

Products: Fixed Income Index Investing

## Watch Out for the Tracking Error of Bond ETFs

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The [Wall Street Journal reports that pricing is becoming an increasing problem for bond ETFs](#). A bond ETF is an exchange traded passive index fund that tracks an index of bonds. This can be an index consisting of treasuries, government bonds or corporate bonds. There are mainly two problems that can potentially compound to the distortion of the pricing of the bond ETF: the first one is that the price of the ETF as indicated on the stock exchange might deviate from the underlying net asset value (NAV) of the bonds. The iShares Barclays 1-3 Year Credit Bond ETF has lately been trading at 2% or more than its NAV, incidentally this bond has never traded within 0.5% of NAV at any time in the third quarter of 2010. The second problem is that an ETF fund provider may not be able to buy all the bonds that are included in a benchmark index.

[Felix Salmon in his blog on Reuters reports](#) that Barclays Capital High Yield Bond ETF was down by nearly 1% in the last 12 months (until end of August) whereas its benchmark index was up by about 6% (the Barclays Capital High Yield Very Liquid Index). This is a considerable tracking error, which is due to the inability of the ETF fund to buy some low quality bonds that had rallied over the last few months and contributed to the good performance of the index. In some cases bond markets do not provide the same liquidity as stock markets and therefore it becomes difficult to track the index.

We have also checked if a tracking error has occurred for some popular Euro-denominated ETFs. Yet the popular corporate bond ETF (IBCX) and short duration government bond ETFs of iShares (IBGS, IBGX) do not display large deviations from their benchmark indices. The corporate bond ETF shows the largest difference and trails its benchmark by 1.2% over 5 years (cumulatively). This tracking error is within acceptable margins.

In short, we find that the pricing problem is definitely existent but seems to have significant (negative) consequences only in a few isolated cases. But investors should be aware that bond markets function differently from stock markets and that this may lead to problems for fund providers to precisely match their benchmarks. Particularly in times of high volatility buying and selling of bonds can become difficult or the spread between selling and buying prices may widen. However, all these problems are not only typical for bond ETFs. Managed active bond funds face the same difficulties. As they are not as clearly tied to a benchmark this might just not be so obvious.

In any case we recommend bond fund investors to be cautious and invest time and effort to analyse the funds they considers buying. An investor should especially check

the tracking error of the fund (how close it is to the index) and how liquid the market for the fund is on the exchange. In addition, an investor should also have an eye on the market price of a fund and compare it to the NAV. The buying of single bonds for a portfolio could also be an alternative but requires considerable experience.