of the fastest-growing liquidity providers specialising in exchange traded funds. We strive to make ETFs accessible in every market worldwide with a focus on intelligent algorithmic trading, tight spreads, reliable presence and the expertise to price a wide range of products.

With offices in the UK and US, GHCO is a market maker on and off all major European exchanges. Throughout a single trading day, we quote a few thousand products and we help asset managers to bring even the most niche and esoteric products to market.

Our entrepreneurial spirit combined with the passion for technology, means we are always solving problems and pursuing challenges as we remain committed to delivering the best results. Reach out and let's start making a difference.

Mutual fund liquidity mismatch pushing investors to ETFs

The stark liquidity mismatch mutual funds face during periods of market stress when offering exposure to less liquid assets highlights a crucial benefit of ETFs, the secondary market.

Investors have found out the problem of mutual funds offering daily liquidity the hard way this year. According to Fitch Ratings, over $62bn worth of global mutual funds suspended redemptions in the first six months of 2020, well above recent full-year volumes.

This includes a string of open-ended UK property funds that suspended trading after the coronavirus volatility made it difficult to value the funds. Although a number of funds have lifted the suspensions, over £5bn remains trapped.

The issue was highlighted by the Financial Conduct Authority in 2019 after star fund manager Neil Woodford was forced to suspend trading on his fund after a string of significant redemption requests. The news even led former Bank of England governor Mark Carney to claim mutual funds were "built on a lie".

The BoE, along with the FCA, opened a review into the £1.2trn mutual fund market to see if rules needed to be brought in. If implemented, the proposed rules will lead to longer notice periods for investors to redeem their funds, a discount mechanism when redeeming and better steps to assess the liquidity of the mutual funds' underlying holdings.

Furthermore, the FCA has separately proposed a potential six-month delay for investors looking to redeem from UK property funds.

While these steps offer some protection against suspension, it does little to address the fundamental flaw of offering illiquid assets such as property or high yield in a vehicle with daily liquidity.

As Fitch Ratings said: "We believe that the spate of suspensions and application of other extraordinary liquidity-management tools will lead investors to re-appraise the liquidity that mutual funds can provide, particularly when invested in less liquid assets." This re-appraisal has already started to take shape with more investors turning to ETFs in the fixed income portion of their portfolios as a way of managing liquidity. According to data from Morningstar, fixed income ETFs in Europe have seen $31.5bn inflows so far this year, as at 6 October, adding to the record $63bn seen in 2019.

> "We believe this will lead to greater regulatory and market scrutiny of how fund managers determine asset valuations and apply liquidity management measures"

With ETFs offering intraday trading on many of the same underlying asset classes as mutual funds, one could be mistaken in thinking the same problems could arise. However, where the ETF wrapper comes up trumps is by virtue of trading on the secondary market.

This was highlighted by the BoE in May's Financial Stability Report which found "the secondary market trading of ETFs means there is lower risk of a dynamic that incentivises the fire sales of their underlying assets".

Meanwhile, the European Fund and Asset Management Association (EFAMA) has described the "overlooked" secondary market as an "additional layer of liquidity when compared to ordinary mutual funds".

Echoing their views, Keshava Shastry, head of ETP capital markets at DWS, said that even when the primary market is suspended and authorised participants can longer create and redeem ETFs, liquidity can still be found in the secondary market.

"The ETF benefits from secondary market liquidity and the transparency of trading on open, publicly listed markets," Shastry continued. "So even when an ETF is closed for creation-redemption – perhaps due to underlying market holidays – clients are still able to access secondary market liquidity through stock exchanges or the diversified broker network."

The real stress test for ETFs came in March when liquidity vanished from the corporate bond market leading many ETFs to trade at record-wide discounts to their net asset values (NAVs).

What the discounts showed was a window into how fixed income ETFs provided real-time price information about their underlying holdings while the NAVs were in catch up mode.

"Even though it is panful to see your positions mark down, at least you know definitively what they are worth," explained Dan Izzo, CEO of GHCO, a market maker. "In periods of market stress, the reality is investors want or have to sell but if you own a mutual fund you cannot, at least not in size or in a timely way."

Izzo went onto stress the importance of real-time pricing with ETFs as this enables investors to sell their positions at a known bid if they must.

"If you want to sell, you know the level and you can make an informed decision," Izzo continued. "You might not like having to make that decision but having been in crisis management positions for many years, I can tell you the only thing scarier than a loss, is an unknown immeasurable loss.

