Up Next: Single-Issuer Corporate Bond ETFs

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Fixed-income ETFs have proven to be the savior the bond market never knew it needed. Not everyone agrees, of course, (active managers among them), but from my perspective, it was ETFs that brought automated market makers into corporate bonds, which, in turn, increased liquidity available electronically, which then drew even more investors to trade electronically, which encouraged more dealers to trade electronically, ultimately increasing market transparency and liquidity overall.

The Evolution of Credit Derivatives

Over time, ETFs have also acted as the credit "derivative" product the market long awaited. The single-name credit-default swaps (CDS) market is a shell of its former self. Index CDS are liquid but too blunt an instrument for those looking for specific exposures, credit futures have yet to make any headway, and other OTC derivatives such as total-return swaps (TRS) remain bespoke and are available only to those with the wherewithal to put ISDA agreements in place.

ETFs (and options on ETFs) now act as a hedging tool—a method of quickly speculating on the direction of credit markets and as a way to put cash to work while the trading desks look for the bonds a fund intends to hold on to for the long term. So while they are not technically, or from a regulatory perspective, a derivative, their use by institutional market participants in these instances suggests otherwise.

So what's next? We've already seen the launch of fixed-income ETFs focused on sectors, ratings, maturities, and durations. More recently, we saw the launch of single U.S. Treasury ETFs, allowing the buyer to get exposure to just the on-the-run 10-year Treasury. The latter followed the launch of single-stock ETFs, a product many were surprised the SEC approved, that have thus far proven popular with retail investors. These announcements made me wonder—where are the single-issuer corporate bond ETFs?

Single-Issuer Corporate Bond ETFs: The Next Frontier?

One of the main reasons cited for the corporate bond market's liquidity problems is the sheer number of tradeable bonds, known in market structure circles as the CUSIP problem. As of September 21, 2022, General Motors has 581 bond issues outstanding. There is no easy or cost-effective way to get exposure to all of the outstanding debt of GM (or any other company) today. Buying the bonds one at a time or via a portfolio trade would get you there, as would entering into a bespoke total return swap, but both options are expensive and time consuming, especially given the relatively illiquidity of many of the bonds needed.

So why not a single-issuer ETF? This would leave it to the ETF issuer to manage that portfolio, while providing the buyer quick, easy and relatively cheap (assuming the issuer can keep fees down) access to the needed exposure. In addition to providing investors with the same ETF benefits listed above, single-issuer ETFs would also allow investors to easily go short that credit, whether to hedge or speculate. Shorting bonds is not easy today, as they're hard to borrow, and gaining short exposure through derivatives isn't much easier, especially given the small size of the single-name CDS market.

And maybe there would even be retail interest, especially now that higher yielding bonds provide a real alternative to equities. Clearly, investors love to buy Apple's equity, so why not its debt? They don't buy its debt today because buying single bonds for most retail investors feels complicated and expensive. Don't get me wrong, we should continue to work on improving retail investor education and access to the bond market itself (more on this coming from us soon). Owning individual bonds rather than ETFs can be advantageous to buy and hold investors, particularly in this market (not to mention the tax benefits). But, right now, ETFs could act as a more accessible gateway drug.

If It Was Easy…

There are some headwinds. The ETF issuer would have to utilize what was effectively an index for the single corporations' credit. Continuing with the GM example, buying all 581 different bond offerings would be difficult if not impossible, as many of those bonds are likely sitting with buy and hold to maturity investors. That means an index that tracks GM corporate bonds without holding all GM corporate bonds while still limiting basis risk must be created.

ETF market makers would also have to feel like they could effectively manage the risk of trading these products, without always have full access to the underlying bonds in the index. Derivatives would have to play a part in that process – perhaps CDS or TRS. But both can be costly to trade and introduce basis risk, which means wider quoted spreads on the ETF.

Nevertheless, given the current market volatility and potential for more stable returns via bonds in the year ahead, making access to popular bond issuers easier for both institutional investors and the Robinhood crowd feels like a step forward.

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