Expert's view

ETFs demonstrate their liquidity in extreme market conditions once again

Facts and overview

- The unexpected spread of the Covid-19 outbreak across the globe has led to a generalised market sell-off since mid-February
- The S&P 500 suffered its fastest decline from a market peak since 1950 over a hectic six-day period
- Volumes on cash, equities and bonds soared. Daily turnover almost doubled for mainstream indices such as the S&P 500, the EuroSTOXX 50 or the Nikkei (chart 2)
- Investors used futures to adjust their exposures extensively. S&P 500 futures daily volumes were three times higher than their three- month average

Our key takeaways

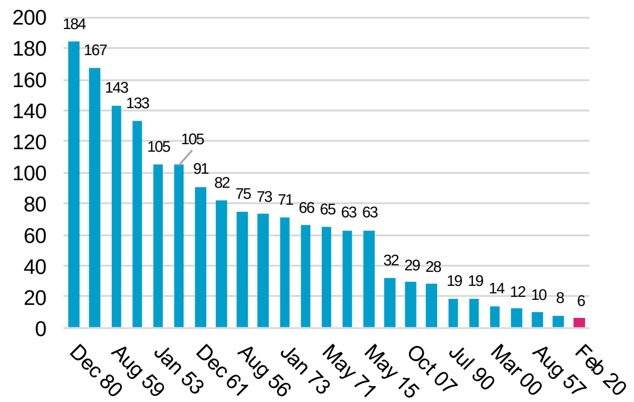
- Amid such volatility, investors relied on ETFs to enter and exit specific asset classes quickly
- ETFs' bid-offer spreads on mainstream equity indices such as the S&P 500 increased in line with those of their underlying markets
- Investors often question how liquid ETFs are during periods of market stress. We cannot predict their future behaviour, but we can say that they now have a 20-year track-record of weathering storms
- This latest extreme scenario is a relevant test of their liquidity during challenging conditions

Fast and furious in February and March

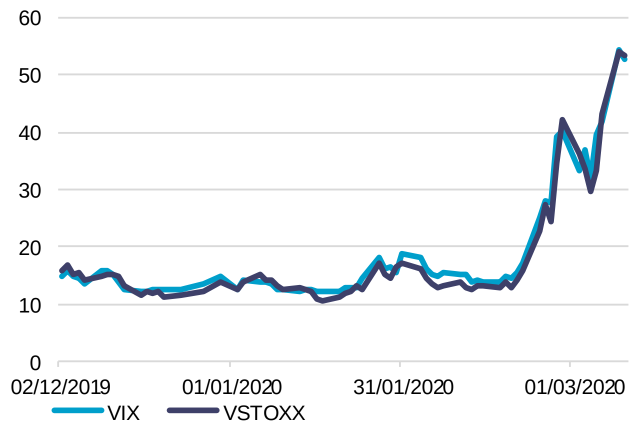
- Markets became increasingly volatile in the second half of February, on fears of the potential economic impact of the Covid-19 outbreak. There were net outflows from equities in many regions, and they came from both active and passive investors (see our latest Money Monitor, February 2020 for more)
- The S&P 500 suffered its fastest decline from a market peak since 1950 and recorded losses greater than 10% in just six days. Market volatility also ramped up over the period as shown by the surge in implied volatility indices in both Europe (VStoxx) and the US (VIX)

Chart 1: The S&P 500's fastest 10% loss since 1950 and much higher market volatility

Time to lose 10% from a recent peak (in days)



VIX and VSTOXX Indices, a reflection of S&P 500 and EuroSTOXX 50 implied volatility



