Bond Case Briefs

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Questioning the Seaworthiness of Bond Funds.

Investors have embraced bond mutual funds and exchange-traded funds as sound and solid places to keep their money. But that growing popularity rings alarm bells with some regulators, who worry that these same vehicles could become sources of instability in a future market crisis.

The Federal Reserve, in a February report on monetary conditions, suggests that individual investors may have gotten the misleading impression that mutual funds and E.T.F.s trade more readily than the bond markets themselves, and the consequences could be quite serious.

"These funds now hold a much higher fraction of the available stock of relatively less liquid assets — such as high-yield corporate debt, bank loans and international debt — than they did before the financial crisis," the Fed said in the report. And as the funds expand, they may pose a threat, it said: "Their growth heightens the potential for a forced sale in the underlying markets if some event were to trigger large volumes of redemptions."

The Fed is essentially asking how smoothly bond E.T.F. shares will trade when markets are in turmoil, as they will surely be one day. It is also concerned that, if people start to panic, traditional fixed-income mutual funds will have trouble raising the cash they need to cover redemptions.

In the report, the Fed didn't answer its own questions. But it clearly intends to keep monitoring these parts of the market carefully. For one thing, the Fed has raised these issues previously. So has a 2014 report from the International Monetary Fund as well as a 2013 report by the Treasury's Office of Financial Research.

These concerns have been fueled, in part, by the rapid expansion of bond E.T.F.s, which were introduced only a dozen years ago. By the end of January, they held assets of just over $308 billion, up from $57 billion in 2008. In contrast, fixed-income mutual funds, a fixture of the marketplace for decades, held about $3.5 trillion in assets at the end of January, up from about $3.2 trillion at the end of 2013.

It's no wonder that mutual funds and E.T.F.s have become so popular: In almost every year since the 2008 financial crisis, bond E.T.F.s and mutual funds have performed well. Average bond E.T.F. returns, for example, hit 9.3 percent in 2009 and stayed strong through 2012, according to Morningstar. They moved slightly into the red in 2013, but rebounded to 4.5 percent last year and gained just over 1 percent in the first quarter of this year. Average bond mutual funds, which gained 17.7 percent in 2009, have trailed E.T.F.s a bit since then; the average bond fund gained 4.4 percent last year, and just under 1 percent in the first quarter.

But although the funds have prospered, regulators are concerned about the nature of the underlying bond market, which is far less liquid and transparent than the robust market for stocks in the United States.

"Bonds are like houses," said Dave Nadig, chief investment officer at the analytical website ETF.com. Like houses, he said, they are unique, some don't sell quickly or easily, and reliable price quotes can be hard to come by. By Mr. Nadig's estimate, there are more than 150,000 individual debt instruments outstanding. Of those, only a few thousand trade as frequently as once a day.

As a result, he said, establishing perfectly accurate market prices for fixed-income securities with the frequency that many retail investors expect is impossible. "How would you propose the market determine a fair price for a Krispy Kreme bond that hasn't traded in four days?"

Industry pricing services gather estimates of what that Krispy Kreme bond would actually fetch if it were sold. But those values may or may not be obtainable in the real world on a normal day, much less during a panic.

Another worrisome fact of life in today's bond market is that many large financial institutions, wary of tighter risk standards imposed after 2008, are unwilling to hold a large inventory of bonds. This makes the overall market much less liquid than it was not long ago.

The mutual fund and E.T.F. industry, on the other hand, is worried that regulatory concerns will give rise to wrongheaded regulations that will damage the retail market and deprive investors of popular, useful products.

For example, in a report in late February, the Investment Company Institute, an industry trade group, said that all but 5 percent of the assets in long-term bond mutual funds were held by households, typically in retirement accounts, and that history has shown that "retirement savers don't flee in hard financial times."

Moreover, statistics provided by institute economists show that the share of total bond market assets held by these funds is lower than the regulatory worries might suggest.

