

Fixed Income In-Focus

June 2021

Translating trends into insight for Asia Pacific market participants

Fixed-Income ETFs: Navigating a Rising Tide of Liquidity

Exchange-traded funds (ETFs) are increasingly recognized as efficient investment vehicles for gaining exposure across a broad universe of assets, sectors and geographies. ETFs achieve this by tracking a certain benchmark index while minimizing tracking errors.

Based on the same principles as their equity counterparts, fixed income ETFs nevertheless differ from equity ETFs due to the fundamental differences of their underlying assets.

While a common share represents an ownership title featuring a set of defined characteristics such as voting rights and the right to dividends, each bond is unique as it comes with different tenor, coupon rate, redemption features etc. Investors may take these differences for granted but they significantly impact the availability, depth and granularity of data available on these instruments and ultimately the risk/return profile of the respective ETF

Sage Patel, Head of Pricing, Valuations and Reference Data, Asia Pacific IHS Markit says, “A major consequence of this lack of uniformity is that, unlike shares, most bonds don’t trade daily on an exchange, while the denominations traded also vary.” This results in a lack of liquidity that, combined with the fact that the upside potential and risk level associated with fixed-income instruments are generally lower, dramatically reduces the pool of buyers and sellers active in the fixed-income space. In addition, many fixed-income investors tend to hold bonds until maturity. Finally, while the value of shares fluctuates with news about a company, it’s not obvious that bond prices contain the same value since what matters to bondholders is the ability of issuers to meet their obligations on time.

Making sense of liquidity

Given the above, many investors have various opinions about what liquidity means when it comes to fixed income ETFs or even the underlying bond market. Are investors confusing liquidity with the ability to easily execute? Regardless of trading patterns, it can be argued that the Average Daily Volume (ADV) and the AUM of ETFs should not be taken as key liquidity metrics since liquidity can be affected by a multitude of factors.

ETF’s mostly trade on exchanges, while fixed income ETFs give investors access to the broader fixed-income market. Since ETFs hold cash securities that mimic a defined investment universe, most fixed-income ETFs contain hundreds of bonds are executed in wholesale market trade sizes when traded on its own, something an individual investor would find difficult to achieve when accessing the secondary market

Liquidity of ETFs partly derives from that of an underlying portfolio. Thus, the ability for liquidity providers to create or redeem ETF units by buying and selling fixed-income instruments also matters. Patel explains, “Notwithstanding the ADV of a given ETF, a market maker should always be able to load-up or sell down short-term US treasuries to create or redeem units for an ETF dedicated to mimicking US treasuries. By contrast, buying/selling sovereign credit instruments of small countries, regional corporate credits or distressed debt might well prove far more challenging for creating units of ETFs seeking to replicate the performance of such assets.”

What does data show?

