Fear And Greed In Corporate Bond ETFs

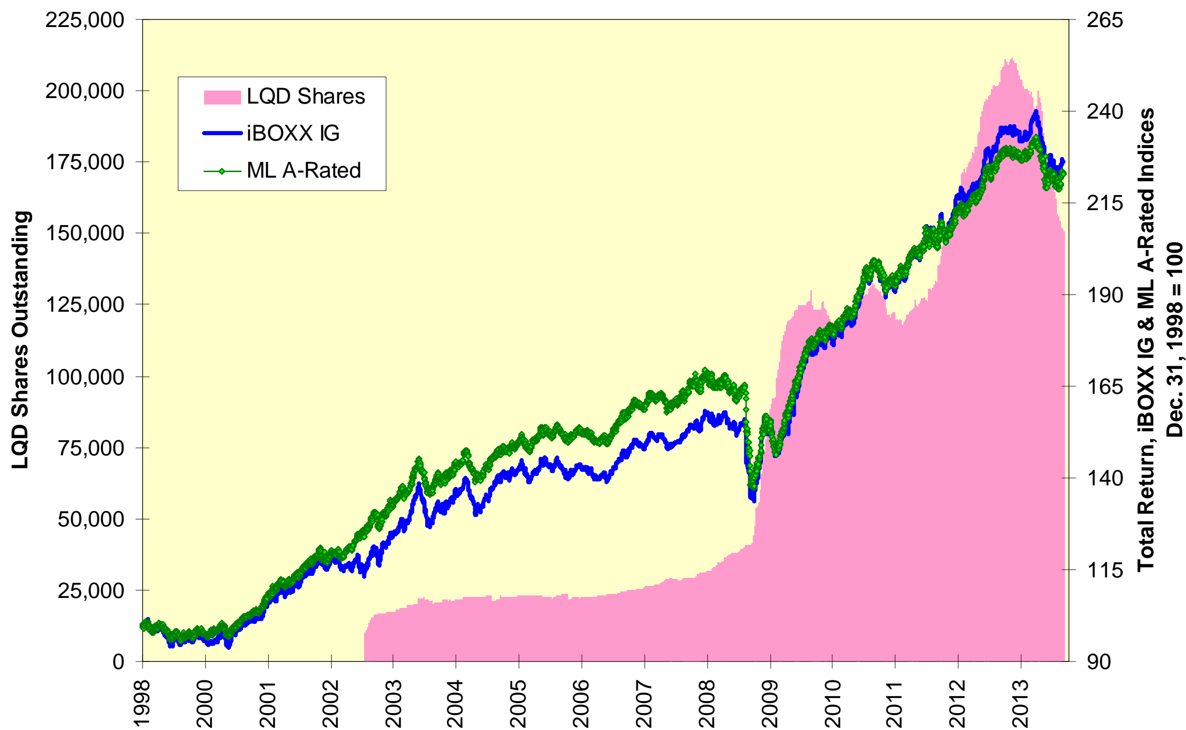
I once had an airplane conversation with a grad student who thought she could avoid her psychology course project by asking me what I did and offering, "I guess you don't have much contact with psychology in trading, do you?"

