August 2020

RISKPRO®

News, Insights, and Disruptive Thinking from RiskPro WealthTech Visionaries

Behind the SHIELD

RISKPRO® SHINES A LIGHT ON PRICING DISCREPANCIES

On February 19, the S&P 500 reached an all-time high of 3,386. Shortly thereafter investors began to price in the economic impact from the COVID-19 pandemic, causing the market to make its most abrupt trip ever into bear market territory, with the S&P 500 falling 34% over a five-week period. Even more shocking than the market drop is what was happening in the lending markets behind the scenes.

In response to the panic, the Federal Reserve made a surprise announcement on Sunday, March 16th that they were cutting the federal funds rate to a target range of 0 to .25 percent. Instead of calming investors, it had the opposite effect, with many viewing the decision as a sign to prepare for the worst. On the Monday following the Fed's announcement, corporate treasurers and pension managers began pulling billions of dollars out of money market funds. This in turn forced those funds to sell bonds to cover redemptions. However, because of the panic, there were almost no buyers. The domino effect of the liquidity squeeze in the fixed income market was massive. Short-term lending markets, which are typically the most liquid, almost completely seized up.

The following day, the Fed stepped in again with the announcement of a new emergency lending program intended to ease the short-term lending markets. An additional program was announced the following day in a second effort to boost liquidity across the credit markets. Ultimately, this calmed investors and a larger crisis was thankfully avoided.

At the same time, many investors were unaware of a near "seize-up" taking place in the markets and the implications it could have on their portfolios, primarily within the fixed income ETF space.

> As you may know, ETFs are priced and traded throughout the day, much like a stock. An ETF simply represents a basket of stocks/bonds and allows investors the simplicity of owning a basket of securities without purchasing them individually. As an example, think of a ready-prepared meal sold at a grocery store. You can either purchase the prepared meal (an ETF), or you could purchase all the individual components and make the meal yourself (buy the underlying individual stocks/bonds that comprise the ETF).

What can happen during periods of market volatility is that the ETF prices may differ from the value of the underlying stocks/bonds that make up a specific ETF. This often occurs because the ETF and the underlying holdings may trade at different times or frequencies. For example, a fixed income ETF may have quite a bit of trading taking place due to market volatility, whereas the underlying bonds may not have much trading taking place. This can cause the price of the ETF to move away from the value of the underlying holdings. During periods of extreme market volatility, the difference in pricing can become exaggerated; supply and demand, or a panic driven market can widen the pricing spread.