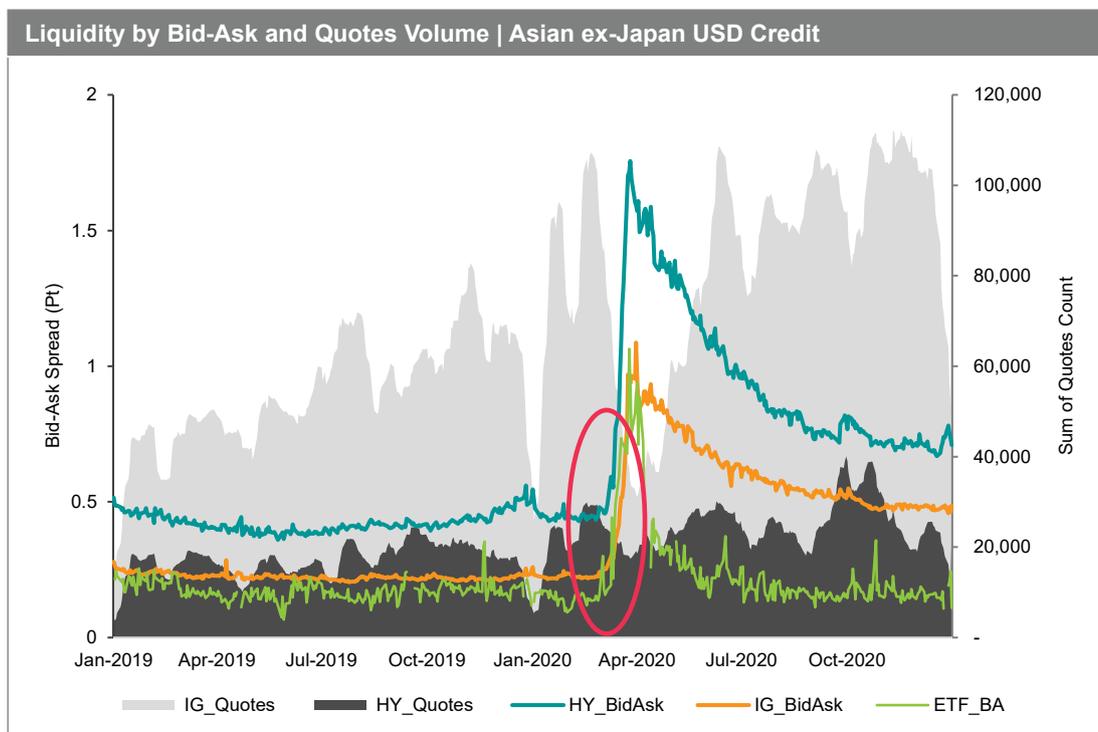
Since there are no satisfactory “one-size fits all” approach to assessing liquidity, it’s vital to analyse relevant datasets when picking a suitable investment vehicle to gain fixed income exposure. Another recent article by IHS Markit titled, “Assessing Liquidity: Why Quality Data Matters in the fixed income Space” covers various segments of liquidity in details. If both quantitative factors and qualitative factors are relevant, understanding the relevance of these factors is not always straightforward, especially when assessing different segments of the fixed income market.

We should start with the basics by looking at a common measure of liquidity: bid-ask prices. Data Indicative bid-ask spread signals potential changes in transaction costs associated with executing a given trade. For example, data on Asian ex-Japan USD credit (Chart 1) shows that the bid-ask spread for both Asian ex-Japan USD IG and HY Credit widened significantly during COVID-crisis, which is not a surprising trend. What’s interesting is that the bid-ask spread of fixed income ETFs reacted ahead of the spike in underlying bid-ask (see activity highlighted by the red circle), suggesting that investors could potentially use ETFs as a leading indicator of potential stress in the market, a function also reviewed in “ETFs are the canary in the bond coal mine”, a piece published in the Financial Times.

There are other structural differences as well as the ETF bid-ask also remained range bound pre- and post- COVID while the widened bid-ask spreads observed on the underlying bond market lingered on post-COVID, suggesting that ETF liquidity may be resilient even during a crisis.

