The U.S. regulatory probe into Bill Gross’s Pimco Total Return ETF (BOND) is highlighting an industry that supervisors say may pose an increasing risk to the stability of the bond market.

The assets held by bond exchange-traded funds have ballooned to more than $270 billion from about $57 billion at the end of 2008 as hedge funds to retirees sought quick and easy access to debt markets, according to data compiled by the Investment Company Institute.

While the amount is still a pittance compared to the $38 trillion U.S. bond market, trading in ETFs is fueling price swings that may become more severe in a downturn -- particularly for the most illiquid markets, like speculative-grade debt. Regulators are examining the danger it will be more difficult than investors expect to get out of the funds in a falling market.

“The ETF market will be the tail that wags the dog,” said Mark Pibl, head of research and fixed-income strategy at Canaccord Genuity in New York.

As assets managed by ETFs of all types more than tripled since 2008 to $1.8 trillion, the fastest-growing product in the money-management industry is drawing scrutiny from regulators. While ETFs have shares that trade like stocks on exchanges, bonds often trade in transactions that are negotiated by telephone and through e-mails.

**Liquidity Illusion**

The financial system’s global regulatory body, the Financial Stability Board, is examining whether ETFs pose a risk to market stability when interest rates rise, Carolyn Wilkins, the Bank of Canada’s representative to the group, said in an interview at Bloomberg’s Toronto office on Sept. 23.

“There’s been investments and positions taken that may not have the liquidity there that people expect, especially as interest rates start to normalize,” said Wilkins, senior deputy governor at Canada’s central bank. “So the liquidity illusion, if you want to put it that way, is something that we’re worried about.”

The U.S. Securities and Exchange Commission is investigating whether Pimco bought smaller lots of bonds at discounts and then marked them up in its Total Return ETF, according to a person familiar with the matter who asked not to be identified because the probe isn’t public. The SEC is separately probing disclosure issues across the industry, the person said.
Mark Porterfield, a spokesman for Pimco, didn’t respond to an e-mail seeking comment.

ETF Debate

Some analysts disagree that ETFs pose a threat.

“We hear a lot of people express concern about the structure of ETFs and the fact that it may be prone to failure in volatile times -- that’s just not the case,” said Eric Gross, a credit analyst at Barclays Plc (BARC) in New York. “The ETF is reflective of the market clearing level, which is what an instrument is supposed to do.”

Credit investors have turned to ETFs because it’s a faster way in and out of the debt market. That’s in part because it’s become more difficult to buy and sell bonds as banks pull back from making markets in the face of higher capital requirements.

While the size of the U.S. bond market grew by more than $5 trillion since 2008 to $38.2 trillion at the end of June, trading in the debt has slumped, according to data from the Securities Industry & Financial Markets Association. Average daily turnover fell to $809 billion last year from $1.04 trillion in 2008.

Stability Threat

“What’s happening now is that more people are utilizing ETFs than the underlying securities,” said William Larkin, a money manager who oversees about $575 million at Cabot Money Management. “I used to buy bonds, now you just buy the ETFs.”

Fixed-income funds such as ETFs may be a potential threat to the financial system when the Federal Reserve withdraws its unprecedented stimulus, Michael Feroli, chief U.S. economist at JPMorgan Chase & Co. (JPM) in New York and three co-authors said in a paper released in February.

When the Fed eventually tightens credit, it risks causing financial-market turmoil similar to the “tantrum” that occurred last year after the central bank said it was considering trimming its bond purchases, according to the paper, which was also written by Anil Kashyap of the University of Chicago, Kermit Schoenholtz of New York University’s Stern School of Business and Hyun Song Shin of Princeton University.

The so-called taper tantrum erased $3 trillion from global equity markets in five days during June 2013 and sparked a rout in the bond market.

Junk Bonds

“The concern is if everyone rushes for the exit at the same time and underlying assets are illiquid, that can lead to a fire sale of the claims and depressed assets,” Feroli said in a telephone interview. “Clearly rising rates could be something that would trigger that.”

As sentiment soured on junk bonds in recent months, investors have turned to the easiest exit, pulling
$2.7 billion since June 25 from ETFs that buy the debt, according to data compiled by Bloomberg.

They withdrew $748 million from BlackRock Inc. (BLK)'s iShares iBoxx $ High Yield Corporate Bond fund, the biggest junk-bond ETF, propelling it to a 2.6 percent loss during that period. That compares with a 1.7 percent loss for the average speculative-grade security, according to the Bank of America Merrill Lynch U.S. High Yield Index.

“When you sell an ETF in a share, there has to be a corresponding sale of the underlying assets,” Canaccord Genuity (CF)'s Pibl said. “Right now some people are burnt and not going to step in and buy bonds on the way down.”

**Individual Demand**

A study published last year by BlackRock found that its high-yield ETF didn’t create disruptions in underlying securities even in moments of market stress.

The fund “will behave in a manner that appropriately reflects conditions in the underlying market while still permitting investors to trade” high-yield exposure through the exchange, authors Matthew Tucker and Stephen Laipply wrote.

More and more individual investors have piled into ETFs that invest in higher-yielding securities as the Fed’s held interest rates near zero for almost six years. Many have gotten into this asset class without appreciating the liquidity risks in the underlying market, Cabot’s Larkin said.

“If the asset class falls out of favor, market makers have to unwind the positions and find a buyer on the other side,” he said. “We could have some abrupt price changes to get people interested again.”

**Illiquid Assets**

The FSB, which consists of regulators and central bankers from around the world and is hosted by the Bank for International Settlements in Basel, Switzerland, discussed at a meeting last week whether ETFs based on assets that trade in less-liquid markets would be able to sell their holdings and honor all their obligations during a large withdrawal, Wilkins said this week.

Investors have plowed more than $32 billion into junk-bond ETFs in the past five years after being virtually nonexistent in the market before the financial crisis, Bloomberg data show.

ETFs have also started moving into the market for leveraged loans, with the PowerShares Senior Loan Portfolio (BKLN) growing to $6.73 billion since its inception in March 2011. Investors pulled $344.5 million from that fund the past three months as it lost 1.1 percent.

“They look right now that they have the liquidity of an equity, but they have the diversification of another type of asset,” Wilkins said. “What’s unclear is whether or not these ETFs in a time of stress, actually have the liquidity that’s there.”

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