IIAC LETTER

Fixed Income ETF Performance and Outlook - 2020[1]

INTRODUCTION

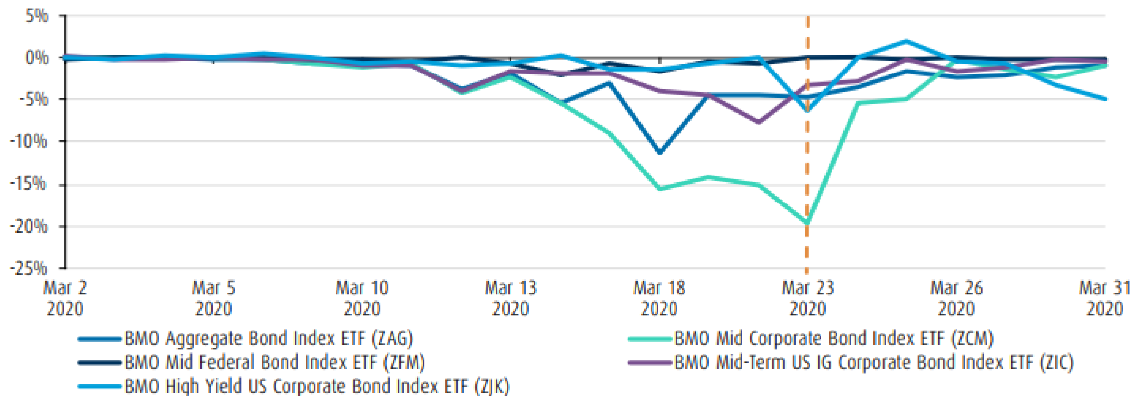
The operating environment of fixed Income ETFs during the first 3 months of the COVID-19 crisis (March - May 2020) has certainly been a challenging one. All areas of the financial markets have had common as well as unique issues resulting from the pandemic. In the underlying bond market, while Government of Canada bond yields moved lower, corporate bonds including investment grade and high yield bonds saw prices fall at the height of the crisis in March. As a result, liquidity in some bond market sectors in the Canadian fixed income market largely dried up and the cost to transact in some markets segments sharply rose.

This paper endeavours to examine both the performance of ETFs during this period compared to the underlying bond market and other products, as well as examine operational issues including ETF liquidity.

RECENT FIXED INCOME ETF PERFORMANCE AND CHALLENGES

For Fixed Income ETFs during the month of March there were instances where ETFs traded in the secondary market at what appeared to be substantial discounts to their net asset value (NAV). This occurred across almost all issues but was particularly pronounced in investment grade and non-investment grade corporate bond ETFs as can be seen sample provided below in figure 1.

Figure 1: Premium/Discount to NAV (March 1-March 31, 2020)



Source: Bloomberg March 31, 2020

1 The IIAC collaborated with The Canadian ETF Association (CETFA) in the production of this report. CETFA supports the growth, sustainability, and integrity of Canada's ETF industry

As figure 1 shows on March 23rd, 2020 the Federal Reserve started a secondary Market Corporate Credit Facility (SMCCF) which materially brought the ETF price discount to the NAV back into line. This also had a significant spillover effect in Canadian corporate markets. Additionally, the Bank of Canada announced its own corporate bond purchase program on April 15, 2020.

There has been some discussion of whether this discount of the ETF prices to NAV represents a breakdown of the natural arbitrage system where discounts of the NAV to ETF price are normally self-correcting. In terms of the arbitrage system it would appear that the normal self-correcting mechanism was impossible during short periods of high volatility because ETF prices were actually based on pockets of liquidity and actual tradeable prices of the underlying components and NAVs were representing stale or hypothetical values.

In addition, there have been some reports that have concluded that the discounts to NAV have had a distorting effect on the prices of underlying bond issues. After analysis it appears that it can be compellingly argued that the opposite may in fact be the case. In volatile conditions the ETF itself may represent the best means for price discovery of some underlying issues that have gone "no bid" in the cash market for a period of time.

In strained and volatile markets ETFs, and in particular fixed income ETFs facilitated continuous market liquidity and material trading volumes and provided transparent price discovery for over the counter fixed income products (OTC). As indicated earlier, it should be noted however that during major bouts market volatility like the one witnessed during the COVID-19 crisis that began in in March 2020, where equity and bond markets moved at dramatic speeds, NAV and ETF price differences were amplified.

It is important that we recognize that this market dislocation is not limited to ETFs, but to how the OTC bond market pricing mechanism operates in general. Many investors relied on fixed income ETFs as they became the best gauges of real time bond prices in wildly gyrating markets. Early in the crisis as bond market liquidity became impaired on-screen bond cash prices were often much higher than where trading desk were willing to provide firms bids. The result was that for many participants, including information services, began to rely on ETF prices to estimate the price of the underlying bonds that were not actively trading. The sell-off in March was followed by a recovery in April 2020 where markets whip sawed the other way in a similarly sometimes-disorderly manner.

EXAMINING RISKS AND OTHER ISSUES

There is a need to examine a bond ETFs exposure to rates and credit and how this has affected their functioning. With a combination of government and corporate bonds underlying some ETFs the investor must consider the ETFs market sector, outstanding underlying issue size of the ETF, outstanding issue size of the ETFs constituents, duration, and convexity. As is evident there are a number of risks and this will have an effect on the performance of the ETF and its underlying components in volatile markets. As the figure 1 snapshot indicates higher risk/less liquid ETF issues traded at a larger discount for a brief period, but all the issues displayed impressively came back into line after central bank and Fed market interventions.

