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Active Funds Should Be Thanking ETFs

BI ETFs, Global Dashboard



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Active Mutual Funds May Gain Most From Bond ETFs' Red Flags

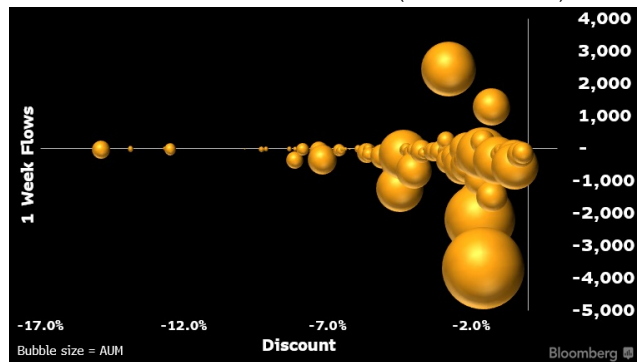
(Bloomberg Intelligence) -- The Federal Reserve's inclusion of exchange-traded funds in its liquidity injection confirms that the central bank monitors the fixed-income ETF market -- to the benefit of active mutual funds. ETFs' dislocations from net asset values highlighted real-time stress. The Fed move will bolster active funds before their NAVs adjust to the poorer conditions. (03/25/20)

1. Dislocations May Have Bailed Out Active Funds

ETFs' dislocations from net asset values may have sped up the Fed's decision to buy corporate debt, we believe. While Fed purchases of fixed-income ETFs will likely directly benefit mostly iShares and Vanguard, the liquidity injection overall will be most helpful to active mutual funds, which have largely avoided declines in net asset values due to delayed pricing or tapping of lines of credit to pay redemptions.

Almost all fixed-income ETFs traded at discounts to NAVs during the sell-off, but not due to a defect in the ETF structure, in our view. Rather, ETFs stepped into the role of price-discovery mechanisms and signaled potential red flags, especially for municipals and investment-grade corporate bonds. (03/25/20)

Fixed-Income ETF Discounts (as of March 20)



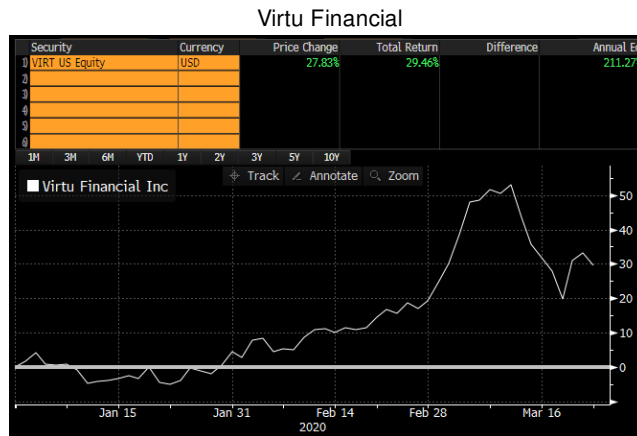
Source: Bloomberg Intelligence

2. Market Makers to Tighten Spreads, Discounts

The Fed's liquidity injection will benefit market makers by helping to remove pricing uncertainty, likely leading to tighter ETF trading spreads. Market makers also should be able to arbitrage more efficiently and close many of the discounts in fixed-income ETFs. At the same time, less-volatile trading and narrower spreads could hurt the revenue stream of market makers, which have benefited from current turmoil. Virtu Financial, one of two publicly traded market makers, is up 28% this year. (03/25/20)

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Source: Bloomberg Intelligence

Active Mutual Funds' ETF Addiction Big Reason for Dislocations

Contributing Analysts Morgan Barna (Strategy)

Bond exchange-traded funds have traded at discounts to their net asset values for the past week partly because active mutual funds are seeing outflows. ETFs are used by many active bond funds to provide liquidity and maintain broad market exposure, while being the first securities sold to cash out redeeming investors. (03/17/20)

3. Dislocations Compounded by Active Funds

Many bond ETFs may be experiencing heightened dislocations and outflows due to selling by active mutual funds, which have increased their use of ETFs as "liquidity sleeves" over the years. The mutual funds sell the highly liquid ETFs first to meet redemptions, which have risen as the sell-off has deepened. Thus, the passive ETFs have become more stressed due to active mutual funds' outflows. The iShares iBoxx High Yield Corporate Bond ETF (HYG), for example, has 19% of its shares held by active mutual funds. For the iShares 20+ Year Treasury Bond ETF (TLT), it's 13%. Many of these ETFs have traded away from their net asset values.

NAVs tend to lag significantly, so the dislocations are likely more a measure of the lack of liquidity in the underlying bond market, which is why the ETFs' volume is increasing. (03/17/20)

Mutual Funds are Huge Owners of Bond ETFs

Ticker	30 Day Avg. Volume \$M	1Month Flows (\$M)	5 Day Avg. Discount to NAV	Mutual Fund Ownership
HYG	\$45.5	-\$3,193	-0.04%	19%
TLT	\$20.5	-\$553	-2.68%	13%
LQD	\$19.5	-\$4,293	-2.26%	6%
JNK	\$12.7	-\$2,492	-0.39%	25%
BKLN	\$11.2	-\$1,486	-2.01%	27%
GOVT	\$10.8	-\$1,155	-0.24%	2%
AGG	\$9.2	-\$2,007	-1.99%	10%
IEF	\$8.3	\$1,409.2	-0.70%	4%
BND	\$7.5	\$252.9	-2.32%	10%

