

## Bond ETF discounts during recent volatility



*Commentary by Rich Powers, Vanguard head of ETF product management*

The waves of volatility from the coronavirus outbreak have reached every corner of the financial markets. For bond ETFs, the waves have resulted in both volatile market price swings and larger-than-usual gaps between market prices and net asset values (NAVs). When the gap is positive (that is, when the market price is greater than the NAV), it's called a premium. A discount occurs when the NAV is greater than the market price. While such gaps can be unsettling, history shows that premiums or discounts are always present with bond ETFs, and their widening amid market volatility tends to be short-lived.

### **Bond ETFs are an important source of liquidity**

Along with heightened market volatility in the bond market over the last week, there's been a drop in liquidity of many types of individual bonds—that is, the willingness of market participants to buy and sell. Bond ETFs, on the other hand, have maintained their liquidity and have been the primary mechanism for price discovery in the fixed income markets.

In such a volatile environment, bond ETFs can be expected to trade at discounts or premiums. Though discounts and premiums of this breadth and magnitude are rare, bond ETFs have been tested during prior bouts of volatility and actually do a good job of reflecting in real time the value of the underlying fixed income securities. In times of volatility with rapidly evolving macroeconomic, interest rate, and credit environments, investors should expect premiums or discounts in bond ETFs. Bond ETFs tracking similar benchmarks have experienced large variations in market returns as well.

### **Fewer inputs can create greater price disparities**

Discounts and performance differences reflect the fact that there are two ways to determine portfolio values. In setting end-of-day NAVs, ETF pricing specialists use both actual trades and an adjustment factor based on bid/ask spreads for bonds, especially for bonds that haven't traded recently. Market prices, in contrast, are collectively determined by ETF investors and "market-makers." If, as happened in the last week, bond trading is fairly diminished



When comparing an ETF's market-price return with its return based on its NAV, focusing on a single day or week as a relevant snapshot of performance may be misleading. It's also worth remembering that, because outperforming the market is a zero-sum game, not all investors are selling at (or into) the discounts. In fact, investors on the other side of recent trades have been buying at a relative discount.

Amid periods of remarkable market volatility, we remind ETF investors: Avoid trading at or near the beginning and end of the trading day if possible and consider using limit orders, which are executed only if the market price meets or exceeds a threshold that you select. And, if you don't have to trade during a period of such volatility, don't---that might be the best approach of all.

#### Notes:

- **Vanguard ETF Shares are not redeemable with the issuing fund other than in very large aggregations worth millions of dollars. Instead, investors must buy and sell Vanguard ETF Shares in the secondary market and hold those shares in a brokerage account. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.**
- All investing is subject to risk, including the possible loss of the money you invest. Fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.
- Diversification does not ensure a profit or protect against a loss.
- Investments in bonds are subject to interest rate, credit, and inflation risk.

VIGM, S.A. de C.V. Asesor en Inversiones Independiente ("Vanguard Mexico") registration number: 30119-001-(14831)-19/09/2018. The registration of Vanguard Mexico before the Comisión Nacional Bancaria y de Valores ("CNBV") as an Asesor en Inversiones Independiente is not a certification of Vanguard Mexico's compliance with regulation applicable to Advisory Investment Services (Servicios de Inversión Asesorados) nor a certification on the accuracy of the information provided herein. The supervision scope of the CNBV is limited to Advisory Investment Services only and not all services provided by Vanguard Mexico.

This material is solely for informational purposes and does not constitute an offer or solicitation to sell or a solicitation of an offer to buy any security, nor shall any such shares be offered or sold to any person, in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities law of that jurisdiction. Reliance upon information in this material is at the sole discretion of the reader.

Securities information provided in this document must be reviewed together with the offering information of each of the securities which may be found on Vanguard's website: <https://www.vanguardmexico.com/web/cf/mexicoinstitutional/en/home> or [www.vanguard.com](http://www.vanguard.com)

Vanguard Mexico may recommend products of The Vanguard Group Inc. and its affiliates and such affiliates and their clients may maintain positions in the securities recommended by Vanguard Mexico.

ETF Shares can be bought and sold only through a broker and cannot be redeemed with the issuing fund other than in very large aggregations. Investing in ETFs entails stockbroker commission and a bid-offer spread which should be considered fully before investing. The market price of ETF Shares may be more or less than net asset value.

All investments are subject to risk, including the possible loss of the money you invest. Investments in bond funds are subject to interest rate, credit, and inflation risk. Governmental backing of securities apply only to the underlying securities and does not prevent share-price fluctuations. High-yield bonds generally have medium- and lower-range credit quality ratings and are therefore subject to a higher level of credit risk than bonds with higher credit quality ratings.

**There is no guarantee that any forecasts made will come to pass. Past performance is no guarantee of future results.**

Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks. Funds that concentrate on a relatively narrow market sector face the risk of higher share-price volatility. Stocks of companies are subject to national and regional political and economic

risks and to the risk of currency fluctuations, these risks are especially high in emerging markets. Changes in exchange rates may have an adverse effect on the value, price or income of a fund.

The information contained in this material derived from third-party sources is deemed reliable, however Vanguard Mexico and The Vanguard Group Inc. are not responsible and do not guarantee the completeness or accuracy of such information.

This document should not be considered as an investment recommendation, a recommendation can only be provided by Vanguard Mexico upon completion of the relevant profiling and legal processes.

This document is for educational purposes only and does not take into consideration your background and specific circumstances nor any other investment profiling circumstances that could be material for taking an investment decision. We recommend to obtain professional advice based on your individual circumstances before taking an investment decision.