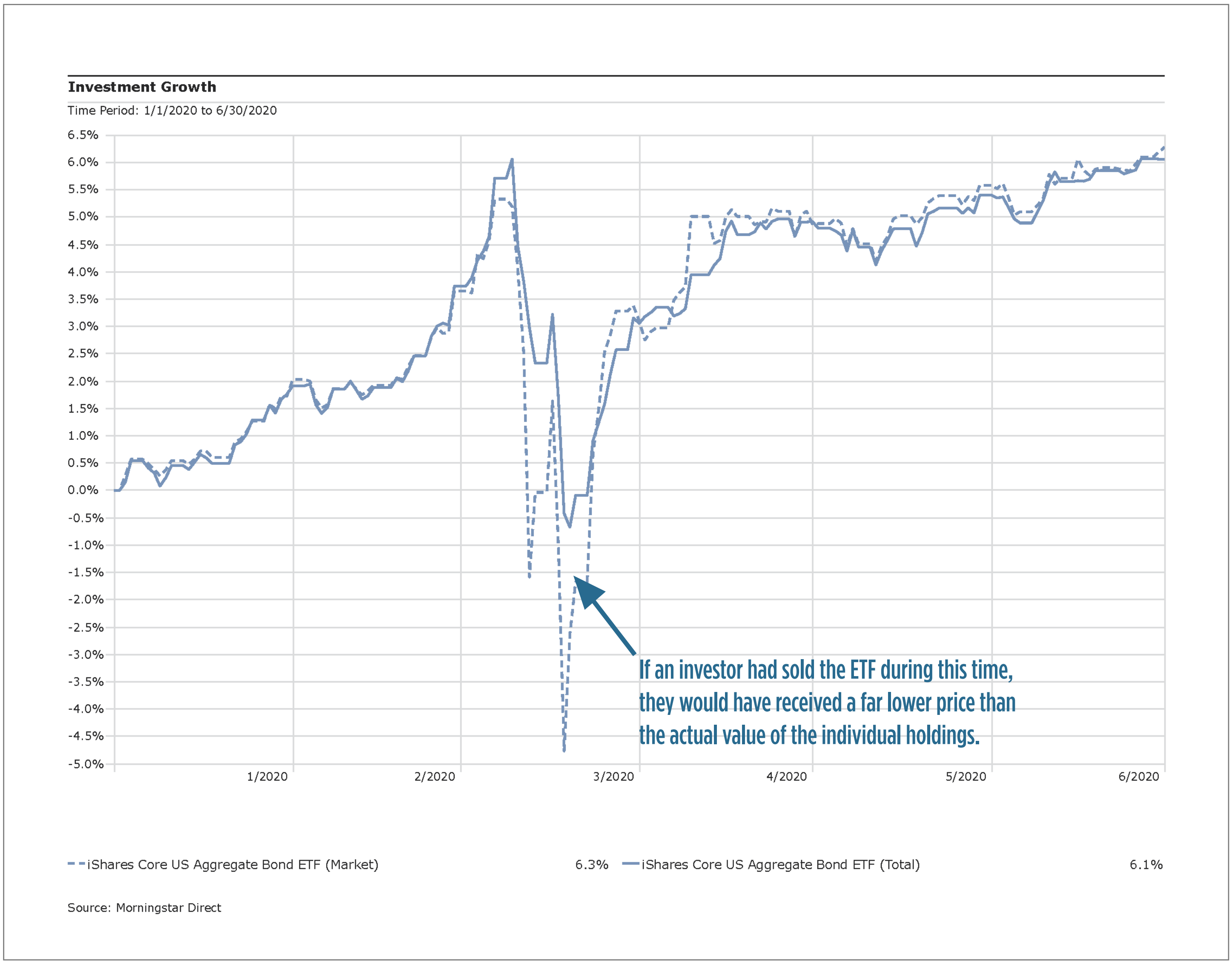
Jeff Olsen
President - RiskPro

"Our volatility-based risk surveillance provides advisers with accurate risk measures they can count on to make informed decisions for their clients."

These discrepancies happen because price and transaction reporting can be less transparent in the fixed income markets due to many bonds trading over the counter without uniform trade reporting facilities.

