Fixed income ETFs in the current market

We have seen recently that fixed income ETFs trade at a discount from their official net asset value (NAV). This is true both in Canada and in the United States. We have grouped in this document the most frequent questions we received lately and discuss the possible actions to take in such circumstances.

How is the NAV of a fixed income ETF calculated?

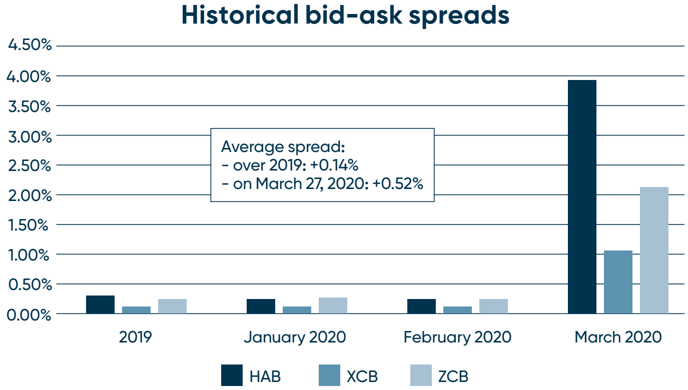
First, the bond market trades differently than the equity market since transactions are not carried out on an organized exchange. If you want to know the value of Facebook, you only need to look at the last transaction on the US stock exchanges. For a bond, you will need to pick up the phone and call several trading desks to find out the price at which they are willing to trade.

Official price suppliers in the fixed income world (used to calculate the NAV of mutual funds and ETFs) interview market participants to determine the value a bond might have. In theory, this system works well. In practice, when a bond has not traded for a few days on a trading desk, the expression "might have" takes on its full meaning. The price suppliers then receive an estimated value or, sometimes even, no response at all from the participants. This has been happening for a few days now in the Canadian and American bond market. Even some institutional investors looking to sell a bond reported some trading desks simply told them "no thanks"!

How do market makers manage to do their job under such conditions?

This lack of information on prices for fixed income securities creates uncertainty and this automatically translates into a larger spread between bid and ask prices. For example, the Corporate Bond ETFs such as HAB (Horizons), XCB (RBC iShares) and ZCB (BMO) are probably the ones with the narrowest spreads in Canada. We can see this on the graph which shows how the spreads for the month of March.

Historical bid-ask spreads



Source: Bloomberg

While fixed income trading desks are no longer offering prices on securities, market makers continue to offer liquidity in the ETF market. The fixed income price discovery process has therefore been moved from the trading desks to the ETFs. Since the start of the crisis, it's fixed income ETFs, not individual securities, that have been used to determine the real value of the bond market. What does that mean? If you want to know the real value of the bond market (or its yield), you need to look at ETFs, not individual bonds or indices.

If the market makers have such large spreads, it is because they want to fill their pockets, right?

It is true that some people could take advantage of the crisis to offer prices ridiculously far from the real value. That said, the real market makers (mainly the big banks and a few independents) are in constant competition and continue to offer tight prices given current market conditions. If one market maker is too greedy, another will offer a better price and get the volume (and therefore the revenue).

The best price competition continues to operate. The larger spreads between the bid and ask prices represent the risk taken, nothing more.

I understand that the price spreads are larger, but why can we see the ask price below the ETF's net asset value in some occasion?

The answer to this question is simple: because the ETF's net asset value in these days means nothing. As said before, the ETF has become the tool for determining the real value of the fixed income market and no longer the price providers' surveys. This means that prices will first move in the ETF and then in the securities that compose it. The price of the securities will change when they are traded. We could therefore expect to see NAVs converging to ETF prices in the coming weeks/months.

In other words, it is not fixed income ETFs that are discounted, but their NAVs that are artificially overvalued.

NATIONAL BANK INVESTMENTS

Fixed income ETFs in the current market

I have a fixed income ETF and want to sell it, should I trade directly with the ETF company rather than accepting the discount price on the exchange?

With ETFs trading at a discount (the bid and ask prices below the ETF's official net asset value), some investors are wondering if there is a way to profit from such overvalued NAV. Free money is always attractive, but it's a "too good to be true" kind of scenario.

There is normally a mechanism in the ETF prospectus that allows investors to request the ETF company to redeem its securities. However, you will not receive the net asset value, but 90% to 95% of this value depending on the ETF. More than that, payment could be made in-kind (that is, to receive one or more bonds) rather than in cash. Overall, it's a long, complex and expensive process that is rarely worth the effort.

With ETFs trading at a discount to their NAVs, could I buy them and make an easy profit?

Unfortunately, it is impossible to arbitrage the spread between the price of an ETF and its net asset value. If such a profit existed, the market makers would have executed the transactions required to close this gap long ago.

There are many good reasons to buy a fixed income ETF today. Easy profit is not. If you are interested in purchasing a fixed income ETF, look at the ask price for your purchase. And please use limit orders! Quality of trade execution is the biggest challenge (and risk) in today's market environment.

Since mutual funds trade at NAV and ETFs trade at a discount, should I sell my mutual funds to buy ETFs and make an easy profit?

Not surprisingly, the possibility of making a risk-free profit in such an operation is unfortunately impossible. You would have to be able to short sell a mutual fund and again, other factors like spreads would influence the outcome.

The two questions to ask yourself before buying an ETF today are simple:

1. Am I ready to take the risk associated with this investment?

2. Is the ETF structure adequate for my needs?

Some ETF companies are currently discouraging people from trading (both on the buy and sell side) their products. Should we listen to them and why?

With spreads between bid and ask prices at historic levels (up to 40 times greater than normal) buying or selling ETFs can be at great cost to the inattentive investor.

That said, with vigilance and patience it is possible to trade ETFs. We suggest you compare ETFs from different companies, monitor their spreads, look carefully at the volume displayed on the bid or ask price (depending your trade) and choose your time of day to trade. For example, it is not recommended to trade an ETF in the 15 minutes following the opening, in the 10 minutes before the close or the 15 minutes after a circuit breaker.

Contact us: nbinvestments.ca 1-877-463-7627