Source: Bloomberg Intelligence

4. HYG's Mutual Fund Holders See Outflows

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The top 10 mutual fund holders of HYG have been hit with outflows during the high-yield sell-off. These mutual

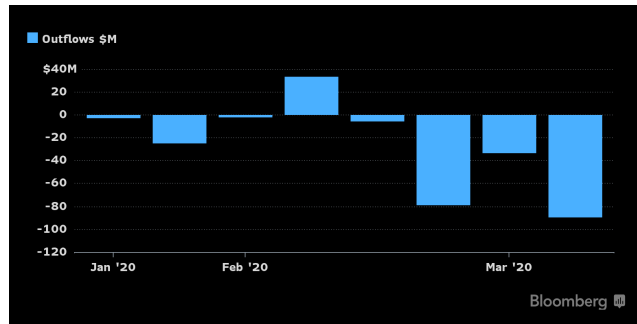
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funds likely would sell HYG before offloading portfolio bonds, given price discovery is much more difficult for underlying issues, and discounts may be even steeper. Mutual fund outflows will continue to put stress on HYG, yet the funds are willing to take the ETF's price rather than try to sell bonds in this market and get even less. The heightened dollar volume of HYG, which has traded \$4-\$6 billion a day, is evidence that big investors such as active mutual funds are using it.

The VanEck Vectors High Yield Municipal Index ETF (HYD), is a more extreme case, trading at a 19% discount. It's also owned by several active funds. (03/17/20)

Flows for HYG's Mutual Fund Holders Turn Negative



5. Liquidity Sleeves Widely Used by Active Funds

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Mutual funds that hold some shares of HYG have \$102 billion in combined assets -- almost a third of the total for high-yield-focused mutual funds. The junk-bond ETF category only has about \$50 billion. This shows that most retail investors use mutual funds for high-yield investing, while ETFs such as HYG are favored for their liquidity rather than as long-term holdings, more like a futures contract. Large bond funds from BlackRock, USAA and Franklin use HYG as a liquidity sleeve, while others will hold bigger stakes in the ETF as part of a tactical trading strategy. This is common for most highly liquid bond ETFs. (03/17/20)

Mutual Fund Owners of HYG Use It Instead of Cash

Portfolio Name	Ticker	% Portfolio	% Out	Mkt Val
1. BlackRock High Yield Bond Portfolio	BHYIX US	1.279	1.72	228.63MLN
2. TD Canadian Core Plus Bond Fund	TDCANCO ...	0.844	1.19	157.69MLN
3. Navigator Tactical Fixed Income Fund	NTBAX US	2.978	1.18	156.3MLN
4. BTS Tactical Fixed Income Fund	BTFAX US	39.662	1.15	152.74MLN
5. AFP Integra F2	AFPINT2 PE	1.284	1.13	150.44MLN
6. Toews Tactical Income Fund	TTHYX US	24.785	0.91	120.56MLN
7. RBC Global Corporate Bond Fund	RBCGLCBD ...	1.475	0.89	118.18MLN
8. Mediolanum Best Brands Global High Yield	CGHYHLA ID	0.000	0.85	113.48MLN
9. AFP Integra F1	AFPINT1 PE	3.496	0.50	65.82MLN
10. USAA High Income Fund	USHYX US	3.311	0.46	61.55MLN
11. TD Global Income Fund	TDBGIAB CN	2.729	0.45	59.51MLN
12. Franklin High Income Fund/United States	FHADX US	1.515	0.35	46.22MLN
13. TIAA-CREF High Yield Fund	TTHYX US	1.130	0.32	43.09MLN
14. RBC Global High Yield Bond Fund	RBCAGHYI ...	1.832	0.32	42.03MLN
15. Virtus Newfleet Multi-Sector Short Term Bond F.	NARAX US	0.751	0.31	41.76MLN
16. TD Global Unconstrained Bond Fund	TDBGUAB CN	2.303	0.28	37.53MLN
17. MFS High Income Fund	MHITX US	2.461	0.27	36.15MLN
18. SCOTIA PRIVATE HIGH YIELD BOND POOL		36.868	0.25	32.76MLN

Source: Bloomberg Intelligence

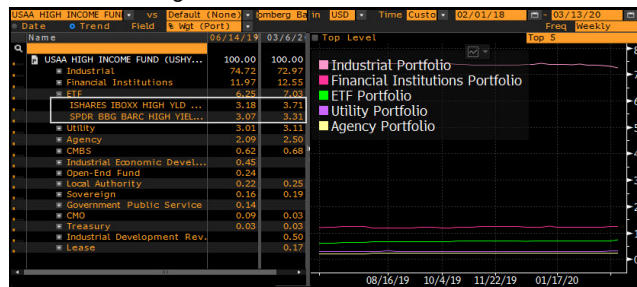
6. USAA High-Yield Fund Holds HYG and JNK

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One active bond fund that uses ETFs is the USAA High Income Fund (USHYX), which has 3.2% of its portfolio allocated to HYG and 3.1% to JNK. While the fund's managers could be criticized for owning the competition, the practice enables the fund to maintain broad beta exposure to the high-yield bond market in a very liquid structure. This eliminates cash drag and allows the fund to cash out redeeming investors without disturbing any of the bond picks in the portfolio. In a rough market, the ETFs give the active fund the ability to sell something liquid vs. its illiquid underlying holdings. (03/17/20)

USAA High Yield Fund Uses Both HYG and JNK



Source: Bloomberg Intelligence

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