What it means when ETFs deviate from NAVs: Cerulli

By Editorial Staff *Thu, May 7, 2020*

'Advisors purchasing a mutual fund as a long-term holding may be overpaying and would be better served in an ETF. Investors who do not need intra-day liquidity but may need to sell at a specific date may well be best served by the mutual fund,' writes a Cerulli analyst.

Deviations in the market price of fixed-income exchange-traded funds (ETFs) from their net asset values (NAV)—one of the concerns most widely cited by financial advisers—occurred several times in March, according to the latest issue of the Cerulli Edge–U.S. Asset and Wealth Management Edition.

"COVID-19 is putting fixed-income ETFs to the test," the report said. "The deviations underscore the importance of educating advisors about the distinctions associated with both the ETF and mutual fund vehicles with the goal being advisors' use of both in concert."

In late February, as the markets began to react to coronavirus, some of the largest fixed-income ETFs traded with increased bid-ask spreads and, at times, significantly below their NAVs. This deviation may force ETF investors to sell their shares below the reported value of holdings at a time of crisis, making the vehicle appear to be a poorer option than a comparable mutual fund that transacted at the NAV.

While this may suggest that investors in the mutual fund vehicle were better served, Cerulli associate director Daniil Shapiro warned that, "This deviation in NAV should be interpreted with nuance and should impact how both ETFs and mutual funds are positioned to advisors."

Why did ETFs fall below the NAV in February? At the highest level, ETF trading is supported by market makers and authorized participants who need to ensure that their activities are profitable and will add a margin of safety, resulting in lower ETF prices and investors effectively paying some price for access to liquidity.

Alternately, since NAVs for many fixed-income positions are "marked-to-model," the share price may need time to catch up to the true value of the underlying holdings—a friction that market makers will try to price in.

"For advisors, the takeaway should be that no vehicle is perfect. Each has unique advantages," wrote Shapiro in the new report. "If discounts exist in an ETF vehicle offering similar exposure, advisors purchasing a mutual fund as a long-term holding may be overpaying and would be better served in an ETF.

"Investors who do not need intra-day liquidity but may need to sell at a specific date may well be best served by the mutual fund. They may avoid paying some liquidity charge should they have to sell during a tumultuous period."