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OPINION

Don't Blame ETFs for Bond Market Stress

Post-crisis postmortems point fingers at the wrong culprit, writes AllianceBernstein's Anita Rausch.

By Anita Rausch | May 15, 2023

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Practically every bout of bond market volatility induces yet another hypothesis that ETFs are incendiary. However, each crisis seems to offer a learning opportunity to prove just how stabilizing ETFs can be.

Recently published academic research suggests that during selloffs, redemptions ensue in ETFs, causing the bonds given out through the redemption process to sit on the market makers' balance sheet, reducing their appetite for buying more. The research, which has been referenced repeatedly in the financial press, says that this process reduces the liquidity or the number of buyers for these types of liquid bonds, further taking liquidity out of the market.

I respectfully disagree with this claim.

Extensive research demonstrates that ETFs are a liquidity buffer, especially in more opaque asset classes like fixed income. The structure and exchange listing of an ETF diversifies the selling and alleviates selling pressure that would have otherwise been there under more traditional wrappers.

If an ETF is under pressure to sell, so are its mutual fund and separately managed account cousins. The portfolio managers of these more traditional products will also be selling the same bonds, so regardless of wrapper, more liquid bonds will be held on the market makers' balance sheet, thereby reducing appetite. That is really the definition of illiquidity: no desire to buy.

Therefore, it's not just the ETF selling bonds into the market. Instead, it is all types of investment vehicles that create a scenario of balance sheet exhaustion.

The authors of the academic paper acknowledge that mutual funds face similar frictions as ETFs, but go on to say that ETFs are a better candidate for study at the moment because their data is much more granular and offered daily. ETFs are being transparency-shamed.

What is not explained is that the majority of redemptions are done by the market makers – not the dealing bank desks. For various reasons, market makers have the majority of ETF market share and therefore take on most of the selling during this period.

While some have become general institutional counterparties in fixed income, the banks still stand as the largest counterparties to institutional bond flow. Consequently, the ETF structure diversifies the selling across more types of balance sheets.

The truth remains that ETFs function as a liquidity buffer. On average, only about 3.75% of the average daily volume of ETFs' trading results in creations or redemptions in the fund. During a time of crisis like March 2020, that number went down to about 3.2%.

I'd like to reiterate that when selling intensifies and volumes of ETFs increase, the percentage of those shares traded that results in redemptions or "selling" of the bonds is only 3.2%. That means that the ETF community – the market makers, buyers, sellers and bank desks – is absorbing 96.8% of the selling before giving it back to the fund.

The paper neglects to address this important fact.

Yes, passive portfolio managers are pushing out liquid bonds first, but they are doing so at a rate that is on average 96.8% less than a mutual fund or separate account that has no buffer and needs to sell bonds outright. This fact alleviates a tremendous amount of selling pressure in specific bonds and only adds to liquidity.

In other words, balance sheet exhaustion on specific bonds is being alleviated because of the exchange listing of an ETF and ability of buyers and sellers to match without always having to transact in the fund itself. The ETF diversifies the selling across different types of balance sheets and keeps more of it in the system than other more traditional wrappers.

The ETF proves time and again that it is a liquidity sleeve and shock absorber, especially during times of stress.

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