Corner Office Views

CERULLI ASSOCIATES

Corner Office Views

Timely Insights to Inform your Business Strategy

Lead with knowledge and perspective.
Connect with secular trends impacting financial services, interpret what they mean for your business, and drive new opportunities. Cerulli's Corner Office Views provides market-leading insights and tangible takeaways for senior executives seeking to strengthen and scale their business models.

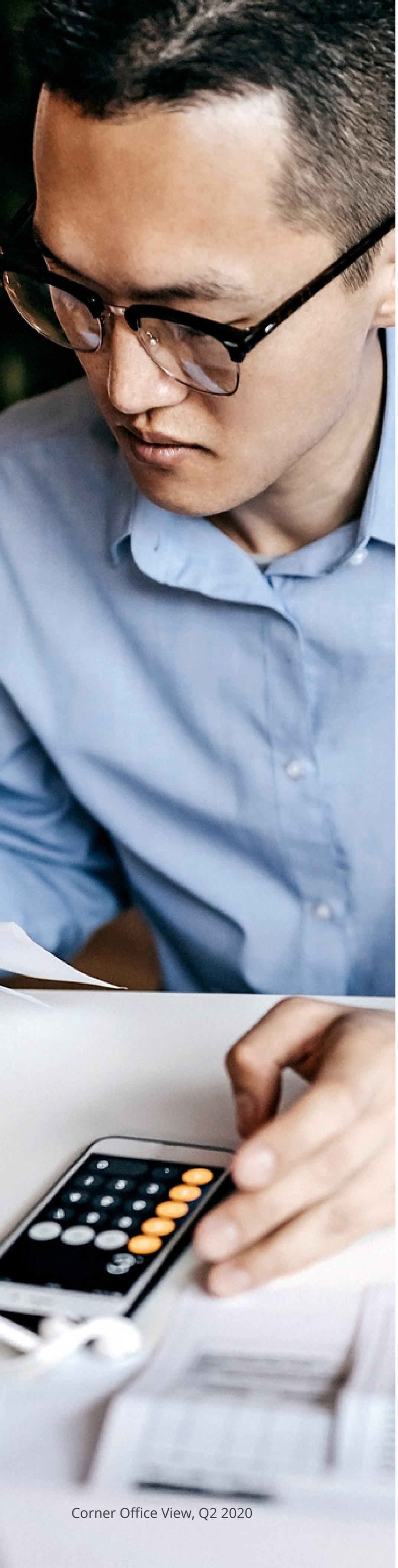
About the Author

Daniil Shapiro

Associate Director,
Product Development

Daniil is part of Cerulli's Product Development practice where he works on the identification and analysis of asset management industry trends and leads research on ETFs and alternative investments.

Prior to joining Cerulli Associates, Daniil was part of the Product Management and Business Intelligence teams with the MainStay Funds, part of New York Life Investment Management. At MainStay, Daniil supported sales efforts via fund and ETF competitive analysis, product research, and development of marketing materials, as well as performance reporting. Before New York Life, Daniil was part of the finance and risk practice at Accenture and held risk management and compliance roles in Global Banking & Markets at HSBC.



What happens when fixed-income ETF prices deviate from the NAV in a crisis?

Performance of ETFs and mutual funds in tumultuous markets underscores benefits to using both vehicles in concert.

Key Implications

- Deviation from the NAV requires ETF investors to sell their shares below the value of the actual holdings at a time of crisis, making the vehicle appear to be a poorer option than a comparable mutual fund that transacts at the NAV, although Cerulli cautions that it has implications for the use of both vehicles.
- ETF trading is supported by market makers and authorized participants who need to ensure that their activities are profitable and will add a margin of safety, resulting in lower ETF prices and investors effectively paying some price for access to liquidity. This was in exceptionally high demand as the Dow dropped by 10% on March 12, 2020, a day referred to as Black Thursday.
- Decisions on the use of ETFs vs. mutual funds can impact outcomes and warrant advisor education on the benefits of each vehicle, with the goal of using both in line with the needs of investors.

