In March equity and bond markets experienced historic volatility, during which liquidity temporarily dried up, making trading difficult. ETFs saw their spreads widen during this time and many traded at a discount to their NAVs – meaning the price to buy them was less than their worth. But that wasn’t necessarily a bad thing. Stephanie Pierce, CEO of ETF, Index and Cash Investment Strategies at BNY Mellon Investment Management along with other experts across BNY Mellon explain the effect of volatility on ETFs and what discounts and premiums really mean for such products.

How liquid are ETFs during market volatility?

Why do we think ETFs help markets function? ETFs provide liquidity and price discovery during market volatility, especially for the fixed income markets. It would be extremely difficult to trade during these times without them. ETF market makers and authorized participants provide transparency into where the underlying assets within ETF portfolios should be trading. While equity ETFs declined in value during the extreme volatility seen in markets in March 2020, they were constantly trading, thereby providing market participants with an important tool for price discovery and liquidity.

How do ETFs help during volatile time periods?

If you consider a functional fixed income market, the most liquid corporate securities trade approximately a dozen or two dozen times a day. ETFs, on the other hand, trade much more frequently. They trade tens of thousands of times a day. As such they can become a tool of price discovery. For example, if an ETF was trading at a 5% discount to NAV, that means the bond prices are stale and they are actually 5% higher than where the market really thinks they should trade. There seems to be a lack of understanding of what discounts and premiums really mean. They are a feature of ETFs, not a flaw. Corporate bonds don’t trade very frequently. In times of large price dislocations, the market doesn’t know where corporate bonds should be trading. ETF discounts and premiums provide some visibility into where the markets should trade.

How does a premium relate to the underlying markets of the securities that the ETFs hold?

An ETF can represent a whole market segment. For example, an EAFE ETF holds securities in Europe and Asia. Those markets close well before the US markets do. An ETF that trades on a US exchange will continue to trade up until 4pm even though the underlying securities are no longer trading. If there is any positive market news after the EAFE markets close, it won’t affect the ETF’s NAV since the value is based on the closing prices of the European and Asian securities. The ETF price, on the other hand, will be affected by any positive news. So, the ETF price could be momentarily higher than the NAV - or at a premium - thereby reflecting the positive news after the EAFE markets closed.

How should ETF investors think about spreads relative to NAVs?

Spreads will always widen out in any asset class during periods of market volatility as market makers digest the information they’re seeing in real time and try to understand the impact to the buying and selling process. Spreads are primarily a function of volume. The more buyers and sellers you have competing on price, in general, the narrower the spread. There are also costs to consider. Market makers have to finance and hedge their positions. ETFs have creation costs at issuers and custodians. In addition, if an ETF holds securities in foreign markets, there may be underlying taxes and costs that a market maker will incur when trading those vehicles. All these factors go into the equation of determining spreads relative to the NAV of the portfolio.

Note: This article was derived from an early April roundtable discussion on March’s market volatility. Participants in that talk, moderated by Stephanie Pierce, CEO of ETF, Index and Cash Investment Strategies at BNY Mellon Investment Management, included Dragan Skoko, Head of Trading and Trade Analytics, Mellon, Paul Benson, Head of Fixed Income Efficient Beta, Mellon and Jason Ronca, ETF Capital Markets Specialist, BNY Mellon Investment Management.

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ETF shares are listed on an exchange, and shares are generally purchased and sold in the secondary market at market price. At times, the market price may be at a premium or discount to the ETF’s per share NAV. In addition, ETFs are subject to the risk that an active trading market for an ETF’s shares may not develop or be maintained. Buying or selling ETF shares on an exchange may require the payment of brokerage commissions.

ETFs trade like stocks, are subject to investment risk, including possible loss of principal. The risks of investing in the ETF typically reflect the risks associated with the types of instruments in which the ETF invests. Diversification cannot assure a profit or protect against loss.

Bonds are subject to interest rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. High yield bonds involve increased credit and liquidity risk than higher rated bonds and are considered speculative in terms of the issuer’s ability to pay interest and repay principal on a timely basis. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. Small and midsized company stocks tend to be more volatile and less liquid than larger company stocks as these companies are less established and have more volatile earnings histories. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability; limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

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