Bond Case Briefs

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The Coronavirus Crash Reveals a Big Problem In Bond Fund Pricing.

The exchange-traded fund industry just threw the mutual fund industry under the bus. BlackRock, Vanguard, and State Street have all made statements over the past—very volatile—month that bond ETF market prices are a “price discovery” tool, arguing that prices of illiquid individual bonds held in mutual funds and ETFs are “stale,” while ETFs have greater liquidity and therefore more accurately reflect the value of their underlying portfolios. That was their explanation for why so many ETFs traded at discounts to their underlying portfolio values—their net asset values, or NAVs, in Wall Street parlance.

But if bond ETF market prices are less than their NAVs—yet more accurate than them—that means similar or identical mutual fund NAVs are wrong and overpriced, since they are calculated in the same way as ETFs. (For illiquid securities like bonds, fund-pricing service accountants employ a fair value system to calculate NAV that extrapolates the price of the entire portfolio for the few individual bonds that trade.)

Vanguard’s case is particularly problematic, as some of its ETFs are really share classes of existing mutual funds and have identical portfolios. Jeff DeMaso, editor of the Independent Adviser for Vanguard Investors newsletter, has tracked the performance and discounts of the (ticker: VBTLX)—the largest bond mutual fund in the world at $269 billion—including its (BND) ETF share class. He has noticed some striking differences of late, especially since more than half of the fund’s portfolio is in ostensibly liquid Treasury and government agency bonds.

“On March 11, the mutual fund was down 0.6% while the ETF was down 1.9%,” DeMaso observes. “On the 12th, the bond market fund was down 1% and the ETF was down 5.4%. So those two days you had the ETF selling off much harder than your own mutual fund. And then on the 13th, you had the mutual fund down 0.5%. But the ETF rose 4.2%.”

DeMaso says that calling the ETF’s varying market moves a “price discovery tool” is “obfuscatory,” and believes the Total Bond Market Index’s portfolio’s “real price is probably somewhere in between” the mutual fund’s NAV and the ETF’s market price.

Vanguard’s Rich Powers is more diplomatic, stating in an email, “It’s not that one [price] is right and the other wrong. Each product has a different set of inputs that go into pricing, so there can be variations between the two. Those variations are more pronounced during times of market volatility.”

How Investors Get Hurt

The problem with the NAV being wrong for the mutual funds is that on days when the ETF’s market price trades at a discount to NAV, that means investors who bought the mutual fund essentially overpaid for its elevated NAV, while those selling received more for their sale than they should have. There is ultimately a delay, as the stale prices for the mutual fund’s bond portfolio have to adjust. Investors saw the consequences of that delay on March 13, when the Vanguard mutual fund fell

0.5% on a day when the ETF rallied 4.2%.

Such delayed pricing means that mutual fund shareholders who stay in a fund when prices are finally marked down bear the brunt of losses for those who got out early. When funds process redemptions, money managers usually sell the most liquid securities first. The remaining illiquid ones, once sold and repriced, amplify the losses for the remaining shareholders who would fare better if the entire portfolio had been repriced earlier.

“Shareholders who remained loyal have subsidized investors that had a shorter time horizon,” says Todd Rosenbluth, CFRA’s director of ETF and mutual fund research, adding that such selling can have a “snowball effect,” as “selling begets selling.”

The Worst-Case Scenario

One saw this with the infamous case of junk-bond fund Third Avenue Focused Credit, which collapsed in 2015, and in 2007 with Regions Morgan Keegan’s funds, which invested in subprime nonagency mortgage debt. More recently, there has been a similar liquidity crunch at nonagency mortgage debt funds Braddock Multi-Strategy Income (BDKAX), which fell 65% from March 18 through March 23, and AlphaCentric Income Opportunities (IOFIX), which dropped 40% from March 18 through March 25. On March 20, in particular, Braddock dropped 34% and AlphaCentric, 17%.

In an email to Barron’s, AlphaCentric stated, “We believe the NAV of the AlphaCentric Income Opportunities fund was accurately priced each day. The price reflects the fair value of its underlying portfolio of residential mortgaged backed securities, not equities….The AlphaCentric fund’s daily pricing was done by ICE, which is one of the largest and most respected independent pricing services.”

Yet ETF experts say that such fair-valuation services employ limited data. “Only about 20% of the bond universe trades every day,” says Reggie Browne, a principal at market maker GTS with a long history developing the ETF business. “How do you go about calculating fair value for something that doesn’t trade? The ETF is priced minute by minute, not a static NAV.”

While Vanguard’s ETFs suffered discounts, they were minor compared with some niche ETFs that invest in low-quality illiquid debt like high-yield muni bonds. The share price of the SPDR Nuveen Bloomberg Barclays High Yield Municipal Bond ETF (HYMB) fell almost 10% on March 16 to trade at an 18.6% discount to its NAV, which only declined 0.7% that day. Meanwhile, the NAV of the Nuveen High Yield Municipal Bond (NHMRX) mutual fund, which invests in the same asset class and holds some of the same bonds, fell only 0.6% that day and then fell 14% over the next four days ended on March 20. Which outcome was more accurate? That depends on whom you want to believe.

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