FIVE KEY POINTS TO FIXED INCOME ETF LIQUIDITY

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09/11/2015

When I see headlines along the lines of "Fixed income exchange-traded funds (ETFs) are not liquid and pose a risk to the system!" I can't help but think, *Stop the madness!* Fixed income ETFs can actually *add* liquidity to the overall ecosystem and could potentially protect investors better than traditional investment structures. Fixed income ETFs have also become a reliable source for real-time pricing in an asset class where the last trade is not always reported or easily known by market participants. That being said, should there be stress in the bond market, many holders of the asset class will be affected in NAV terms, regardless of whether they are invested in individual bonds, mutual funds, closed-end funds or ETFs[1]. But before you take the headlines at face value, remember these five points when thinking about using an ETF for your fixed income investments: **1. Fixed Income ETFs Can Add Liquidity:** Through secondary market trading, another layer of liquidity is added to the ETF ecosystem. Natural buyers and sellers can be paired off in the secondary market without having any transactions occur in the primary bond market. If secondary market trades are not matched by natural buyers and sellers, then a market maker is most likely providing liquidity on the other side of the trade. A market maker also does not necessarily need to transact in the underlying bonds to hedge their position. The ETF ecosystem affords market participants the ability to use highly correlated vehicles other than the underlying bonds themselves to potentially hedge their ETF positions. Some of these hedges include other ETFs and derivatives such as futures and credit default swaps. These added layers of liquidity via the exchange or correlated securities are unique to the ETF structure and can help soften the blow of any selling pressure in the fund. **2. There Is No Forced Selling:** All ETFs have an authorized participant (AP) that sits between the fund company and the investor when assets are moved into or out of the fund. This is particularly important when it comes to fixed income ETFs, as the AP is not forced to redeem ETF shares on the exact day a trade has occurred. Rather, they can hold their position and go through the redemption process when they feel they can sell the underlying bonds in the marketplace for more than they purchased the ETF shares (plus any costs to them). In fact, studies show that only $1 of every $5 in fixed income ETF volume leads to a transaction in the primary market.[2] In mutual funds, however, the portfolio manager may have to sell assets in the fund to raise cash when redemption orders are placed, thus forcing the fund to dump bonds on the market when it may not be most advantageous. We previously discussed the basic differences between ETFs and mutual funds, here. **3. Intra-day Liquidity:** The exchange-traded nature of ETFs can provide a significant advantage to investors. Let's discuss two investors in a hypothetical example: one investor holds an ETF, the other holds a mutual fund. Both want to sell their fixed income position at 10:00 a.m. The ETF investor can receive execution at the time the order is placed. The mutual fund investor, on the other hand, would have to wait to receive the 4:00 p.m. NAV price, even though they placed their order at the same time. Should there be some kind of negative market event between 10:00 a.m. and 4:00 p.m., the mutual fund investor would receive the lower price reflected in the 4:00 p.m. NAV. This would provide the ETF investor with a distinct competitive advantage of having liquidity at the time of order.[3] **4. Real-**

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Time Pricing: In the fixed income world, bond pricing can be somewhat opaque due to its over-the-counter nature. ETFs provide real-time pricing and can act as price discovery vehicles for the underlying bonds themselves. ETF liquidity providers in fixed income funds are pricing the ETF where they can buy or sell the bonds and not where they *think* they can buy or sell the bonds. This price transparency can be beneficial to investors when deciding on the right time to execute. **5. Small Part of the Overall Market:** Fixed income ETFs have seen tremendous growth over the past several years. However, ETFs still represent a fairly small overall portion of the bond market. For example, in the $1.1 trillion high-yield bond market, ETFs represent only 4% of the assets, compared with mutual funds, which control 36% of the market.[4] In the event there is a rush to the exits, ETFs can be more flexible and represent a smaller piece of the pie. **Summary of Fixed Income ETF vs. Mutual Fund Liquidity**

	ETF	Mutual Fund
Structure Adds Liquidity	YES	NO
Forced Selling in Primary Market	NO	YES
Intraday Liquidity	YES	NO
Real-Time Pricing	YES	NO
Large % of Underlying Market	NO	YES

The key takeaway for investors is that an ETF is a wrapper around a basket of securities, and those securities dictate only part of the ETF's overall liquidity. The beauty of the ETF structure is that the underlying securities are not the only component of the total ETF liquidity. When thinking about fixed income ETFs, remember that the structure itself can add to the overall liquidity picture that could benefit investors during most market environments. I hope these five points provide more confidence in fixed income ETF trading and investing. [1]Of course, the holder off an individual bond is promised repayment of the face value of the bond upon maturity, while fixed-income funds do not promise to repay a shareholder's principal. [2]Source: Citi ETF Perspectives, 7/27/15. [3]It should be kept in mind, however, that ETF shares can trade below NAV whereas mutual fund shares are always redeemed at NAV. [4]Source: Citi ETF Perspectives, 7/27/15.

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DEFINITIONS

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Real Time Calculations : A price calculation used if the basket is open to calculate the current price of a security also known as "fair value&rdquo.

Net Asset Value (NAV) : The calculated assets minus liabilities divided by shares outstanding. NAV is the straightforward account of the actual assets in the fun.

Closed-end fund : is a collective investment vehicle based on issuing a fixed number of shares which are not redeemable from the fund. New shares/units in a closed-end fund are not created by managers to meet demand from investors. Instead, the shares can be purchased (and sold) only in the market. Closed-end funds are usually listed on a recognized stock exchange and can be bought and sold on that exchange. The price per share is determined by the market and is usually different from the underlying value or net asset value (NAV) per share of the investments held by the fund.

Secondary market : A market where investors purchase or sell securities or assets from or to other investors, rather than from issuing companies themselves—exchanges such as the New York Stock Exchange and the NASDAQ—are secondary markets.

Market maker : Someone who quotes a buy and a sell price in a financial instrument.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Market participant : Anyone interacting with the ETFs in some capacity. It can be end investors, market makers, hedgers, authorized participants.

Derivative : a security whose value is determined by another asset.

Credit Default Swap : A swap designed to transfer the credit exposure of fixed income products between parties. The purchaser of the swap makes payments up until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third party debt if this party defaults on the loan.

Authorized Participant (AP) : An entity, usually an institutional investor, that submits orders to the ETF for the creation and redemption of ETF creation units.

Creation and Redemption Process : The process whereby an ETF issuer takes in and disburses baskets of assets in exchange for the issuance or removal of new ETF shares.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.