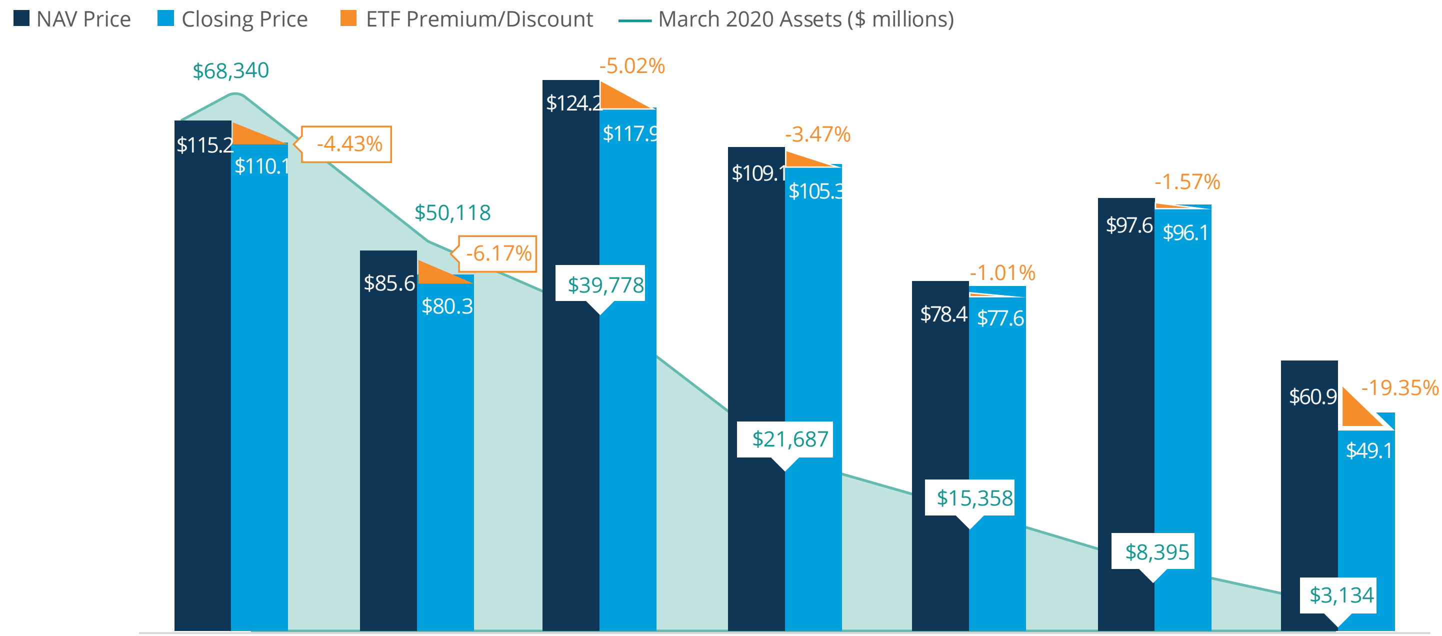
Advisor concerns

Advisors express concerns that a key drawback to their use of fixed-income exchange-traded funds (ETFs) was the possibility of a deviation in the price of the traded product from the net asset value (NAV) of the fund during periods of market volatility. This deviation, which has occurred several times in March 2020, illustrates the importance of educating advisors about the distinctions between this product versus a mutual fund.

The ongoing market volatility associated with the impacts of COVID-19 has been the first time that the exchange-traded fund (ETF) vehicle has been tested in that ETFs were a smaller and newer offering during the global financial crisis of 2008. Other market stressors since that period (e.g., 2015 flash-crash and 2018 drawdown) were not tied to the systemic malaise associated with crisis. A deviation in the price of a traded product from the NAV would require ETF investors to sell their shares below the value of the actual holdings at a time of crisis, making the vehicle appear to be a poorer option than a comparable mutual fund that transacted at the NAV. Despite this exact scenario taking place in March of 2020 in some of the largest fixed-income ETFs, Cerulli believes that this deviation in NAV should be interpreted with nuance and should impact how both ETFs and mutual funds are positioned to advisors.