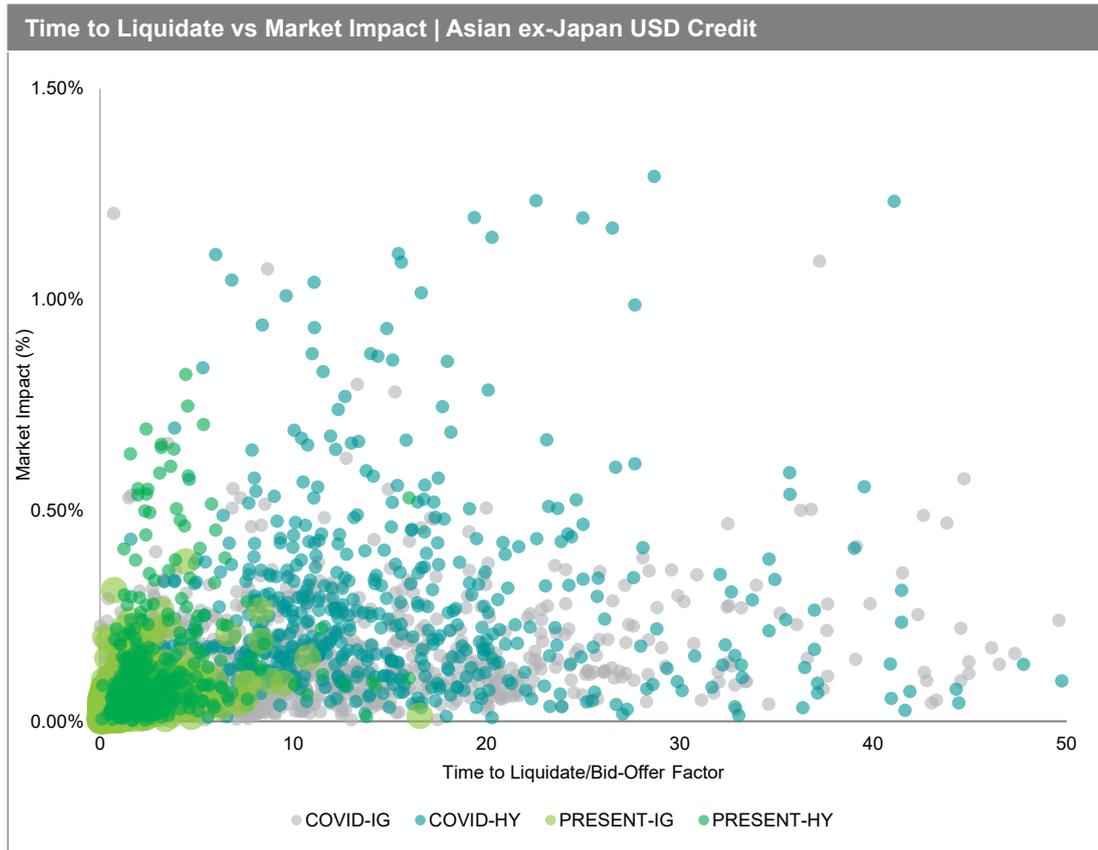
Patel says, “Another measure of liquidity is market depth as indicated by quotes volume and trade volumes. Marrying these data with bid-ask prices could generate an interesting correlation perspective. While the relationship isn’t always obvious, it can still serve as an indication of dealers’ interest.

“Still, trade activity on ETFs and the underlying bond market should be interpreted with care since there are no consolidated tapes or trade repositories readily available, especially for European and Asian fixed income markets.” As such, the timeliness, volumes of trade reporting (e.g. proportion of reported trades as % of outstanding amounts) and market fragmentation continue to pose substantial challenges when aggregating data and trying to present an holistic view to end users. It also begs the question about who should own the provision of such data e.g. regulated or non-regulated entities? As always, it’s crucial to balance commercial interest with market development.



By IHS Markit Fixed Income data, MSCI liquidity metrics, ETF & Benchmarking solutions

Liquidity could also refer to the ability of investors to liquidate assets in a timely manner without dramatically impacting the market. As Chart 2 illustrates, the average time required to liquidate a given bond position (assuming a weighted average notional position size of between USD250k to USD25M) and the market impact of such liquidation (with price impact being a function of the amount outstanding) were both markedly extended over that period, with both metrics remaining fairly consistent across IG/HY credit, even when adjusting for credit quality (indicated by yellow and grey dots).



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Understanding the virtuous cycle of liquidity

By providing an additional proxy for the liquidity of underlying assets comprising, ETFs can help enhance the liquidity of underlying bonds as market makers stand ready to offer bid-side liquidity when the market is oversold while investors will buy once yields reach attractive levels. Patel adds, "Understanding how the interplay of these Bid/Ask metrics affects volumes can help investors gain new insights about the investment strategies needed to manage risk while addressing these structural challenges."

