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Explosive growth of bond ETFs stirs fears of impending crisis

High-profile investors say a sudden fall in debt prices could trigger a vicious cycle

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by: **Joe Rennison** in New York and **Thomas Hale** in London

Almost 15 years after BlackRock launched the first bond exchange traded fund (ETF), these low-cost products have become a meaningful part of the way investors gain exposure to bonds — a market that typically lacks the kind of transparent pricing and ease of buying and selling that typifies equities.

While fixed income ETFs have provided investors with a relatively seamless way to ride the great bond market rally, critics say they have yet to be tested by a significant fixed income shock, such as a rapid and sustained rise in yields.

High-profile investors such as Carl Icahn have warned of an impending crisis in ETFs. The fear is that if debt prices suddenly decline, investors will rapidly sell the ETFs that track the underlying bonds, triggering a vicious cycle that further hits the bonds and sparks broader market volatility.

The rapid expansion of ETFs tracking fixed income comes at a time when the business of selling and trading bonds is being transformed by tougher regulations and higher capital costs hitting the Wall Street banks that have long dominated the industry. Huge flows of money into global bond markets during the current era of ultra low and negative interest rates has spurred hefty debt sales by companies and governments.

“I think it is very very dangerous to assume you can turn an illiquid market into a liquid market,” says Gershon Distenfeld, director of high yield at AllianceBernstein.

Assets invested in global fixed income ETFs have grown from about $60bn at the end of 2007 to more than $600bn at the end of July 2016, according to ETFGI data. This year, investors have put more money into US fixed income ETFs than the larger pool of equity ETFs, with inflows currently standing at $83bn compared with $62bn, according to Bloomberg data.

The suppression of bond yields and market volatility by central banks has also generated an investment climate that has reduced the ability of active portfolio managers to outperform the returns offered by passive, index-linked vehicles.

For many investors, the ETF appears a logical way to profit from markets, while the fees charged by mutual funds — a more traditional way to gain exposure to bond markets — can be a drag even if better returns are achieved. Fixed income ETFs, through which investors can buy shares backed by a basket of bonds, are a fraction of the cost, and getting cheaper.

“These are tools that we can use that mean the costs for us and our clients go down,” says Toby Vaughan, head of fund management, global multi-asset solutions at Santander Asset Management. “They’re providing a really good challenge to the active management industry.”

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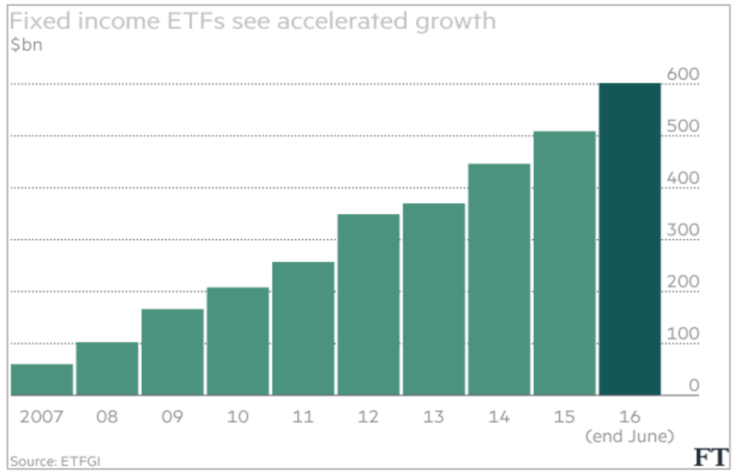
ETF providers say they help provide a reference point for investors to gauge the price they receive from banks to invest directly in bonds.

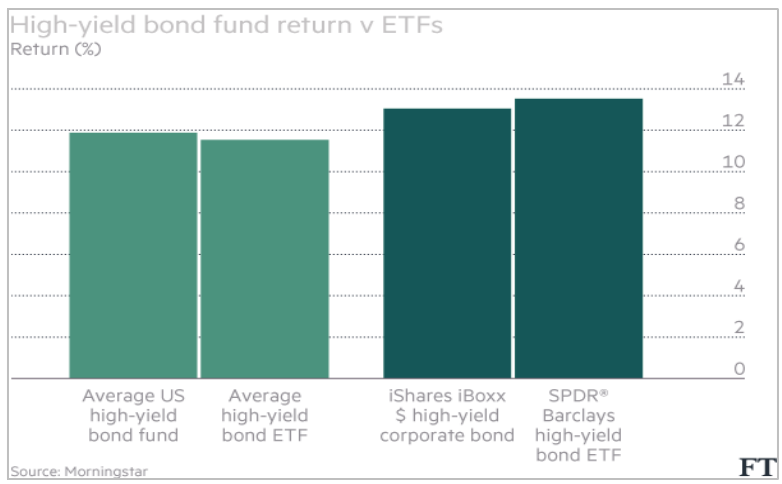


"The increased pricing discovery supported by daily ETF trading in the underlying fixed income holdings helps provide markets with bond prices for securities that otherwise might not have traded hands on a given day," says James Meyers, director of fixed income product strategy at Invesco PowerShares.

The flipside is that any reversal in the market runs the risk of being exacerbated if an ETF begins to have redemptions, with bonds then being offloaded into an already falling market, increasing the sell-off.

"Instead of seeing a 20 per cent decline in bonds in two days, we will see it in two hours," says Dave Nadig, director of ETFs at Factset, a data company.

The issue will probably impact few ETF providers themselves due to the fact that the vast majority of ETFs redeem "in kind", meaning they hand back bonds rather than cash to "authorised participants" eligible to create and redeem shares in the ETF. In order for this redemption to be in the interest of the AP, the price of the shares they buy from investors must be lower than the price of the bonds they receive back and then sell.



It's an issue the ETF industry acknowledges, but rather than seeing ETFs as fanning risks in the event of sharp reversal in bond prices, they argue the products improve the situation, giving investors a product for price discovery and a way to adapt to changes as bond prices fall. "I would like to think it is better. It adds a level of transparency to what is going on," adds Mr Nadig.

ETF providers highlight the performance of ETFs during the closure of Third Avenue Management's high-yield bond fund last December, when the volume of trades in high-yield ETFs increased as investors quickly sought to position themselves as bond prices deteriorated. They see it as justification for the claim that ETFs add liquidity to a market that trades infrequently, allowing investors to quickly move in and out of positions without having to buy and sell the underlying bonds.

This example doesn't provide enough comfort to those who fear a bigger interest-rate shock could generate more damage in what is still a new, fast-growing and untested market.

"I disagree fundamentally with the position of the ETF providers," says Mr Distenfeld.