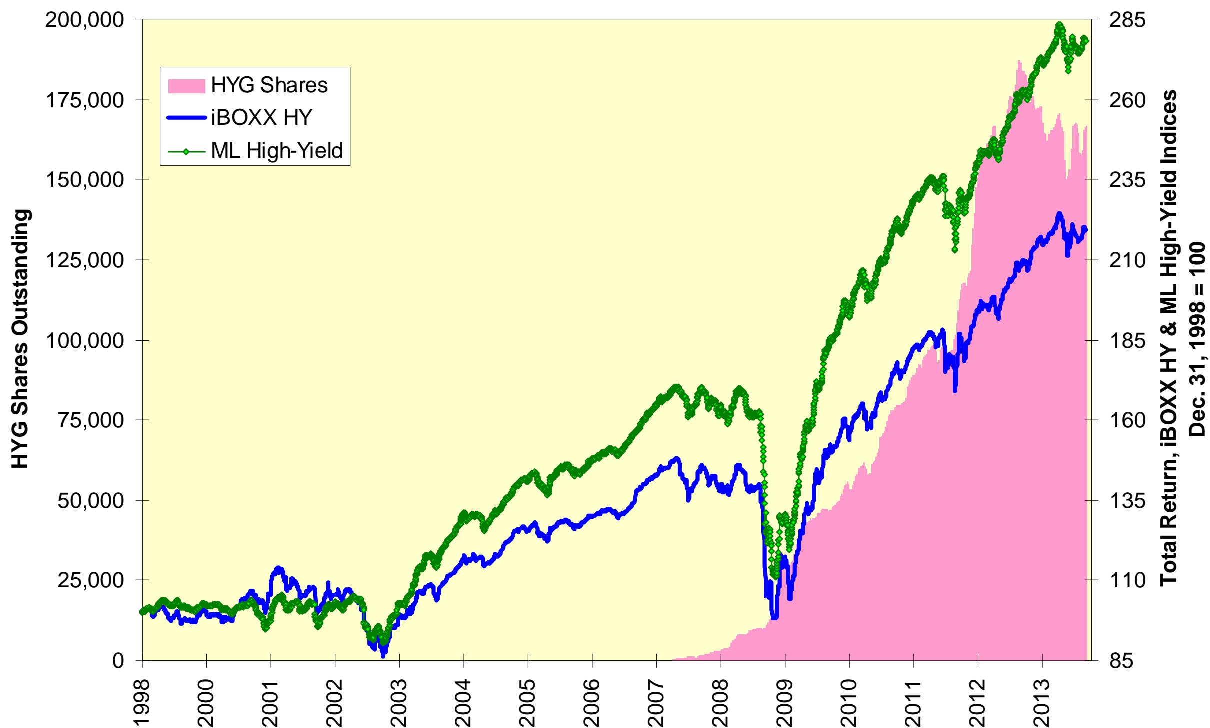
What makes behavioral finance, regarded by some as a pseudo-science or, in the characterization of the late Nobel laureate Merton Miller, "a series of anecdotes in search of a theory" interesting is how two sets of investors can react so very differently to the same set of external stimuli. Let's take the case of corporate bond ETFs, a topic last discussed here in February 2012. Is it possible for risk-averse investors to flee the allegedly safer investment-grade index at the exact same time risk-seeking investors are fleeing into the allegedly dodgier high-yield index? If so, they would be duplicating what investors in municipal bonds have done, as noted in January 2011.

ETF Shares Outstanding

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. These indices are narrower than the Bank of America/Merrill Lynch A-rated and High-Yield II indices, and their return paths displayed on the charts below can and do diverge very significantly therefrom, especially in the high-yield case. The investment-grade index' returns have converged to a greater degree as more and more issues have been added to the LQD.

Shares outstanding for the LQD and HYG peaked in December and September 2012, respectively, and have retreated almost 29% and 11%, respectively, since then. But that does not tell the whole story; the shares outstanding for the LQD have continued to decline steadily in 2013 through all of the corporate bond market's ups and downs. Shares outstanding for the HYG have increased about 0.30% since the start of the policy confusion era in May and have increased more than 10.6% since late July despite negative performance.





Different Risk Preferences
I noted back in March how new highs in the stock market were being accompanied by new lows in negative short-term real interest rates. Investors were forming their own barbell approach; some were seeking refuge from negative returns on cash by moving into pricy, option-embedded assets such as stocks and convertible bonds and some were seeking refuge from their own fears by paying the implied insurance costs of negative real rates. Both sides were getting exactly what they wanted from the market.

This is not at all irrational. I used to pose a question to students whether people could be both borrowers and lenders simultaneously. A large number missed the obvious cases, such as having a money-market account as a lender and a mortgage as a borrower. Both individual and markets have these preference segments. As an aside, this is why having perfect forward information about a firm's earnings and about the interest rate environment will not get you to the right "fundamental" answer on a stock's price: You never will be able to assess the net risk preferences of the investor at the margin.