ETFs Change Corporate Bond Behavior

Do you remember some distant elementary school science class where you learned, as if you did not know, the differences between solids, liquids and gases? Liquids have a fixed volume and conform to the shape of their container; think about this the next time you are doing a set of 12-ounce curls. Gases, just like financial markets, have no fixed volume, sometime lose their liquidity and are filled with people who just cannot contain themselves.

This brings us to our subject at hand, the role corporate bond ETFs play in shaping this relatively illiquid market. Indexation of any kind changes the behavior of investment managers who inevitably get their performance measured against an index. What is worse is how even the most arbitrarily assembled index, one which might be important only to its creator and to anyone who has a vested interest in volume therefor, suddenly is elevated to exalted status by participants at all levels. Even the broadest and most senior indices change behavior; you will find individual investors fretting they are underperforming the S&P 500 and not have an inkling as to why they should care.

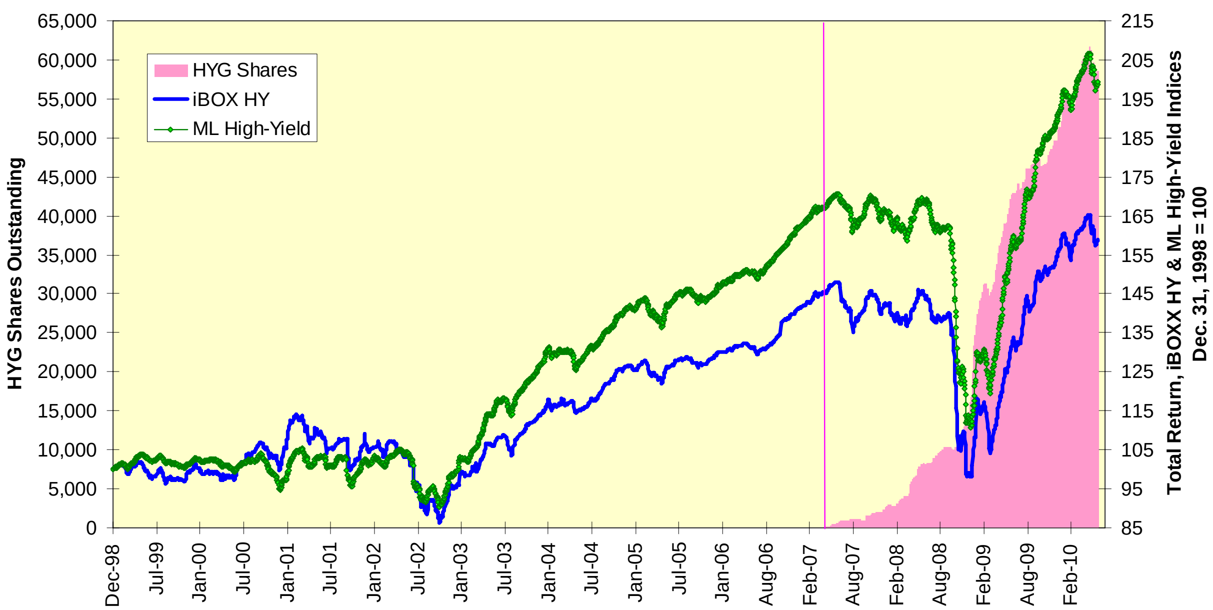
ETFs have existed since July 2002 and April 2007 for the iBOXX investment-grade and high-yield bond indices, respectively. These ETFs trade under the LQD and HYG tickers. If we compare the total returns for these two indices against those for the Merrill Lynch A-rated and High-Yield II indices going 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.

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.

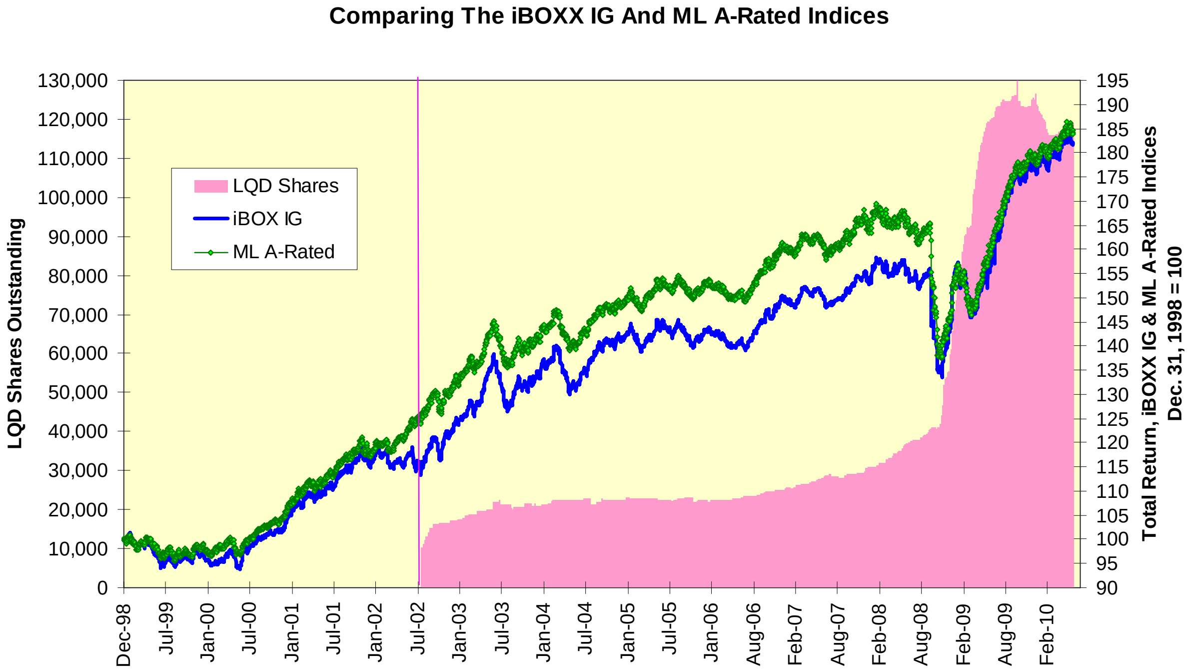
Smell a slam-dunk coming? You should.

Before And After
First let's take a look at the high-yield portfolios. The number of shares outstanding surged higher after the financial panic in the fall of 2008 and took the Merrill index along for the ride. The iBOXX index trailed. Statistically, the two periods, before and after the introduction of the HYG ETF are different at 99% confidence.

Comparing The iBOXX HY And ML High-Yield Indices



Now let's take a look at the investment-grade portfolios. Once again, flows followed performance as investors followed their most sacred rule, do what everyone else is doing and call it a strategy. But note how closely the iBOXX and Merrill indices tracked one another before and after the introduction of the LQD. Here the two periods are equal at near-100% confidence.



The conclusion is inescapable: The presence of a viable investment-grade ETF forced bond portfolio managers to track the iBOXX index as closely as possible. The higher liquidity of these bonds allowed them to assemble similar portfolios, either naturally or synthetically with credit default swaps (yes, those things are useful in the right hands). High-yield managers would have forced conformance if this were really possible with these less liquid bonds, some of which have a nasty habit of defaulting. Junk does that, you know.

I am convinced a swindler who created a bogus index and a liquid ETF could, in a reprise of The Emperor's New Clothes, force highly paid managers to chase it. Solid citizens who are full of gas; I understood it in grade school.