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A Case Study on Bond ETF Illiquidity

That we are even talking about this kind of truly esoteric *'systemic risk'* shows how far markets have progressed since the 2008 financial crisis. We will do our best to explain what this risk is and why it is a hot topic. But first we will start with a few definitions.

A bond ETF refers to a mutual fund which pools investors' money and holds bonds on their behalf and is traded on the stock exchange. ETF stands for exchange traded fund. You can buy and sell these funds in seconds and it is estimated that the total size of this market is just under $2 trillion dollars.

Bond ETF's have become popular because they solve a few key problems with owning bonds. The primary problem is that buying individual bonds is fussy. For the average investor the quote is controlled by their broker and pricing is opaque which means you are at an immediate disadvantage. Also choosing which bond to own is too time-consuming given the investor is just trying to make an interest rate bet.

So the mismatch comes because the investor wants interest exposure but without the individual distinction of comparing which bonds they want and at what price. As interest rates go down and prices go up this is a gradual positive self-reinforcing process. However, if the ETF market collectively hits sell, as a possibility, there is no distinction on price and what gets sold.

Liquidity refers to the *depth* of the bond market. We will use this bit of financial jargon only to demonstrate that the financial market can actually be quite poetic. In clear language this means, if I want to sell a bond, is someone there to buy it? Regulation designed to make the banking industry more stable now requires banks to restrict their market making which means a bank cannot be a buyer to create liquidity. Often in the past a bank would buy a bond and wait for a buyer to show up.

Government bonds are easy to trade but most other bonds are not. So in the scenario that there is a one sided selloff, government bonds can fall, but at some point pension plans and insurance companies will come in to buy the bonds. The root of the panic argument is that many non-government bonds do not have a deep liquid market. If selling is truly one sided, because it is an interest rate bet, there is no one to buy the actual individual bonds.

The irony with the bond market is that if the company does not need to issue debt then they can wait for the panic to pass. If, however, the company needs to issue debt or roll over their existing debt then they can get caught paying a much higher interest rate for new debt. This is simply to say the consequences are real for many companies.

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Avenue’s bond portfolio strategy has always embraced the shortcomings of the bond market head on. We get the best institutional pricing we can by using a simple strategy of patience and multiple dealers. We also believe there is real value to evaluating and buying individual bonds. The broad industry term is called credit analysis. If a bond panic selloff occurs, there are bonds of many completely solvent companies that we would be happy to own at higher interest rates. We believe Avenue has the capability to take advantage of any potential bond ETF illiquidity shock.

Avenue Investment Management
Getting there together

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