As of 2014, according to the institute, bond mutual funds, whose assets dwarf those of bond E.T.F.s, owned about 10 percent of the total supply of Treasury and government bonds and 26 percent of the supply of municipal bonds. In the high-yield bond market and some sections of the international bond market, already thinly traded and likely to be more troublesome in a future crisis, mutual funds hold about 22 percent of high-yield bonds and less than 1 percent of international bonds.

Still, one significant problem is that the interaction between the funds and the underlying fixed-income markets can be quite complex. When it comes to E.T.F.s, for example, not even the regulators are in agreement about the liquidity risks they pose.

Academic research is inconclusive, with two Fed studies reaching opposite conclusions. Recently, Michael S. Piwowar, a member of the Securities and Exchange Commission, told a fund industry conference that he thought some regulatory worries about E.T.F.s were "misinformed," "unsubstantiated" and "overblown."

IT'S easy to see how even regulators could be fuzzy about how much liquidity there is in the E.T.F. market. The first question they meet is, "Which E.T.F. market?"

That's because there are actually two markets — the primary market occupied by big institutions, and the secondary market where retail investors trade.

This, briefly, is how it works. In the primary market, only big institutions (called "authorized participants") can do some important kinds of business with the E.T.F. sponsor. They can redeem shares to get a prorated portion of the fund's assets, or they can deliver a fresh supply of those assets to the sponsor in exchange for a stack of newly created E.T.F. shares.

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“Authorized participants are the linchpin of the E.T.F. ecosystem,” said Ben Johnson, an analyst at Morningstar. “They intervene to create and redeem shares to keep market prices in line with underlying values.”

Imagine, for example, that a bond E.T.F.’s shares trade in the secondary market for $9 but their net asset value — that is, the value of the underlying bonds — is actually $10 a share. In such a case, authorized participants could buy the shares in the secondary market and redeem them in the primary market for full value, pocketing a dollar profit per share. Their purchases in the secondary market would, in time, drive up the price of those discounted shares.

One dilemma noted by Mr. Johnson is that if panic selling were underway for whatever reason, the authorized participants who were expected to buy E.T.F. shares in the secondary market and exchange them for bonds from the underlying portfolio would instantly sell the bonds to lock in their profit. As a consequence, he said, no matter how well the primary market works, it cannot fully insulate the underlying bond market from the impact of panicky secondary-market selling. That has regulators worried.

Investment industry representatives say that the E.T.F. markets have performed well under difficult circumstances. Rochelle Antoniewicz, senior economist with the Investment Company Institute, cites “an ideal test case” that arose in the summer of 2013, when investors feared the Fed would raise rates sooner than expected. Fixed-income E.T.F.s continued to trade smoothly, she said.

Individual investors may not be aware of these issues, though they should be, Mr. Nadig of ETF.com said.

“It is important for investors to understand all of the aspects of liquidity for their E.T.F.s,” he said. They should know what the long-term volume of secondary market trading in their fund’s shares has been, because E.T.F.s with skimpy daily trading volume are especially vulnerable to large price gaps in turbulent times.

Investors also need to understand the risks of holding E.T.F.s that, in turn, invest in less liquid assets like high-yield debt and foreign bonds. No amount of secondary market trading will prevent the E.T.F.s from losing money when the value of that underlying asset falls — and the less liquid the asset, the steeper its decline could be when the market falls.

Finally, investors need to know that the second-by-second prices quoted for their fixed-income E.T.F. shares, and the daily prices reported for their bond mutual funds, typically do not entirely reflect purchases and sales in the underlying bond markets.

Deeper solutions may not be forthcoming soon. Matthew Hougan, the president of ETF.com, who calls himself an “eternal optimist,” said he hoped that today’s regulatory worries about liquidity would “in the end, be refocused on reforming the bond market” to make prices more reliable and trading more visible.

But Mr. Nadig, his ETF.com colleague, said he found that unlikely. Bond prices “ultimately have to be set by market participants,” he said. “If they’re not willing to do that, then no amount of regulatory hand-wringing” can solve the basic liquidity problem.

That problem may not be evident every day. But bond E.T.F. and mutual fund investors may want to remember that, by the time any serious pricing and liquidity problems do arise, it may be too late for them to worry.

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