Investors might want to use a multifactor approach incorporating other elements such as holdings dispersion/investor base, insights from securities lending market about utilization rate and concentration changes as well as the efficiency of alternative synthetic exposures to derive a more holistic view of what liquidity means in this context.

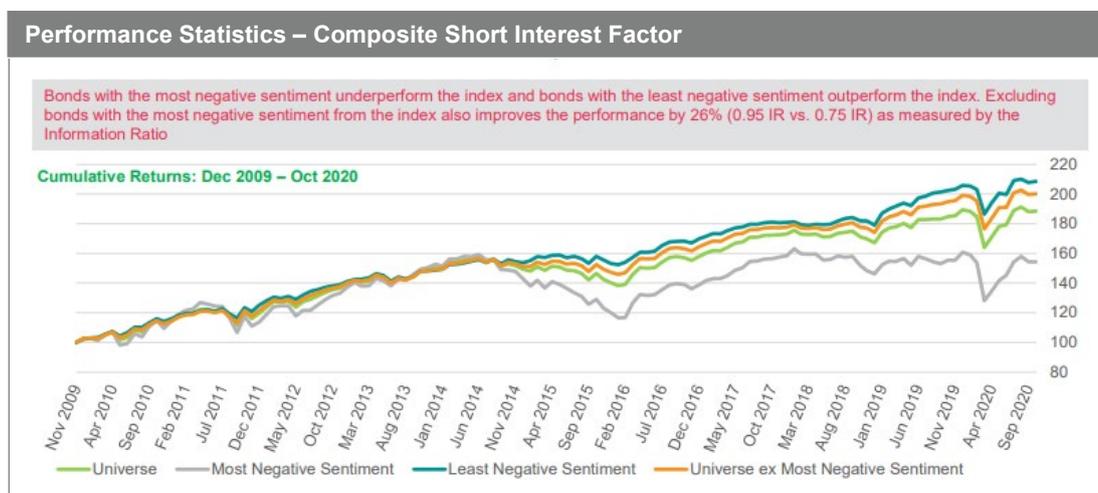
As more information-driven investors start actively trading these arbitrage opportunities, they might help alleviate some of the liquidity challenges of Fixed-Income ETFs such as the lack of tapes and the "buy-and- hold" bias of traditional fixed-income investors. In the end, liquidity begets more liquidity.

Other signals to consider

Equity finance and short interest data are well-known inputs for quantitative models which seek to forecast equity returns. The general concept is that equities with more short interest will underperform those with less. Similar signals can be derived for corporate bonds using the IHS Markit Securities Finance dataset for corporate bond borrowing. In this note we'll review some academic literature which supports this use case and discuss updated results including the volatile period in 2020.

Using IHS Markit Securities Finance Corporate Bond data Hendershott et al (2018) published a paper in the Journal of Financial and Quantitative Analysis testing the theory that corporate bond short selling is a predictor of bond returns. The results, drawn from a sample period from 2007 to 2011, suggest that for high-yield corporate bonds there is a significant correlation between bond price returns and the level of bond borrowing.

Example of using short interest data to derive performance signals



IHS Markit Securities Finance

There are multiple reasons to borrow and short a corporate bond, which may range from a broker-dealer borrowing to deliver against a long sale or a relative value trade between two bonds. The paper noted above cites a previously published paper, Asquith et al. (2013) using a single lender's dataset, which suggests that corporate bond borrowing is a suitable proxy for short positions in the bonds. More recent anecdotal evidence, including correlations between bond borrow costs and CDS pricing, reinforce that conclusion. An interesting agreement between the papers is the observation that there did not appear to be signal pre-GFC. While not every bond borrow equates to a directional short bet in that bond, there is evidence to support the theory that the signal is representative of short positioning in general.

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