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High-Yield Bond ETFs: A Source of Liquidity

By Shelly Antoniewicz

The high-yield bond market has been buffeted recently, as market participants reassessed the risks of this sector and sent prices for many such bonds tumbling. These developments triggered fresh worries about liquidity in the high-yield bond market and—according to some pundits—generated the potential for fire sales that could create problems elsewhere in the financial system.

In an *ICI Viewpoints* published December 16, we put recent outflows from high-yield mutual funds in perspective, finding that individual high-yield mutual funds have weathered periods of outflows without posing challenges to financial stability.

High-Yield Bond ETFs Added Liquidity

With this in mind, let's take a look at high-yield bond exchange-traded funds (ETFs) and the comments of some observers who feared that such ETFs created an "illusion" of liquidity that could disappear in a turbulent market. Looking at the facts, we find that ETFs *added* substantial liquidity to the high-yield bond market at the height of the recent turmoil. Secondary market trading of bond ETFs relieved pressure on trading in the high-yield bond market by providing an alternative mechanism for investors to reduce or increase their exposure to high-yield debt.

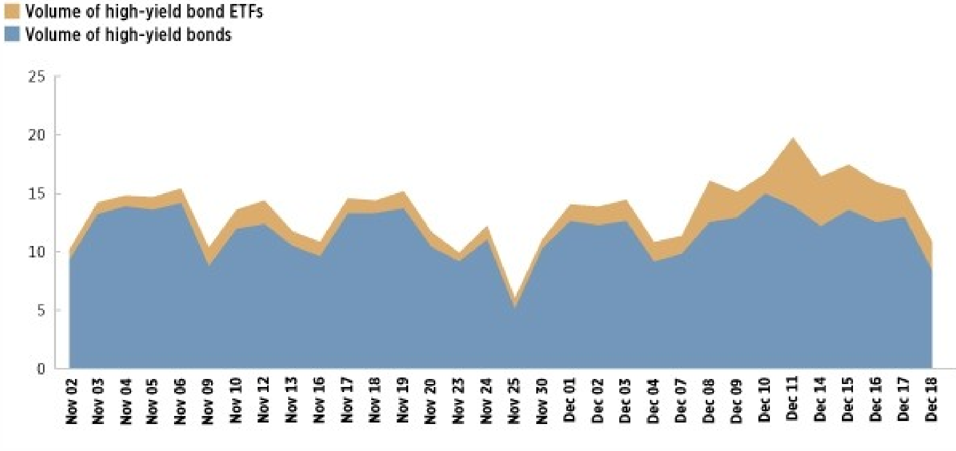
As investors sought to shed or gain high-yield exposure, depending on their risk appetites and expectations of future returns, bond ETFs provided them with an efficient means of transferring risk while limiting the impact on the underlying high-yield bond market. For the most part, when investors buy and sell shares of a bond ETF on an exchange, only the shares change hands while the bonds that are contained within the portfolio remain untouched. In other words, secondary market trading of bond ETFs can add liquidity to the underlying bond market—as it did in this case.

Figure 1 below shows daily secondary market volume of ETFs (the gold shaded region) and daily transaction volume in high-yield bonds (the blue shaded region) from November 2 to December 18. Daily trading in high-yield bond ETFs averaged $1.3 billion during the five weeks before December 8, while daily transaction volume on high-yield bonds averaged $11.3 billion over the same period. Secondary market trading of high-yield bond ETFs, during this period of relative calm, added roughly 10 percent ($1.3 billion/$11.3 billion) to daily liquidity in the high yield market.

Beginning December 8, however, trading in both high-yield bonds and the respective ETFs surged, as stresses emerged in the high-yield market. From Tuesday, December 8, through Friday, December 18, average daily value traded of high-yield bond ETFs jumped to $3.3 billion, while daily transaction volume in high-yield bonds increased to $12.6 billion. During this stressed period, secondary market trading of high-yield bond ETFs provided an additional 26 percent ($3.3 billion/$12.6 billion) in daily liquidity to the high-yield market.

Secondary Market Trading of High-Yield Bond ETFs Added Liquidity to High-Yield Market

Billions of dollars; daily, November 2–December 18, 2015



Note: Data exclude high-yield ETFs designated as floating-rate. Data also exclude Veteran's Day and the Friday after Thanksgiving.

Sources: Investment Company Institute, Bloomberg, and FINRA TRACE

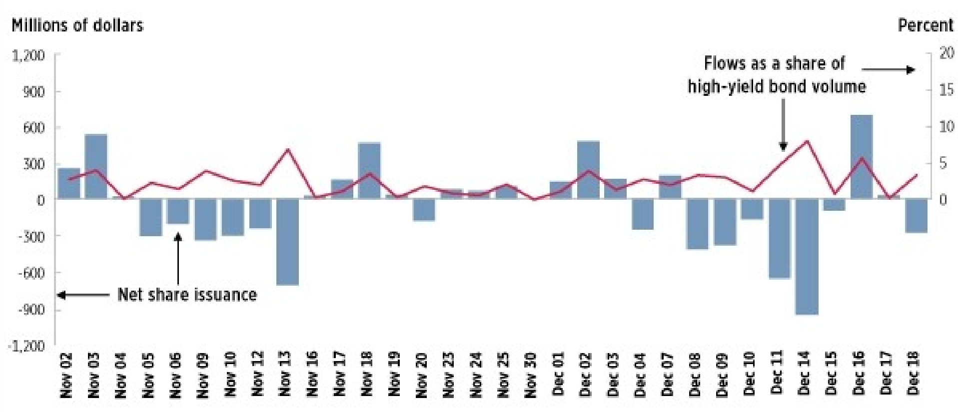
An Efficient Way to Transfer Risk

Over the past few years, some commentators warned that high-yield bond ETFs would add to instability in a stressed market. Their hypothetical storyline was that investors would rush to sell their high-yield bond ETF shares in the secondary market, only to find few buyers. Market makers would passively accumulate the unwanted ETF shares and, in turn, would redeem them through authorized participants (APs), who would exchange the shares for the underlying bonds. APs subsequently would sell these bonds, triggering further losses and a vicious cycle of redemptions, bond sales, and a downward spiral in bond prices.

The *actual* experience of high-yield bond ETFs during the past couple of weeks tells a much different story. Even in the face of sharply declining prices, sellers of high-yield bond ETFs found willing buyers in the secondary market and ETF shares were not redeemed en masse back to the funds. As shown in Figure 2, daily net redemptions of high-yield bond ETFS (the blue bars) have been modest so far in December. The largest daily net outflow—$1 billion on December 14—accounted for only 8 percent of trading in high-yield bonds (the red line) on that day.

High-Yield Bond ETFs' Net Flows* Are a Small Share of Underlying High-Yield Bond Volume

Daily, November 2–December 18, 2015



*Net flows represent the net share issuance of high-yield bond ETFs.

Note: Data exclude high-yield ETFs designated as floating-rate. Data also exclude Veteran's Day and the Friday after Thanksgiving.

Sources: Investment Company Institute and Bloomberg

High-yield bond ETFs provide benefits to investors and to the underlying bond market by allowing investors to efficiently and smoothly transfer risk amongst themselves. The result: increased liquidity in the high-yield market. In this most recent stressed episode, liquidity provided by high-yield bond ETFs expanded as secondary market trading in high-yield bond ETFs surged. At the same time, high-yield bond funds experienced modest net redemptions, limiting their impact on the underlying market for high-yield bonds.

Maybe it’s time to revise the hypothetical narrative on high-yield bond ETFs.

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