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Bond ETF buyers, beware

Popular investment hits investors with hidden risks

By Sam Mamudi, MarketWatch

NEW YORK (MarketWatch) -- Investors seeking safety have been pouring cash into bond funds -- but when it comes to exchange-traded funds they run the risk of limiting gains or magnifying losses.

ETFs are seen as liquid, transparent investment and trading vehicles, but with bond offerings this typically isn't the case. That's because liquidity issues make bonds a poor fit for ETFs, so an ETF's share price, dictated by market demand, is often different from its net asset value. As a result, investors often aren't buying and selling fund shares at levels close to their true value.

The problem is "an inherent flaw in non-Treasury bond ETFs," said Matt Hougan, managing director of ETF analytics for Index Publications. "The corporate bond market is notoriously illiquid [and yet ETFs require liquidity] -- it's a square peg in a round hole."

The difference between the price and the value of the bond ETF shares is increasingly important after a year which saw the funds rake in assets and ahead of what many expect will be a tough bond market as interest rates start to rise. The likelihood is that many investors bought into the ETFs at a premium and could beat a retreat as the bond market turns, at which point they'll be selling below NAV.

"If you buy the shares at a premium, you have to be careful you don't sell it at a discount," said David Levy, portfolio manager at Austin, Texas-based Kenjol Capital Management.

No bargains

Take a look at SPDR Barclays Capital High Yield Bond ETF (NYSE:JNK) to see how bond ETF share prices can move differently to their value.

At Friday's close, the SPDR shares traded at almost a 1% premium to net asset value. Each share based on the ETF's holdings was worth $38.28; the shares closed the day at $38.65. By Tuesday afternoon, the fund's shares traded at a slight discount to NAV. What's more, by mid-afternoon on Tuesday, the fund's share price had fallen about 1% from the open while its NAV, the measure of the value of its assets, was up 0.6%.

"Investors aren't making the investment they thought they were," Levy said. "They want the underlying securities, not the buy-sell value of the market."

Levy's firm avoids bond ETFs, choosing instead bond mutual funds, where shares are always priced at NAV.

The choppy markets and growing popularity of bond ETFs have highlighted the dislocation between the price and the value of their shares.

Bond ETFs saw almost $60 billion in net inflows in 2009, a near-50% rise in assets and well ahead of the $19 billion that went to stock ETFs, according to fund tracker Lipper Inc. The inflows have created demand that pushed bond ETF shares to premiums.

It's not just about premiums, though. In the fourth quarter of last year another high-yield bond ETF, iShares iBoxx $ High Yield Corporate Bond Fund (NYSE:HYG) posted both premiums and discounts to its share value. On Dec. 14 the premium peaked at 2.15%, while on Oct. 1 it was trading at a discount of 0.9%. Through the quarter the ETF saw only five of 64 trading days when the ETF's share price was within 0.5% of its net asset value.

The swings were even wider in the first quarter of 2009. The iShares fund had several days during that period when premiums were more than 6% of NAV and also saw occasions when discounts were greater than 3%. In the same quarter the SPDR Barclays Capital High Yield Bond ETF swung from premium of more 12% on January 5, 2009 to a discount of 4.9% on March 2.

Premiums and discounts cut both ways. Just as inflows pushed up premiums last year, once interest rates rise and bonds lose appeal, the sell-off in these funds will lead to discounts, meaning the shares will be sold for less than their underlying value.

"Premiums were large last year [because of bond ETFs' popularity], but when people rush out next year when rates go up it could cause discounts," said Hougan.

He added investors should be "nervous" about a bond ETF with a premium or discount of 1% or more from its NAV.

That said, investors shouldn't necessarily avoid bond ETFs. "You need to weigh the differences," Hougan said. "Mutual funds are usually more expensive and slightly less tax efficient."