Corporate Bond ETFs And Self-Fulfilling Prophecies

Lou Gehrig famously called himself "the luckiest man on the face of the Earth," but I respectfully disagree with the Iron Horse. The luckiest people have to be those corporate executives who stock pops higher because it just moved into the S&P 500 or because of some artifact in the annual "Russell Hustle" surrounding the reconstitution of those indices and who stock options soar as a result. If your stock benefited because it grew into that slot, fine. But if it moved up in the ranks because others were taken out and shot, well, you are just lucky.

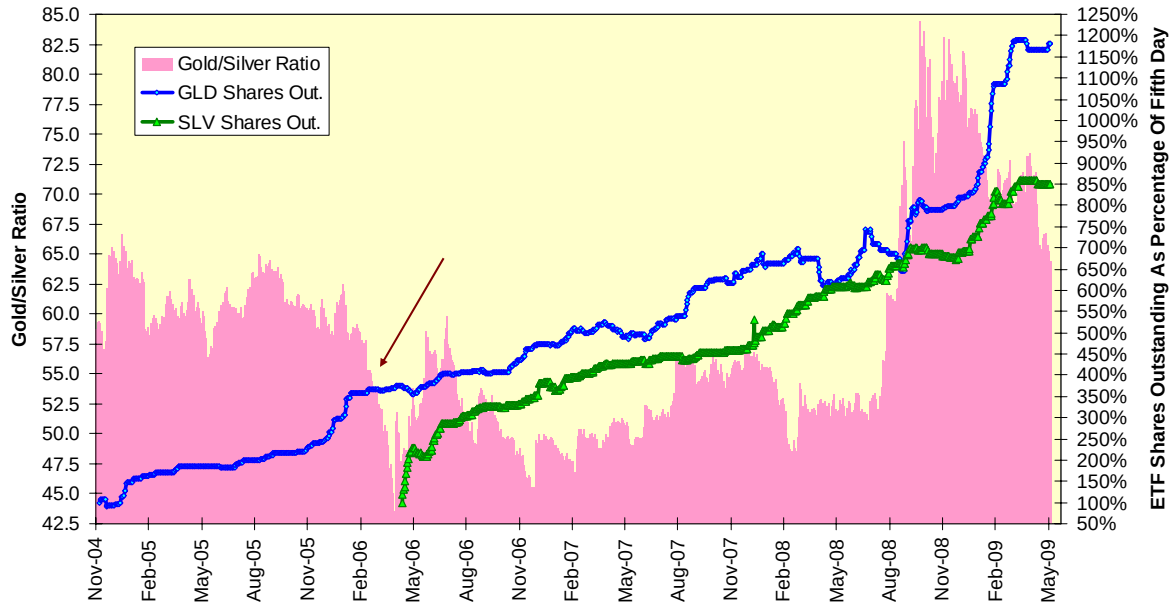
The ETF Effect

This inclusion effect worked with the introduction of commodity exchange-traded funds such as the SPDR Gold Trust in November 2004. The ETF holds gold bullion to back its shares and with more than 1,100 metric tons in the vaults, it now ranks in the top ten holders of bullion in the world.

As imitation is both the sincerest form of flattery and the most common business model on Wall Street, ETF creators began to plan for other ETFs backed by physical commodities. None were as neat as gold, and some such as the United States Oil Fund were both badly designed and ultimately poor investments despite their popularity as predicted here in April 2006.

The proposal for a silver ETF ran into a buzz-saw of protest from the Silver Users Association, which pointed out that while gold is mined to be reburied in vaults, silver has numerous industrial uses. Anticipation of the ETF's ultimate approval to launch in April 2006 led to a hoarding effect in silver and a large jump in its price relative to gold. If we map the gold/silver ratio against the growth in the number of shares outstanding for the GLD and SLV ETFs expressed as a percentage of its shares outstanding after five days of trading, we see a large anticipatory drop in the gold/silver ratio, highlighted with an arrow. Just as indexation affects stock prices, ETFs can affect commodity prices.