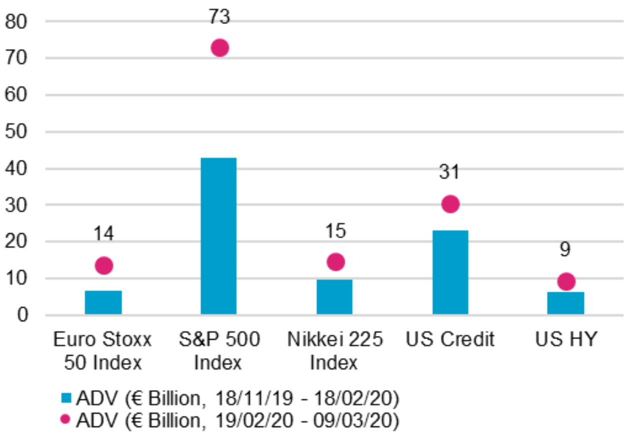
Source: Bloomberg LP, Lyxor International Asset Management. Data as at 09/03/2020
Past performance is not a reliable indicator of future returns.

Turnover soars on equity, bond and futures markets

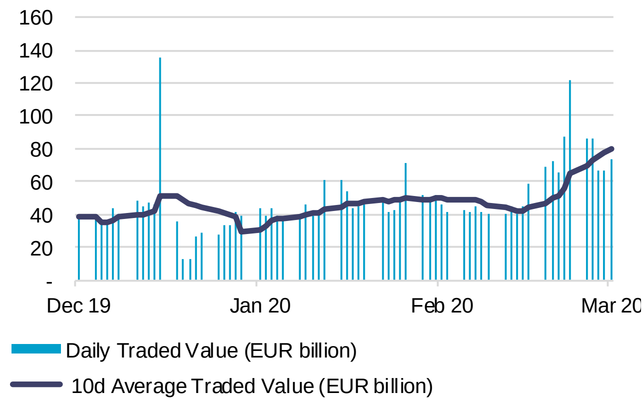
- The challenging market conditions triggered a rapid flight to safety. European Equity ETFs, for example, suffered €10bn outflows between 24 February and 6 March
- Volumes were particularly high for equity indices. The average daily turnover for mainstream indices such as S&P 500, the EuroSTOXX 50 and the Nikkei was almost double their three-month average (see chart 2). US Investment Grade and High Yield bond indices experienced lesser volumes than equity indices, but turnover was still much higher than usual
- Investors used futures to adjust their portfolio allocation extensively (chart 3). Average daily volumes on S&P 500 futures over the period were three times higher than those seen prior to the sell-off (pre 19/02/2019). Chart 2 and 3 also show that the daily turnover on index futures was up to 8-10 times higher than it was before the market sell-off

Chart 2: Trading volumes were well above recent averages for equity and bond markets

Average daily turnover (in €bn) for different indices and asset classes



Daily turnover of S&P 500 and its 10-day average (in €bn)



Source: Bloomberg LP, Finra TRACE, Lyxor International Asset Management. Data as at 09/03/2020
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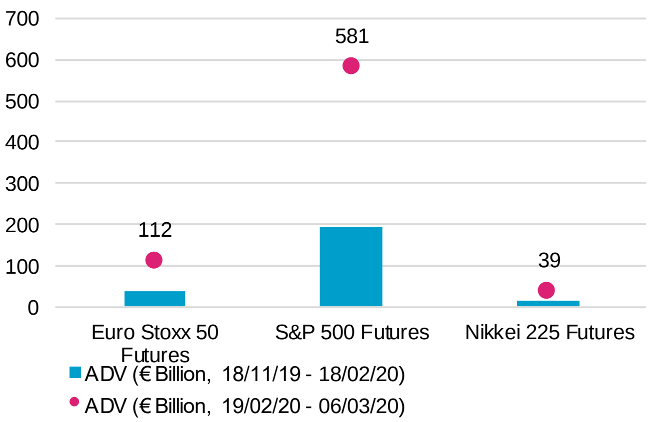
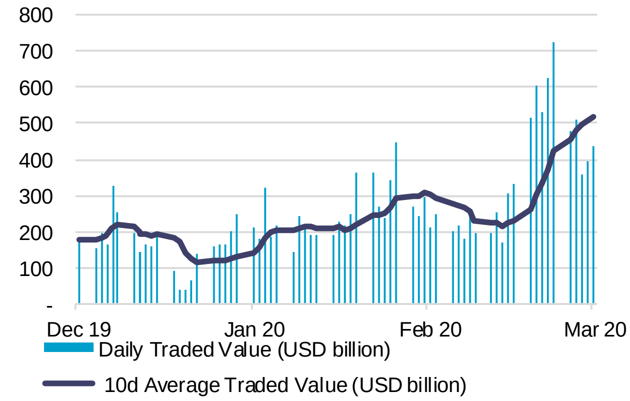
Chart 3: Equity futures volumes were multiples of their recent averages

