Corporate Bond ETFs Now Wagging Index Dog

Any Corporate Bond Manager Who Shadows the Indices Is Useless

One of the ironies of our connected age is the ability of everyone to express an opinion has led to a lower diversity of thought: How many times have you encountered the same story in twenty different blogs with no one certain as to the veracity of the original information?

Financial markets reached this point of circularity with indexation a long time ago. Burton Malkiel's original research back in the early 1970s highlighted how difficult it was for active managers to beat a passive index as the latter could piggyback on the former's research and avoid many of the costs associated with investing. Once index funds became popular and spawned such Hollywood-camp proselytizing fare as *Sinners in the Hands of an Angry Bogle*, the tide turned in two interesting ways. First, life began to imitate art as active fund managers became closet indexers. Second, the internal time-bomb of capitalization-weighted indexation, the absolute imperative to buy increasing quantities of ever-more overpriced stocks and sell greater quantities of ever-more underpriced stocks, blew up at the peak of the dotcom bubble and, much like Humpty Dumpty in this most mixed of all metaphors, has yet to be put back together again.

Corporate Bond ETFs

Let's return to June 2010's ETFs Change Corporate Bond Behavior. I will repeat verbatim:

> ETFs have existed since July 2002 and April 2007 for the iBOXX investment-grade and high-yield bond indices, respectively. These ETFs trade under the LQD and HYG tickers. If we compare the total returns for these two indices against those for the Merrill Lynch A-rated and High-Yield II indices going back to the December 1998 inception of the iBOXX indices, we can determine to what extent, if any, the addition of the ETFs changed the behavior of the underlying indices.