ETF Discounts and Bid/Ask Spreads, February 2020 and March 12, 2020

Sources: Morningstar Direct, Cerulli Associates



	IShares Core US Aggregate Bond ETF	Vanguard Total Bond Market ETF	iShares iBoxx $ Investment Grade Corp Bond ETF	iShares MBS ETF	iShares iBoxx $ High Yield Corp Bond ETF	SPDR® Bloomberg Barclays High Yield Bond ETF	VanEck Vectors High Yield Bond ETF
Ticker	AGG	BND	LQD	MBB	HYG	JNK	HYD
				Average Bid/Ask Spread			
February '20	.01	.01	.01	.01	.01	.01	.01
March 12 '20	.05	.13	.05	.10	.02	.06	.17

The takeaway

For advisors, the takeaway should be that no vehicle is perfect, but that each has unique advantages. If discounts exist in an ETF vehicle offering similar exposure, it is possible that advisors purchasing a mutual fund as a long-term holding are overpaying and would be better served in an ETF. At the same time, investors that do not need intra-day liquidity, but may need to sell at a specific date may well be best served by the mutual fund to the extent that they will avoid some liquidity premium should it become priced in when it is time to sell. While a far more nuanced approach, it is evident that, in crisis, such decisions can indeed impact outcomes and warrant advisor education on the benefits of each vehicle, with the goal of using both in line with the needs of their investors.

Cerulli believes that this deviation in NAV should be interpreted with nuance and should impact how both ETFs and mutual funds are positioned to advisors.

While this may suggest that investors in the mutual fund vehicle were better served, Cerulli urges caution in extrapolating from such divergences.

Paying for liquidity

While ETF trading (and particularly that of equity ETFs) has broadly remained orderly since the markets began to react to COVID-19 in late February, it cannot be ignored that some of the largest fixed-income ETFs traded with increased bid-ask spreads and, at times, significantly below their NAVs. Because Vanguard ETFs are share classes of Vanguard mutual funds, the performance of the approximately $50 billion Total Bond Market ETF (BND) relative to the mutual fund version shows the difference in making the same investment through two different vehicles. On March 12, 2020, ETF investors would have experienced a significant decline of 5.44% as the mutual fund returned a decrease of less than one percent, the same as the decline of the fund's NAV. While this may suggest that investors in the mutual fund vehicle were better served, Cerulli urges caution in extrapolating from such divergences.

Why do ETFs fall below the NAV?

There are several explanations for ETFs falling below the NAV during the latest period of market stress. At the highest level, ETF trading is supported by market makers and authorized participants who need to ensure that their activities are profitable and will add a margin of safety, resulting in lower ETF prices and investors effectively paying some price for access to liquidity. This was in exceptionally high demand as the Dow dropped by 10% on a day referred to as Black Thursday.

For advisors, the takeaway should be that no vehicle is perfect, but that each has unique advantages.

Another, but related, explanation was offered in a blog post by Dave Nadig, which explored the challenges of properly valuing the fixed-income securities priced into the NAVs that index providers and pricing services calculate. As fixed-income liquidity has declined over time, it has become more difficult to have confidence in the valuations of some of the underlying bonds—often achieved via marking to model. This practice can add to the margin of safety added by market makers, but it is also possible that by having capital at risk, market makers can be ahead of the curve in pricing the underlying bonds.

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Headquartered in Boston with fully staffed offices in London and Singapore, Cerulli Associates is a global research and consulting firm that provides financial institutions with guidance in strategic positioning and new business development. Our analysts blend industry knowledge, original research, and data analysis to bring perspective to current market conditions and forecasts for future developments.

Cerulli's research product line includes the Cerulli Report series, the Cerulli Edge series, and Cerulli Lodestar.

Contact us to learn more:

info@cerulli.com | www.cerulli.com

CERULLI ASSOCIATES

Research | Analytics | Consulting

info@cerulli.com | www.cerulli.com

United States

699 Boylston Street
Boston, MA 02116
United States
+1 617-841-1011

Europe

Valiant House,
4-10 Heneage Lane
London EC3A 5DQ
United Kingdom
+44 (0)20 7645 9040

Asia

10 Anson Road, #24-15
Singapore 079903
+65 6327 4045