Silver Rallied Sharply Before SLV Introduction



Corporate Bond ETFs

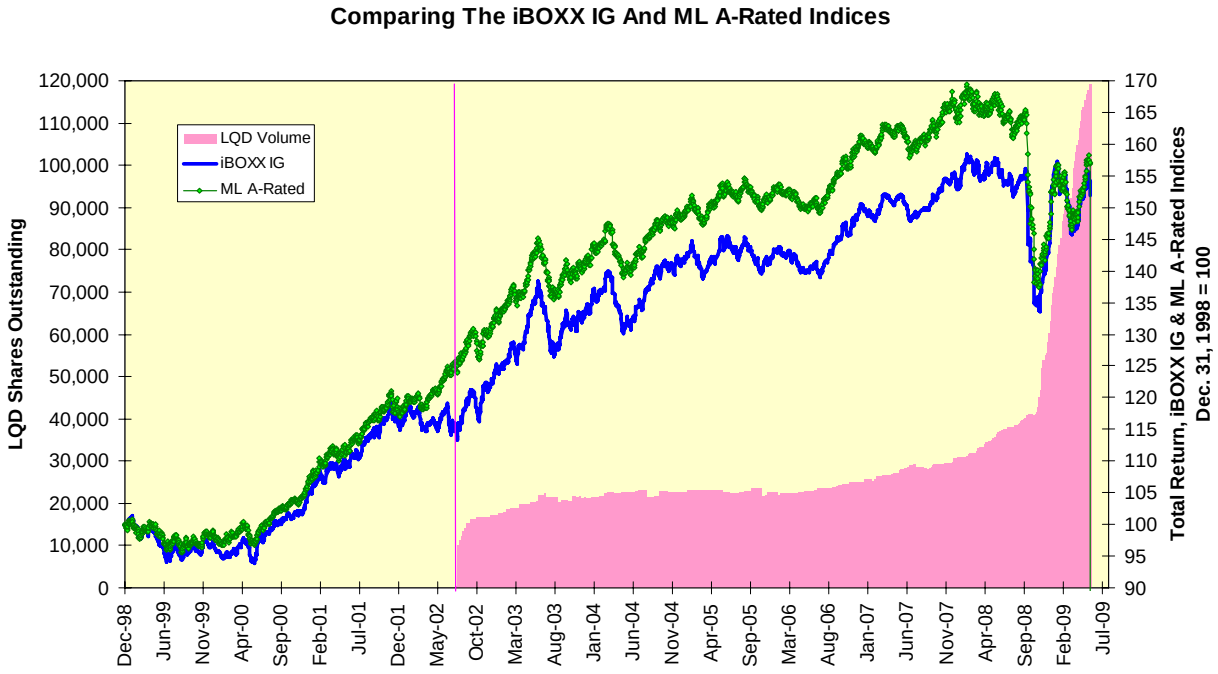
The popularity of bond ETFs such as the LQD and HYG based on the iBOXX investment-grade and high-yield indices, respectively, prompted me to consider whether a related phenomenon might be afoot in these markets. The number of bonds in each of the ETFs is relatively small, 104 and 51 for the LQD and HYG, respectively, and it would be relatively easy to push their prices in a buying stampede. The largest issue in the HYG, for example, is the Dollar General 10.625% callable and due July 15, 2015, and it has only $1.175 billion outstanding. The largest issue in the LQD, a Pepsico 7.9% due November 1, 2018, has $2 billion outstanding.

Now let's ask the question whether the flow of funds into the LQD and HYG have changed the relationship between the iBOXX indices and similar Merrill Lynch indices for A-rated and high-yield corporate bonds, all series on a total

return basis. This can be determined by running a regression between the Merrill Lynch indices against the independent variables of the iBOXX indices and ETF shares outstanding for the periods before and after the introduction of the ETFs.