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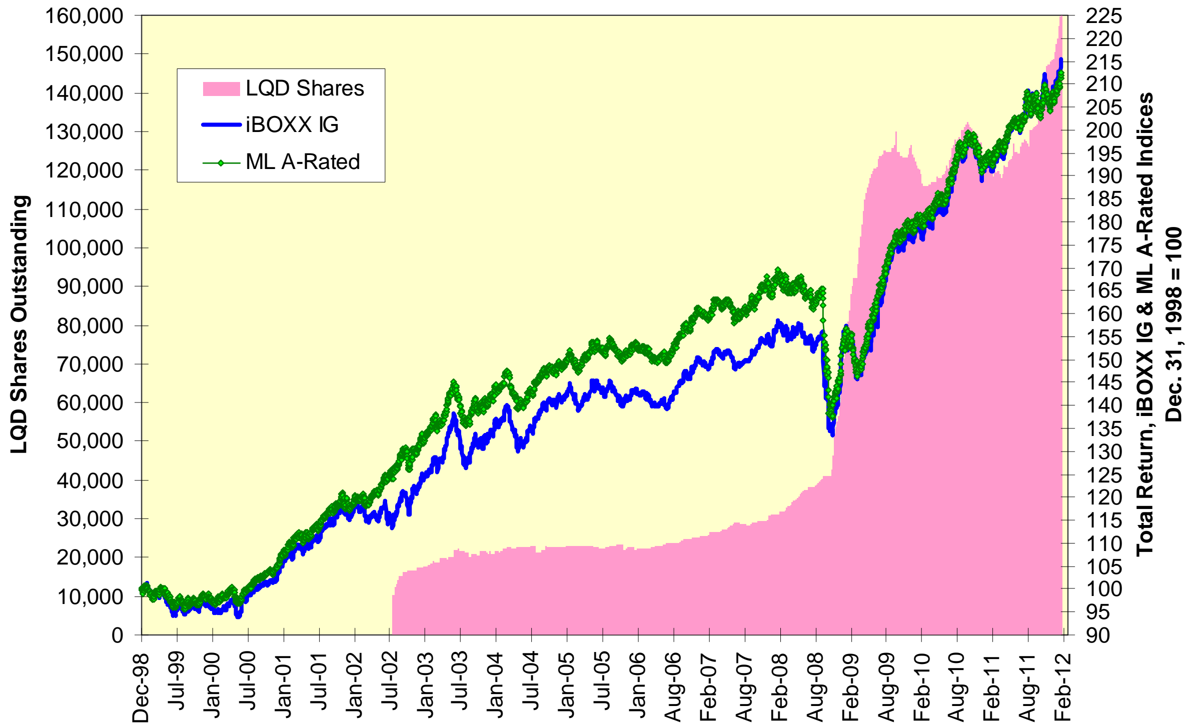
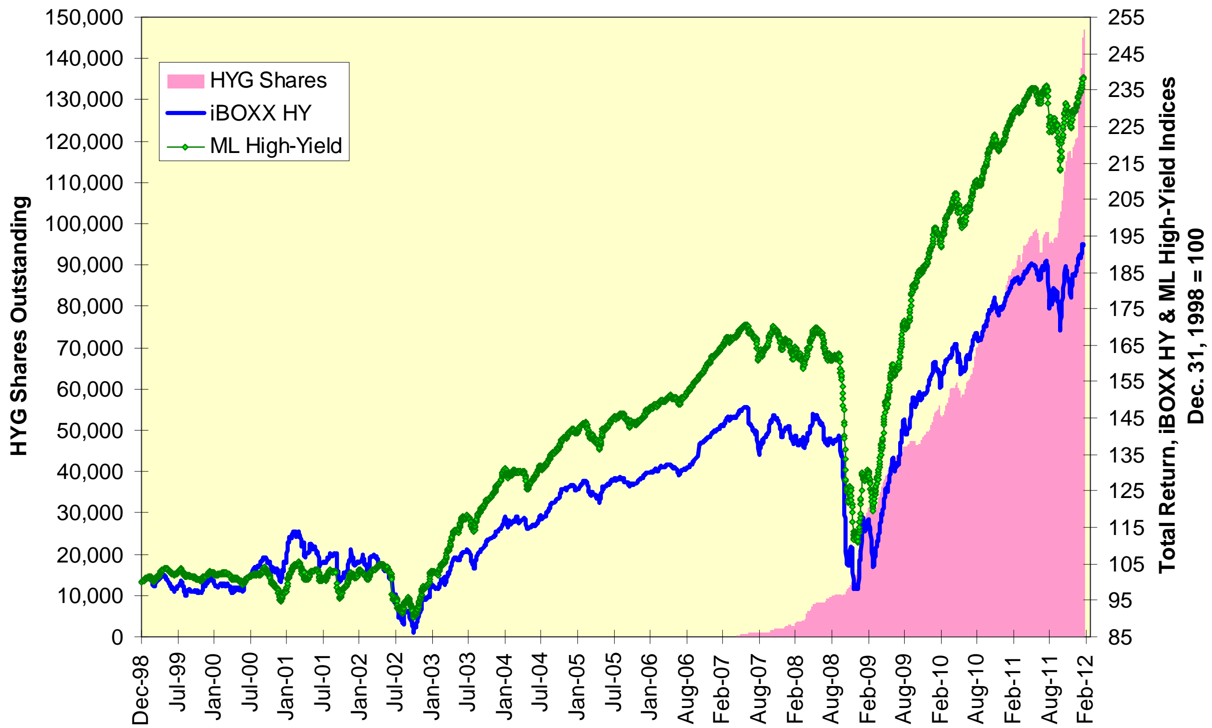
> The test is simple: We can regress the total returns for the Merrill Lynch indices against those of the iBOXX indices both before and after the introduction of the ETFs. If the indices converge so that their statistical fits are equivalent at a high degree of confidence, we can say the ETFs changed behavior.

That point has been achieved: The behavior of the iBOXX indices has been jammed into conformance with the broader Bank of America/Merrill Lynch corporate bond by the popularity of the LQD and HYG ETFs. This is very noticeable visually on the chart below for the LQD; it exists statistically for the HYG but is less visible given the vertical difference in return paths.





The key is the ascent in the number of ETF units outstanding. As these ETFs have become larger and larger, they have had to include more issues and therefore have broadened out to look like the major indices. In May 2009, the LQD and HYG included 104 and 51 bonds, respectively; those numbers today are 746 and 475.

The capture, therefore, is complete. Just as indexation overwhelmed active management in stocks before its problems came to the fore, it will overwhelm corporate bonds until its problems arrive. I cannot imagine what will happen if and when we hit a bear market in corporate bonds and these ETFs try to liquidate positions in the secondary market. You might be able to sell tickets on some pay-per-view channel to watch that unfold.