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Solving The Bond ETF Discount Problem

Bond exchange-traded funds can be tricky to trade at times. Although these securities trade within a reasonable range of their net-asset value (NAV) most days, there are those periods when the ETF market just doesn't want to cooperate. Last week was a good example. Here are two ways to solve this problem.

I have been writing about pricing issues with bond [ETFs](#) for quite some time, first in [The ETF Book](#) and later in articles such as [Why We Don't Buy Corporate Bond ETFs](#). Most of the time, there's nothing wrong with bond ETFs or how they're priced, as long as you're not in a big hurry to trade during a big selloff in the market.

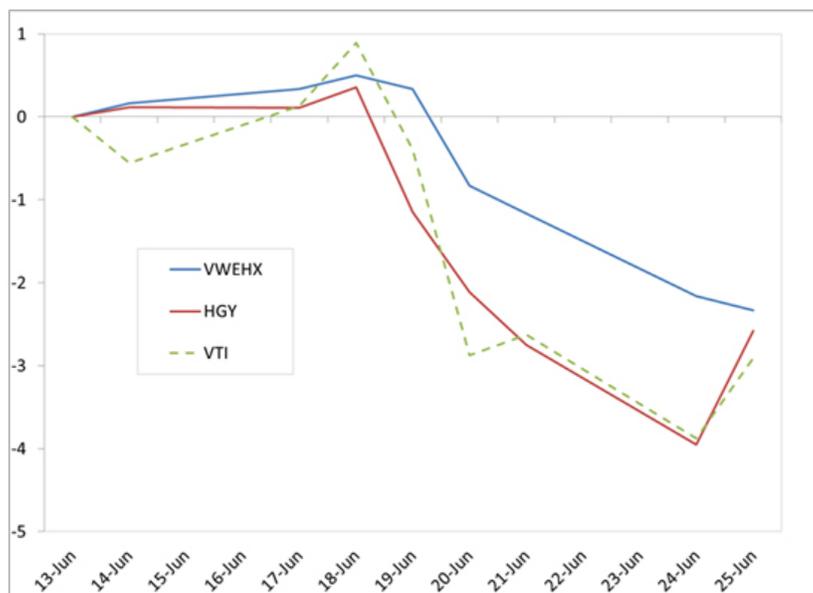
[Bonds](#) are traded over-the-counter while bond ETFs trade on a stock exchange. There is usually enough liquidity in the underlying bond market for bond ETF prices to be held reasonably close to their NAVs through an arbitrage mechanism. When an ETF's price is higher than its NAV, authorized participants (APs) sell ETF shares and buy underlying bonds in the over-the-counter market, thereby garnering a risk-free return. The opposite trade occurs when bond ETFs trade at a discount to their underlying securities. See [The ETF Book](#) for details on how this process keeps the ETF market efficient.

Problems occur in the ETF arbitrage mechanism if liquidity in a bond market begins to deteriorate. The reduced liquidity creates a larger risk for APs who are tasked with keeping the ETF market flowing. This, in turn, increases the spread between the ETF price and NAV. ETF prices trend back toward NAV as the markets stabilize and liquidity comes back.

Last week was a good example of this phenomenon. Liquidity in some bond markets began to erode as "riskier" assets were sold across all markets. This created a larger spread between bond ETFs holding these securities and their underlying bond values.

Figure 1 illustrates the loss in three investments from June 14 to June 25. It highlights the relative performance using the closing price of three investments: iShares iBoxx \$ High Yield Corporate Bond Fund ([HYG](#)), Vanguard Corporate High Yield Bond fund ([VWEHX](#)), and Vanguard Total Stock Market ETF ([VTI](#)).

Figure 1: Performance of three funds from June 14 to June 25 (closing prices)



Source: Vanguard, iShares

HYG and VWEHX are fairly similar investments. They're both broadly diversified high yield corporate bond funds, although Vanguard avoids bonds that are below a B- rating. On normal volatility days, the closing price of HYG tracks fairly closely to the NAV of VWEHX, a traditional mutual fund that only trades once per day at its NAV. However, on severe down days in the markets (known as "risk-off" days), the price of HYG can trade well below VWEHX. The parity picks up again when the risk-off trade ends.

That's what occurred from June 19 to June 24. The markets went risk-off on June 19 and everything from municipal bond ETFs to corporate bond ETFs sold off. June 25 was a recovery day and June 26 finished off the recovery (not shown in the figure). Bonds ETFs are now back to near their NAV prices.

This brings us to the two ways to solve the bond ETF discount problem:

1. Don't buy bond ETFs. Stick with traditional open-ended funds that trade at NAV at the end of the day. You won't have to worry about ETF price swings due to liquidity issues and other matters.
2. If you do decide to invest in bond ETFs, don't trade them during volatile days. Wait until prices recover before putting in your order. In the words of someone much wiser than me, [this too shall pass](#).

I'm not against bond ETFs of any type. They're fine investment as long as you know their quirks and know how to trade them. Once you understand the marketplace and all its blemishes, then you won't be surprised by pricing issues that can occur on occasion, and you won't mind waiting it out.

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