Scarsdale Investment Group

The Unbeaten Path to Secure Investment Growth

Bond ETF's: What you don't know can hurt you

"However beautiful the strategy, you should occasionally look at the results."
-Winston Churchill

The financial services industry can create a beautiful product. When it first appears, it is held by the financial media as a revolution to which all sane investing people should flock. It is only after it has been in existence for a while and gained acceptance that the creators of the product begin to innovate. Generally speaking, these innovations are not in the interest of the individual investor. They benefit the creators themselves.

The Exchange Traded Fund (ETF) is one of those creations. It has a very innovative structure. The fund purchases securities which are traded by Authorized Participants (AP). The individual investor purchases shares of the ETF which owns the underlying securities. The individual investors do not own the underlying securities, only the shares in the ETF. We discussed this in an earlier article on bond Funds on our website.

The individual investor can trade the ETF shares any time during the day. For this benefit they pay a commission to trade in and out. If you are like so many individual investors that like to add to their investments on a monthly basis, this becomes very costly because you are paying commissions with every transaction.

As the market moves, the APs buy and sell to keep the securities in line with a market benchmark. This is a voluntary action. APs will only buy or sell if it is profitable for them. They are not responsible for keeping the value of the ETF shares in line with the value of the underlying securities.

One of the primary sales features of the ETF is the liquidity. The claim is because you can buy and sell any time during the day, the ETF is more liquid than the mutual fund. If you want to exit a mutual fund, you must accept the closing price on the day of sale. Theoretically, if you thought the market was behaving erratically, you could exit at any time of the day from the ETF. But let us take a look at reality.

On August 24, 2015, market trading holds were placed on eight S&P 500 stocks, which created a bottleneck for 42% of all US equity ETFs.[i] The price of the Vanguard Consumer Staples ETF (VDC) reportedly fell 32% while the underlying holdings just dropped 9%. The APs watched the carnage and did nothing. One market participant, Theodore Feight, saw prices fall through his stop-loss order - set to trigger at a 15% decline - only to kick in at a market drop of 30%. Most scary was that the Securities and Exchange Commission did not fully understand and could not explain exactly what caused this event. The ETFs that use the S&P 500 as a benchmark are the most liquid of ETFs. Imagine what might happen to less liquid bond ETFs if a similar situation arose.

Bond ETFs benchmark their performance against an index. Sometimes they arbitrarily change the index, or even create their *own* index to benchmark against. When a fund tracks an index, the fund contains the bonds that are in that index. Those indices may change their holdings, requiring changes to the portfolios of the ETFs. This may result in front running, as those with knowledge of the changes buy bonds, mark them up and then resell them to the funds.

We recently took a close look at IShares New York Muni Bond ETF. The net assets of this ETF, as of July 8, 2016, were valued at about $236 million. As of that date, it had 431 holdings. However, many of those holdings were concentrated in positions of certain states' largest issuers. This might be expected in a fund concentrated in holdings from one state, but you might pause to consider that you are not getting the diversification you might expect from a fund.

The 30-day SEC yield for the ETF in June 2016 was 1.06% with an average duration of 4.56 years. The distribution yield was 2.36%, which means that the investor is receiving a proportion of principal along with each distribution.

The ETF was formed on October 4, 2007. If it bought new issue bonds at that time, then many of those bonds will mature, or begin to be called in 2017 if they had ten-year call protection. Call risk is high because the majority of the bonds have 5% coupons and current interest rates are at all time lows.

Reinvestment risk for the funds is also the biggest risk for you, the individual investor. With five-year interest rates skirting 1% or less, what will happen to you if interest rates remain the same and matured or called principal in the funds have to be reinvested at the current low yields?

In anticipation of refunding, the largest position in the ETF is the money market account, which in today's environment earns very little interest. In addition you have to pay an annual fee of .25% for owning the ETF. While this is considered a very low fee, it still occurs annually, which can add up if you own a fund for a long time. In summary, here are the downsides of a Bond ETF.

1. Trading is costly because commissions are paid with each transaction.
2. Liquidity is a mirage because there is no mechanism set to buy your shares if you decide to sell in difficult times.
3. Reinvestment risk is significant as high coupon bonds purchased years ago are called and replaced by lower yielding bonds.
4. Like any fund, there is an ongoing annual fee.
5. Credit quality and diversification may not be what you would choose.

In contrast, individual bonds come due. The individual bonds need not be sold. The cash flow stays the same for the individual bonds. There are no ongoing fees. You select the bonds. You control the credit quality. You can determine your cash flow.

---

[i] Editorials. "ETFs liquidity contested." InvestmentNews, July 11, 2016. P. 8.