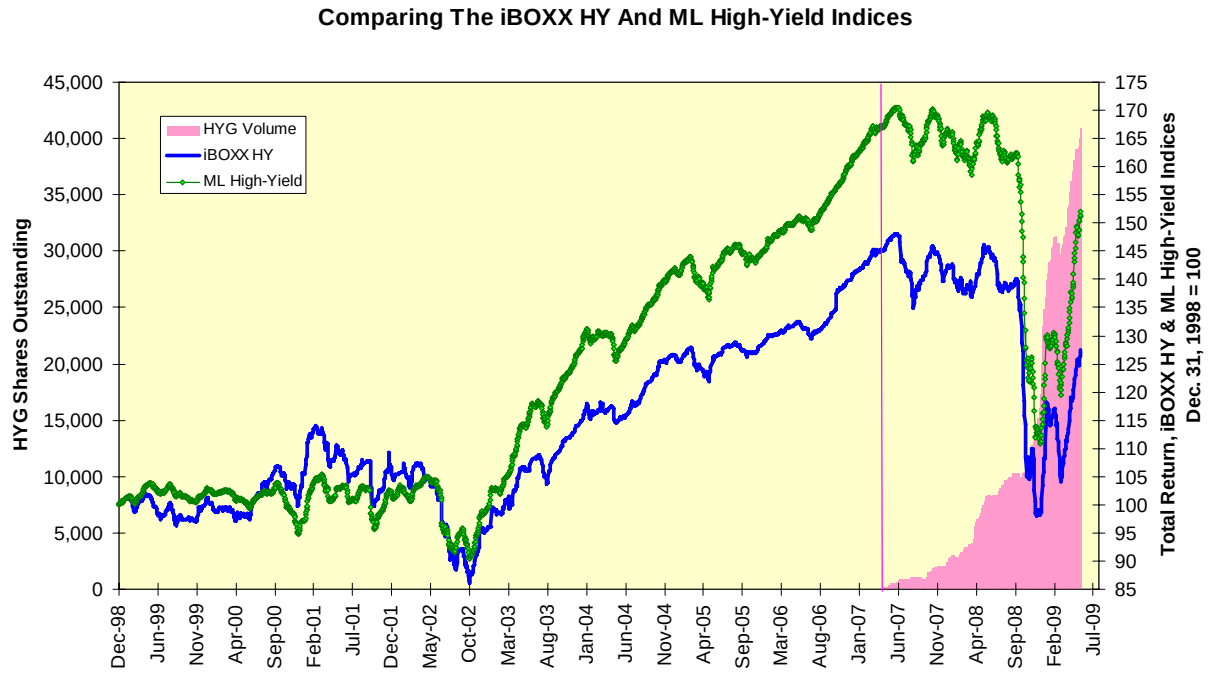
The LQD

The number of shares outstanding for the LQD has almost tripled between October 2008 and today, and we certainly can see how closely linked the iBOXX and Merrill Lynch index returns have become since mid-September 2008. However, the two indices were linked closely before the July 2002 introduction of the LQD. As a result, the two regressions were similar with 85.9% confidence and we can reject the notion the flow of funds into the LQD changed the iBOXX investment-grade index' relationship with the Merrill Lynch A-rated index.



The HYG

The answer is different for the high-yield case. The number of shares outstanding for the HYG has exploded higher since its April 2007 introduction in general and has quadrupled since last October. The longstanding weak relationship between the iBOXX and Merrill Lynch high-yield indices has tightened both visibly and statistically since last fall, and the two regressions are different at virtual 100% confidence. This is not the same as proving the flow of funds into the HYG has changed the underlying relationship between the two high-yield indices, but it is consistent therewith.



We have fallen into a trap where every move lasting more than two days is classified as a bubble; this is understandable after the damage caused by the real bubbles in our experience. If we define a bubble as self-fulfilling behavior, buying something because its price has gone up which in turn attracts more buying, then the results above should at least get our attention in the high-yield case.

The spreads on these bonds were enormously attractive last fall and this winter; I wrote about them in the context of high-yield convertibles in November 2008 and for corporate bonds in general in February. But with long-term Treasury rates starting to rise and with high-yield option-adjusted spreads falling more than 1,000 basis points since December 2008, the easy money has been made in high-yield bonds. An allocation of 5-10% of your portfolio, preferably in a tax-deferred account, should be sufficient for now.