Average daily turnover (in €bn)



Daily turnover of S&P 500 futures and its 10-day average (in €bn)



Source: Bloomberg LP, Lyxor International Asset Management. Data as at 09/03/2020
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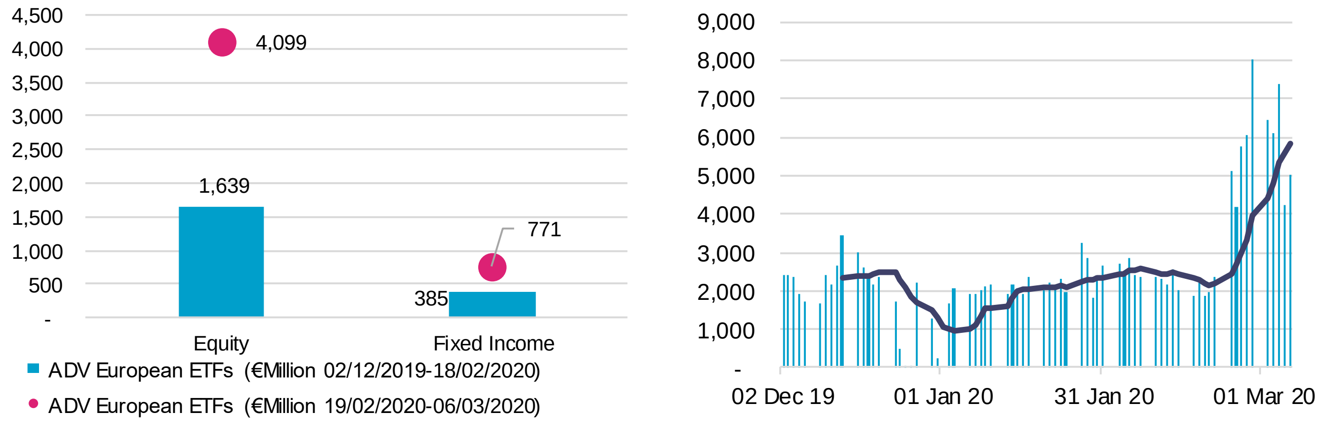
ETFs weather the storm, again

- Investors often question the liquidity ETFs can offer during periods of market stress. Chart 4 shows that average daily volumes of European domiciled ETFs were well above their historical averages. Unsurprisingly, equity ETFs experienced the highest turnover over the period allowing investors to adjust their market exposure easily
- Chart 5 shows the market sell-off was not only a source of greater volumes but also of higher bid-offer spreads for both ETFs and their underlying cash index. While the bid-offer spreads on European domiciled ETFs replicating the S&P 500 were elevated, the increase was in line with those of its underlying market
- Overall, ETFs have, once again, played their part fully and made it easy for investors to adjust their portfolio exposure when markets are under stress. Their high level of liquidity allowed investors to trade at a known price – something which has not necessarily been the case for traditional open-ended funds

Chart 4: Europe-domiciled ETF volumes were multiples of their recent averages

Average daily turnover of all Europe domiciled ETFs, by asset class (in €Mn)

Combined daily turnover of all Europe domiciled ETFs (in €Mn)



