In the most volatile month for the S&P 500 market in history and the worst since the financial crisis for bonds, March saw liquidity dry up, ETF spreads widen and trade at a discount to their NAVs. But with unprecedented support for markets from the Federal Reserve, the situation was relatively short-lived. In mid-April ETF experts from across BNY Mellon Investment Management got together with Stephanie Pierce, CEO of ETF, Index and Cash Investment Strategies at BNY Mellon Investment Management to discuss the situation and how they believe the ETF industry may have changed as a result.

**Participants in the discussion included:**

Dragan Skoko, Head of Trading and Trade Analytics, Mellon
Paul Benson, Head of Fixed Income Efficient Beta, Mellon
Jason Ronca, ETF Capital Markets Specialist, BNY Mellon Investment Management

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How did the March market volatility express itself in the ETF landscape?

Market makers create or redeem shares in order to close the distance between the market price of the ETF and its net asset value (NAV). For example, in times of heavy selling, market makers have excess inventory and they redeem those shares to bring the share price back in line with the underlying NAV. Market makers also like to take advantage of the price dislocation between the price and NAV. When the price trades at a premium or a discount to the value of the underlying securities, there can be an economic incentive for the creation or redemption to occur to profit off that mismatch. In March, certain bonds were not trading at all. This made that arbitrage trade really difficult to execute. This is why there were discounts in bond ETFs – until the Fed introduced its buying programs.

Were the Fed’s actions helpful in settling the markets?

Yes. They helped financial markets function again from a liquidity perspective. The Fed used the blueprint from the 2008 financial crisis to quickly come in and address markets that were essentially frozen. Market participants expect certain securities to function normally, such as repos, treasuries, and inflation-protected securities. The Fed programs brought some liquidity into the fixed income market, which benefited multiple fixed income categories. As part of its relief package, the Fed also announced they would purchase corporate debt, including bond ETFs, with the goal of providing additional support to markets.

Which assets classes experienced the largest differences relative to their price and NAV amid the March volatility?

Equity ETFs had the smallest differences between share price and NAV during the volatility in March. While equity returns were down during this period, the market prices for stocks remained transparent, which led to smaller differences relative to their price and NAV. Fixed income, on the other hand, had the biggest differences relative to price and NAV. Some individual bonds didn’t trade for days or weeks. During the height of the March volatility, bond markets were largely frozen, which made it very difficult to determine the fair value of those securities. This meant that bond prices were stale. That’s why investors were seeing ETF prices that were much lower than their NAVs.

How did ETFs help during this volatile time?

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. In March, when there was a liquidity issue, ETFs became the only tool of price discovery. For example, if an ETF was trading at a 5% discount to NAV, that meant the bond prices were stale and they were actually 5% higher than where the market really thinks they should trade. Based on recent commentary, there seems to be a lack of understanding of what discounts and premiums really mean. We think they are a feature of ETFs, not a flaw. Corporate bonds generally 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 be.

Following the March event, do you think institutional investors will adopt ETFs more broadly?

We do believe there will be a greater adoption of ETFs by institutional clients over the next few years. We may see larger institutional investors designing their investment strategies with ETFs, based on the liquidity that they provide. Institutional clients generally have a firm understanding of the role ETFs play in fixed income trading and in providing functional markets. They know ETFs are providing liquidity, an efficient means of risk transfer, and price discovery.

What assets classes do you think ETF investors will flock to in the near future?

One of the Fed’s programs is aimed at shoring up the bond market. They have stated they will buy ETFs tracking the bond market. Retail investors could try to benefit from those trades. Gold has been a traditional ‘safe-haven’ asset during times of volatility. For instance, flows into gold ETFs have been solid through the first quarter of the year. This may likely continue. Buy and hold investors for the most part have held onto their passive equity ETFs. In fact, flows into equity ETFs have been higher this year than last year, notwithstanding the volatile performance we have seen in equity markets thus far in 2020.

Are there longer-term implications for ETF growth and investor demand after this recent bout of volatility?

We think there is an opportunity on the corporate credit side for ETFs. The credit universe is moving quickly towards the use of ETFs to help with price discovery. There could also be an opportunity with ETFs in mortgage backed securities and municipals. In addition, there is potential for growth in ETFs that do not provide full transparency in their underlying portfolio on a daily basis. If these structures work, and the arbitrage mechanism functions as intended, there could be more traditional active managers launching active ETFs.

“It was the most turbulent single month in financial markets in our lifetimes. I think we should feel incredibly encouraged based on how the markets themselves behaved operationally in terms of continuity, in terms of transparency and how all the market participants worked together to keep things intact.”

Dragan Skoko
Investors should consider the investment objectives, risks, charges and expenses of a fund carefully before investing. To obtain a prospectus, or a summary prospectus, if available, that contains this and other information about a fund, contact your financial advisor or visit im.bnymellon.com/etf.

Please read the prospectus carefully before investing.

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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