The Asset Management Industry
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INVESTMENT COMPANY INSTITUTE

LETTERS TO THE EDITOR & RESPONSES

August 7, 2016

ETFs Boost Liquidity in Times of Financial Stress

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(As published in Investment News, August 7, 2016)

Do exchange-traded funds offer an illusion of liquidity? The notion persists among critics—and even some regulators. Yet these assertions fly in the face of facts, as proponents of this idea look past real-world data and experience to build a false narrative of ETF opacity and illiquidity.

The “illusion” story is often trotted out in reference to bond ETFs. Far from posing risks in times of market stress, however, bond ETFs actually relieve pressure on their underlying securities and enhance liquidity. This is because most ETF activity occurs in the secondary market, where only the shares of the ETF change hands, leaving the underlying securities untouched. ETFs provide an efficient and cost-effective mechanism for investors to reduce or increase their exposure to a particular asset class or investment strategy, even in times of volatility.

This is not just a theoretical proposition—it has been repeatedly tested, and each time bond ETFs have acquitted themselves well. In the summer of 2013, when the Federal Reserve hinted that it might curtail its massive bond-buying program, the bond market took a good-sized hit. But despite this stress, data show that secondary market liquidity in bond ETFs actually increased to nearly $5 billion per day, compared to $3.8 billion from January to April 2013. Furthermore, bond ETF shares were not redeemed to the funds en masse: The ratio of bond ETF primary market activity (creations and redemptions) to total bond ETF activity in the primary and secondary markets remained constant, at 18%, throughout the summer.

The high-yield bond market provides another useful example. In late 2015, prices for many high-yield bonds tumbled after market participants reassessed risks in this sector. ICI analyzed how ETFs fared during this turmoil and found that they added substantial liquidity to the market. In the face of sharply falling prices, sellers of high-yield bond ETFs found willing buyers in the secondary market. Again, there was no flood of redemption requests. This secondary market trading of ETF shares relieved pressure on trading in the high-yield bond market by providing an alternative mechanism for investors to adjust their exposure to high-yield debt, enabling investors to efficiently transfer risk among themselves.

Naysayers will often point to market volatility on Aug. 24, 2015, to raise questions about ETFs and liquidity—but once again they ignore the facts. Yes, some equity ETFs experienced declines in prices on Aug. 24 that were far steeper than those in their underlying securities, because flaws in the structure of the U.S. equity market temporarily hurt the ETF arbitrage mechanism. Some of these shortcomings in market structure are highlighted in the SEC's Research Note on the events of Aug. 24, which provides empirical data and other information on the disparate opening processes and re-opening processes after a “limit up-limit down” trading halt in a security across primary listing exchanges. Often ignored is that these ETFs did not experience significant redemptions, and their prices were back to equilibrium within an hour of the opening bell.

The events of Aug. 24 also demonstrated how the use of market and stop-loss orders can cause investors to unnecessarily absorb heavy losses. Such orders expose investors to choppy markets by demanding liquidity at any price. The events of this day should serve as a reminder to advisers and investors that such order types are extremely risky during periods of volatility—but they should not cause anyone to question the nature of exchange-traded funds.

If the critics are right and ETF liquidity is just an illusion, bond ETFs also should have encountered difficulties on Aug. 24. They did not. Indeed, ICI research shows that bond ETFs were resilient, and that there was no apparent spillover from equity to bond ETFs that would indicate a general problem with the ETF structure. In fact, the average estimated discount for domestic bond ETFs remained in a narrow range throughout the entire day, reinforcing the fact that shortcomings in the U.S. equity market structure were responsible for the events of Aug. 24.

Most recently, the illusion theory failed in the wake of the Brexit vote. Sellers of both equity and bond ETF shares found willing buyers in the secondary market, the ETF mechanism worked smoothly and efficiently to rapidly close gaps between ETF prices and underlying values, and ETFs did not face significant redemptions.

Despite all of this evidence, critics continue to suggest we are just one investor panic away from an ETF meltdown. They say a severe market event would cause investors to rush to sell ETF shares in the secondary market, forcing market makers to passively accumulate the unwanted shares and redeem them through authorized participants. The APs, they argue, would exchange ETF shares for the underlying securities and then sell those securities, triggering a vicious downward spiral in prices that would force even more selling and ETF redemptions.

This negative feedback loop theory would be compelling if it were true—but it has been disproven at every test. It failed for bond ETFs in 2013, for high-yield bond ETFs in late 2015, again for bond and equity ETFs on Aug. 24, and for both bond and equity ETFs after the Brexit vote.

Some critics go so far as to suggest ETFs are inherently risky simply because they are more liquid than their underlying securities. If we apply the same logic to other financial instruments, where could we invest? A stock promises greater liquidity than the ownership stake it represents; a 30-year Treasury bond provides greater liquidity than a claim on federal assets redeemable in 2046. In many ways, the entire point of financial instruments is to promise—and deliver—greater liquidity than their underlying assets.

ICI has provided data and analysis to the public and regulators to demonstrate how ETFs convey substantial benefits to investors while providing liquidity to our markets. We have shown again and again that fears of a liquidity illusion surrounding ETFs are simply not informed by real-world experience. Indeed, ETFs represent a financial innovation that enhances the dynamism and resiliency of our markets and justifies their growing popularity.

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