Source: Bloomberg LP, Lyxor International Asset Management. Data as at 09/03/2020
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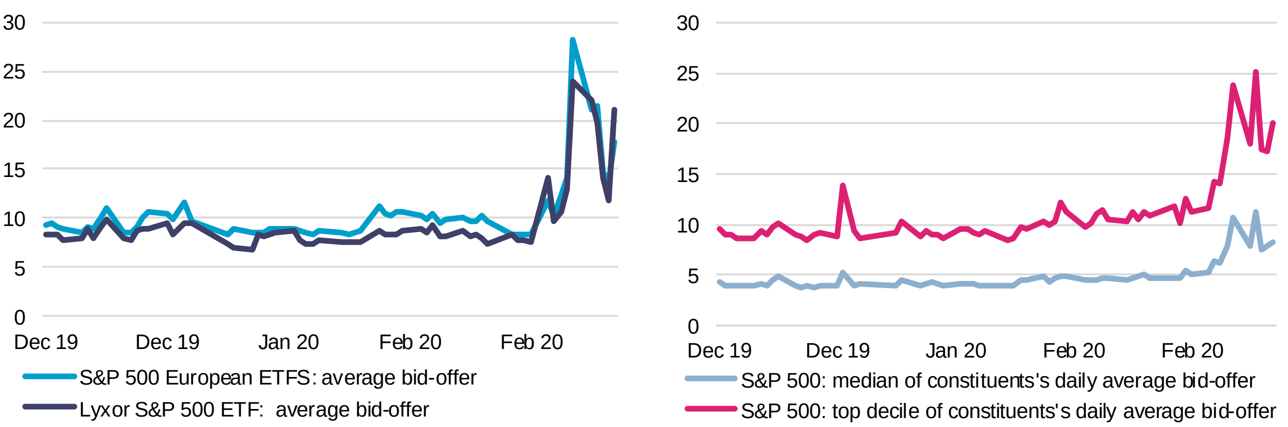
Chart 5: ETFs' bid-offer spreads have adapted to underlying's liquidity conditions

Average S&P 500 ETFs' bid-offer spread (in bps)

Median and top decile of S&P 500 constituents' bid-offer spread (in bps)



Source: HID, Bloomberg LP, Lyxor International Asset Management. Data as at 10/03/2020
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For more information, please contact your Lyxor ETF sales representative.

Knowing your risk

It is important for potential investors to evaluate the risks described below and in the fund prospectus on our website www.lyxoretf.com

Capital at risk

ETFs are tracking instruments: Their risk profile is similar to a direct investment in the Underlying index. Investors' capital is fully at risk and investors may not get back the amount originally invested.

Replication risk

The fund objectives might not be reached due to unexpected events on the underlying markets which will impact the index calculation and the efficient fund replication.

Counterparty risk

With synthetic ETFs, investors are exposed to risks resulting from the use of an OTC swap with Societe Generale. In-line with UCITS guidelines, the exposure to Société Générale cannot exceed 10% of the total fund assets. Physically replicated ETFs may have counterparty risk if they use a securities lending programme

Concentration Risk

Thematic and Smart Beta ETFs select stocks or bonds for their portfolio from the original benchmark index. Where selection rules are extensive it can lead to a more concentrated portfolio where risk is spread over fewer stocks than the original benchmark.

Underlying risk

The Underlying index of a Lyxor ETF may be complex and volatile. For example, when investing in commodities, the Underlying index is calculated with reference to commodity futures contracts exposing the investor to a liquidity risk linked to costs such as cost of carry and transportation. ETFs exposed to Emerging Markets carry a greater risk o potential loss than investment in Developed Markets as they are exposed to a wide range of unpredictable Emerging Market risks.

Currency risk

ETFs may be exposed to currency risk if the ETF is denominated in a currency different to that of the Underlying index they are tracking. This means that exchange rate fluctuations could have a negative or positive effect on returns.

Liquidity risk

Liquidity is provided by registered market-makers on the respective stock exchange where the ETF is listed, including Societe Generale. On exchange, liquidity may be limited as a result of a suspension in the underlying market represented by the Underlying index tracked by the ETF; a failure in the systems of one of the relevant stock exchanges, or other market-maker systems; or an abnormal trading situation or event.