

## Three Things Missing From the Junk Bond ETF Discussion

*Investors in exchange-traded funds that buy high-yield corporate debt aren't necessarily crazy.*

By [Eric Balchunas](#)

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Given the [relentless concern](#) about a pending liquidity crisis in the junk bond market, you'd think anyone who owns a junk bond ETF is crazy, or reckless, or just plain ignorant.

But what if they aren't?

The worry about a liquidity freeze in the high-yield debt market is raising concerns, among everyone from Carl Icahn, to Howard Marks, to Jeffrey Gundlach, in the past few months.

Some of their concerns are justified. After all, the majority of the bonds in a junk bond ETF don't trade every day. This stands in sharp contrast to the shares of the ETFs that track and hold such debt themselves, which can trade more than half a billion dollars' worth a day. That is what is called a bona fide liquidity mismatch. But this only half the story. A few things are largely left out of this discussion that may explain why these investors could be smarter than they seem.

### 1. The Opportunity Cost of Not Using Junk Bond ETFs

In a world where the Federal Reserve has purposely punished savers by keeping interest rates extremely low, investors have had to look elsewhere for their income. Thus the opportunity cost of giving up returns is simply greater than concerns of a potential liquidity freeze. Say an investor read about the dangers of junk bonds five years ago and moved \$100,000 out of the SPDR Barclays High Yield Bond ETF (JNK) into something safer, such as the iShares 3-7 Year Treasury Bond ETF (IEI). The investor would have received \$1,300 a year in income instead of \$6,200 a year. That is \$24,500 in lost income over a five-year stretch. Many investors need that income.

### 2. The 'Too Big to Fail' Factor

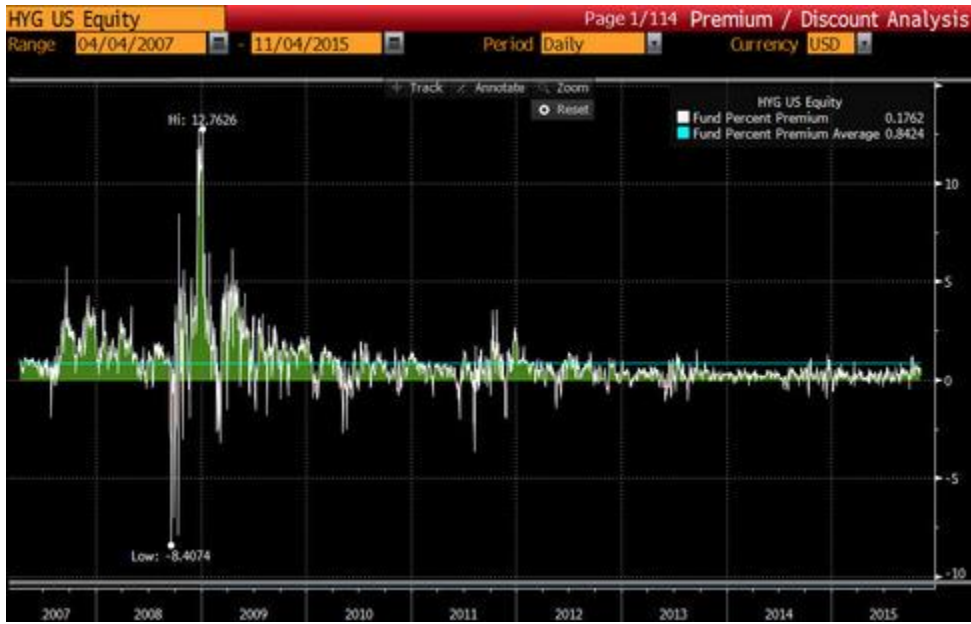
One reason bond market liquidity has been declining is arguably due to regulatory reforms that have resulted in greater capital and liquidity requirements for banks. This is said to have hamstrung the banks' ability to keep and trade large inventories of bonds. At the same time, another government body—the Federal Reserve—has kept rates at historical lows, which has resulted in investors "reaching" for yield. This is why junk bond ETFs have swelled to \$40 billion in assets. (That is a lot of money, but it is also nickel and dime compared with the \$338 billion in high-yield mutual funds.) This raises the question: Is the government really going to let all these middle-class investors bear the brunt of some kind of liquidity freeze when they are the ones responsible for the situation? This notion may be providing some investors with an indirect feeling of protection (otherwise known as moral hazard). After all, it would really be something if the federal government bailed out Wall Street but opted to not bail out Main Street.

### 3. The Increase in ETF Liquidity

While an ETF is truly only as liquid as its underlying securities, that hasn't stopped investors from using the funds as a vehicle to dip quickly in and out of the market. For example, the iShares iBoxx \$ High Yield Corporate Bond ETF (HYG)

now trades about \$840 billion a day, which is more than Wal-Mart Stores, and has dozens of market makers who trade it all day, every day. This increase in liquidity and market participants has resulted in a steady decrease in HYG's premiums and discounts—on both normal days and stressful days—as seen in the chart below.

"The ETF structure itself doesn't make single-security liquidity problems go away," said Linda Zhang, head of research at Windhaven Investment Management, whose firm uses high-yield bond ETFs in its portfolios. "However, ETFs with a sizable and active secondary market might help provide a cushion to the liquidity issue. This is especially the case during market stress periods, when individual security trading becomes more problematic."



All this still doesn't mean that concerns over junk bond ETF liquidity are any less valid, nor will everyone agree that these are justifiable reasons to use these structures. It is just that for many investors, they are outweighed and dampened by these other factors.

And that is something investors aren't given enough credit—pun intended—for understanding.

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