"Pretending your mutual fund has not depreciated because its underlying bonds have not traded for two weeks is not only inaccurate reporting, it is a giant blind spot in the decision-making process for investment managers."

Uncertainty around valuations was the key driver in mutual fund suspensions this year, according to Fitch Ratings, compared to redemptions issues in previous years.

"We believe this will lead to greater regulatory and market scrutiny of how fund managers determine asset valuations and apply liquidity management measures," the ratings agency added.

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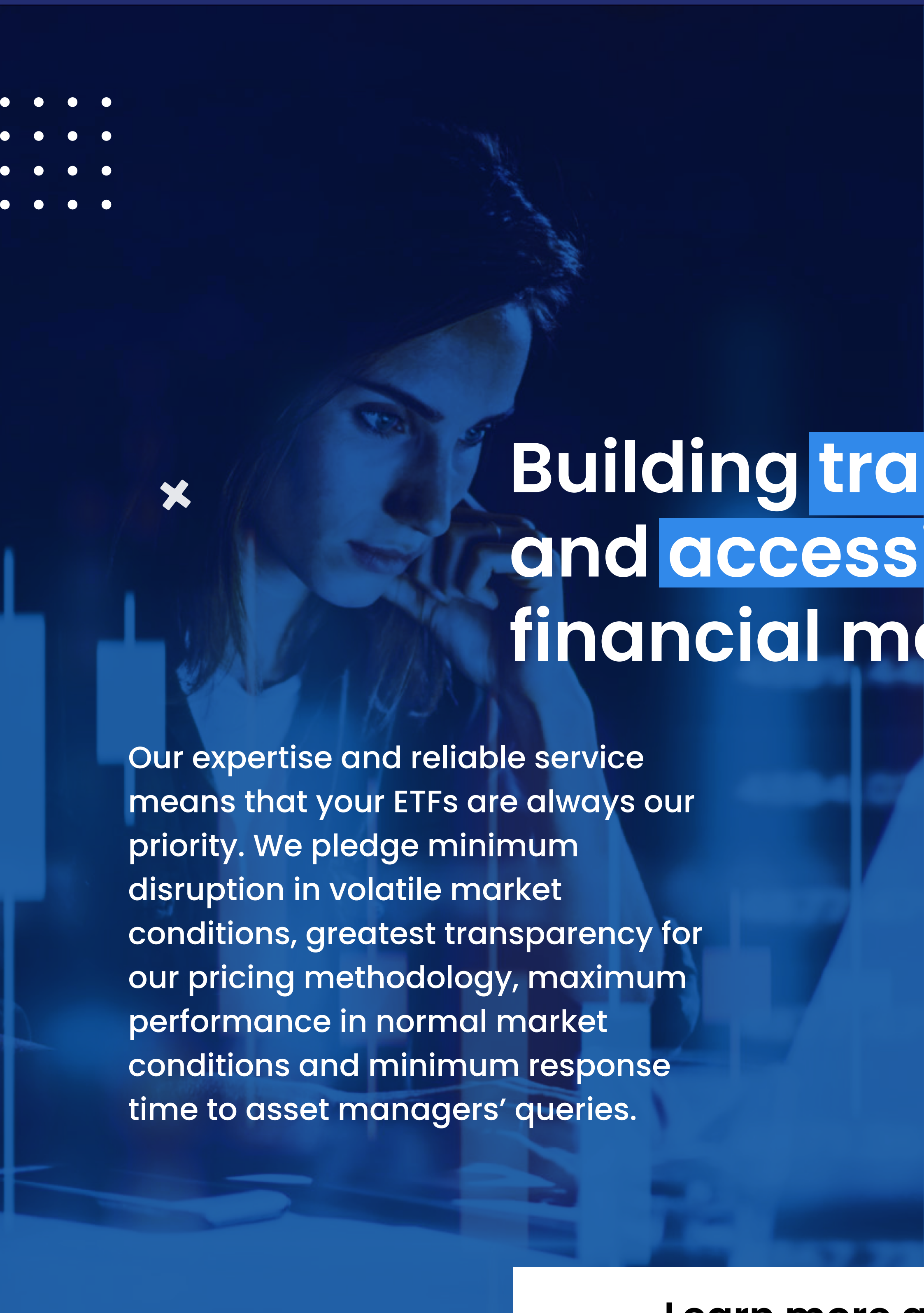

Building transparent and accessible financial markets

Our expertise and reliable service means that your ETFs are always our priority. We pledge minimum disruption in volatile market conditions, greatest transparency for our pricing methodology, maximum performance in normal market conditions and minimum response time to asset managers' queries.

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