Looking at authorised participants, (APs), there have been concerns voiced and raised by regulators and others that ETF AP arrangements could break down in times of market stress.

During the recent crisis there is little or no evidence of this in Canada. Despite the extreme volatility experienced through the crisis and in particular in the middle of March the AP system appears to have functioned effectively. A robust and well designed and diverse AP network is of great importance to market functioning in times of stress.

There have also been conflicting statements in the mainstream news media and from financial firms, partly as a reflection of complex evolving markets and a vast array of products with different risk profiles. However, after examining trade volumes, temporary divergence of ETF prices to the NAV and the price discovery that ETFs provided in choppy markets, it clearly appears that ETFs performed quite well during one of the most volatile markets in history.

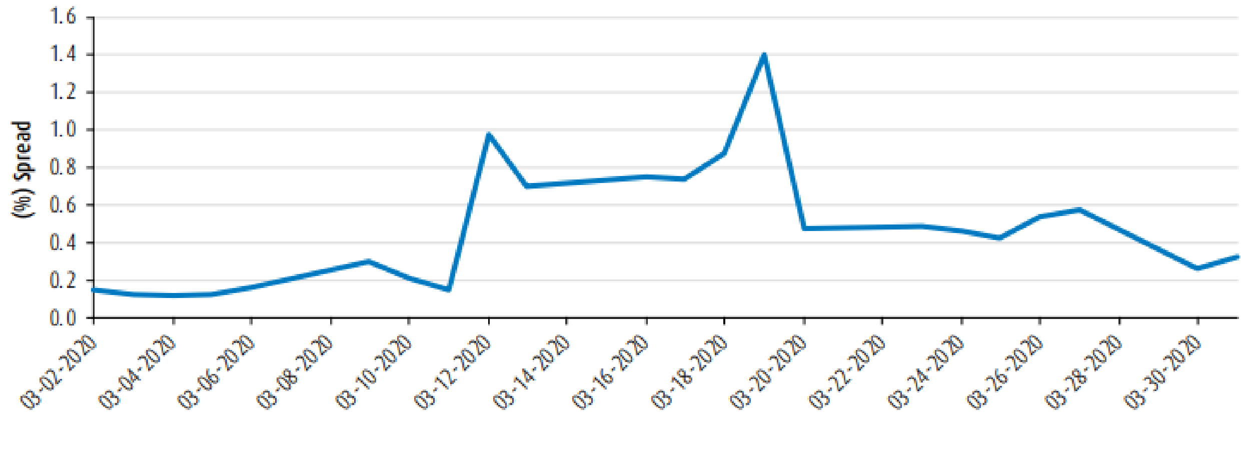
Re-balancing did present some challenges during this period of stress, but the trades were able to be executed as required.

BEST PRACTICES FOR TRADING ETFS ARE PARTICULARLY IMPORTANT DURING A PERIOD OF CRISIS

Since the beginning of March 2020, the COVID-19 pandemic has led to a period of increased market volatility and shaken the confidence of investors. On the positive side there has also been some discussion that ETFs have made re-balancing of investors' portfolios easier through less transactions and readily available price discovery as certain underlying corporate credit components of ETFs went no-bid at times.

That said there were instances of widening ETF spreads during bursts of high stress for the entire financial market as well as ETFs as Figure 2 indicates.

Figure 2: Aggregate Bond Index ETF Avg Bid-Ask Spread (March 1–March 31, 2020)



Source: Bloomberg March 31, 2020

There are some best practices that market participants can observe that can help limit the discount or premium of an ETF transaction to the NAV.

Avoid Trading at the Open of the Market

The first 10-15 minutes of a trading day should be avoided to get optimal pricing and execution of a transaction.

Transact When the Underlying Cash Market is Open

Trading when the underlying market is closed can result in wider spreads. The price of constituents will have to be modeled and a wider spread will likely be used.

Market Participants should Always Use Limit Orders

Using a limit order enables a set price to be filled on the trade. In volatile markets that are moving fast limit orders may need to be reset during the day as prices change.

Be Cognizant of Overall Market Instability and Volatility

While a fixed income ETF is, at a minimum, as liquid as its underlying bonds it is important that the ETF is constructed with a portfolio that has trading volume requirements.

CONCLUDING THOUGHTS AND FUTURE OUTLOOK

At the height of the volatility in the markets during the COVID-19 pandemic the fixed income market was an area of concern for investors. Specifically, corporate bonds and, particularly, high yield bonds saw liquidity dry up and go no-bid in the cash market. Impressively, ETFs provided price discovery of underlying issues in many cases and continued to actively trade through difficult times. In fact, it can be compellingly argued that ETFs, given their real time transaction levels, were more reflective of actual market prices than other products such as mutual funds or the levels published by data market services during this period.

The ETF technology will likely continue to experience strong growth into the foreseeable future. However, with this anticipated growth in the total size of the market, the inclusion of some riskier strategies, and a greater number of ETF providers and APs, investors and regulators have remained on alert. What the recent ETF performance during the pandemic has taught us is that, to date, the current fixed income ETF structure in Canada is robust and it does not currently appear to require material changes or additional regulation. In closing it should be noted that Canadian ETFs provided transparency and demonstrated ongoing liquidity during the depths of the market volatility experienced in March 2020.

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