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Junk-Bond ETFs Show Just How Desperate Traders Are for Liquidity

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Junk-bond investors are getting more and more desperate for liquidity as the Federal Reserve moves closer to ending its era of unprecedented stimulus.

The proof is in the hefty price they're willing to pay to own the most frequently traded bonds, which have steadily returned less than the broader $1.7 trillion U.S. high-yield market for more than three years. They're also increasingly turning to exchange-traded funds to enter and exit the market, as evidenced by bigger trade sizes.

"People will say, 'I just need a liquid way to gain exposure or reduce exposure,'" said Oleg Melentyev, a credit strategist at Deutsche Bank AG in New York. "The more liquid part of the market is trading at more of a premium."

The most-active bonds have underperformed the broader market by 0.8 percentage point this year, worse than their 0.5 percentage point lag during the same period of 2014, according to Markit iBoxx and Barclays Plc bond-index data.

The overall market just had its worst month since September, losing 1.5 percent in June, and is down another 0.1 percent since then as oil slumped. Given it's getting more difficult to transact in the debt -- -- which typically trades over the counter in telephone calls and e-mails -- it's no wonder investors are looking for faster ways to adjust their exposure.

Big Deals

As volumes stagnate in credit-default swaps that used to act as a proxy for the market, ETFs are proving the easiest way for big institutions to enter and exit, according to Melentyev.

The growing size of trades in the funds tells the same story: Transactions of more than $1 million are making up about a quarter of volumes in the two biggest high-yield ETFs now, up from 15 percent in early 2012, according to a July 10 Deutsche Bank report.

These ETFs typically track indexes of the most-active notes -- the ones that have been underperforming -- in order to fulfill their promise of allowing investors to speedily enter and exit infrequently-traded markets.

So, even though investors may be getting easy access to risky debt, they're still paying a premium for it: BlackRock Inc.'s $13.4 billion fund, the biggest of its kind, has returned 1.8 percent this year, compared with 2.4 percent on Barclays U.S. Corporate High-Yield bond index.

But ETFs have been increasingly providing institutions with a safety valve to get out of investments quickly. These days, big bond buyers are willing to fork over cash for that.