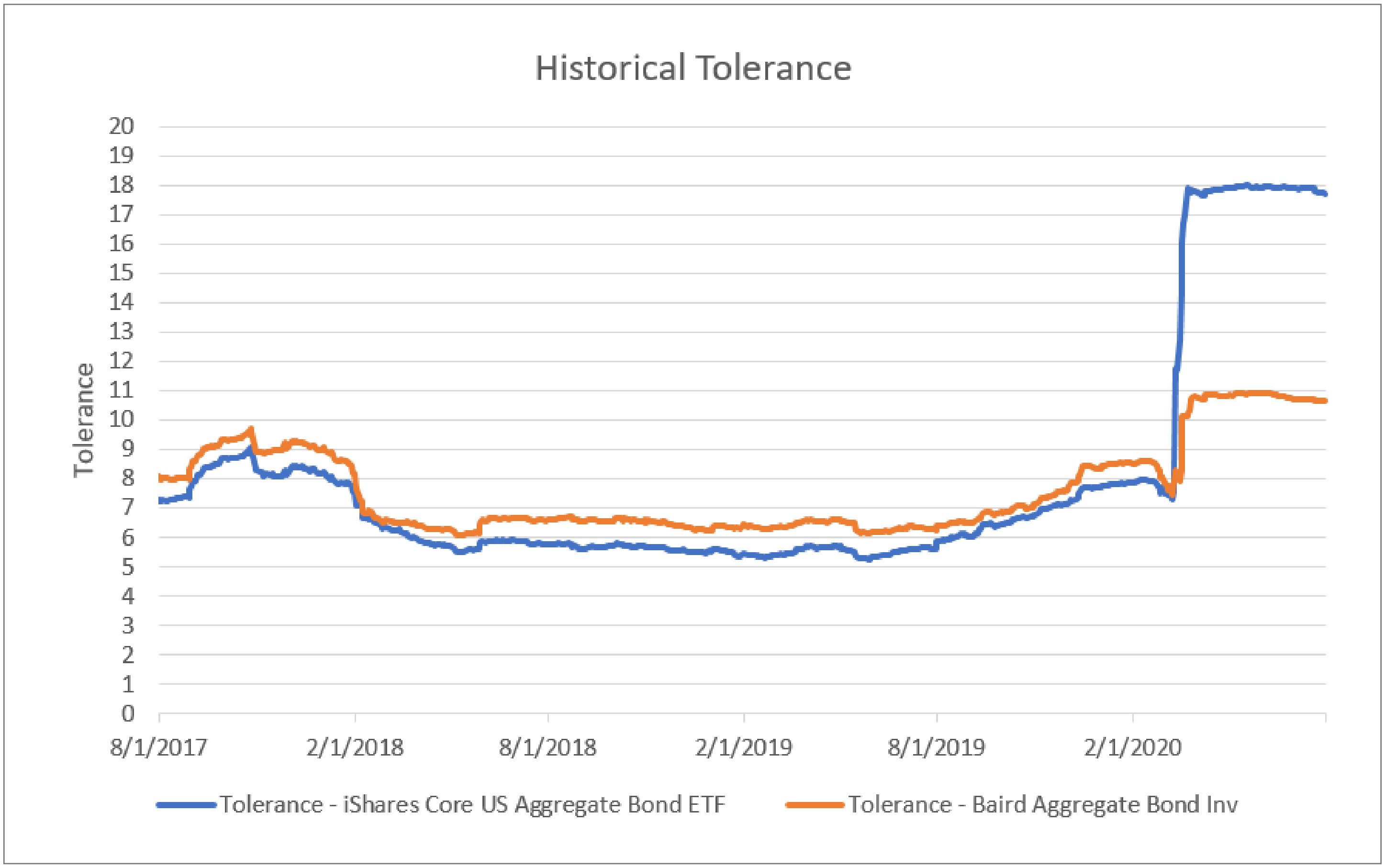
> Of note, mutual funds do not have the same pricing issues ETFs can have because a mutual fund's Net Asset Value (NAV) is priced at end of the trading day after markets close, and intra-day volatility is not a factor.

The chart below represents an example of the discrepancy in prices that occurred in the iShares Core US Aggregate Bond ETF, which is one of the most widely used fixed income ETFs available. The solid line represents the gain/loss if an investor sold the individual holdings of the ETF during a certain period of time, whereas the dashed line represents the actual gain/loss the investor would have received if they sold the ETF during the time period. At its most extreme, an investor would have incurred a loss of -4.75% selling the ETF versus a loss of -0.70% had you sold the underlying positions individually. As you can see, the difference in pricing tends to converge over time, but many advisers and investors are unaware of just how extreme these differences can be during certain market conditions.



Institutions that utilize RiskPro's technology as a translator of risk when proposing suitable investment portfolios also rely on the technology to closely monitor client accounts daily. While most advisers and investors were unaware that these fixed income ETF pricing discrepancies even existed, RiskPro users were alerted to the much higher volatility percentages. Supply and demand, or panicked selling intra day pushed prices below the underlying values and RiskPro users had an effective measure to display this in fixed income exchange traded funds across client accounts.

Below is the historical tolerance for iShares Core US Aggregate Bond ETF over the past three years relative to the tolerance for a mutual fund which also tracks the Barclays Aggregate Bond Index. The tolerance for the ETF in RiskPro accurately reflected the excess volatility investors in fixed income ETFs were subject to, at the same time, many investors were unaware of this excess risk.



The year 2020 is proving to be an exceptional one in many, many ways. A worldwide pandemic, subsequent government shutdowns, and a near freezing up of the credit markets are just a few of the events that advisers and investors have endured. In the midst of all the uncertainty, RiskPro once again proved to be superior at shining a light on the risk that is usually unseen, and can be harmful to advisers and investors ignorant of it. Financial firms, brokers and advisers not only have the ability to mitigate the risk, but they can communicate these findings to clients easily with RiskPro. Building and keeping strong client relationships with communication that's understood by all is what you'll find with our technology. Leaning on RiskPro for Perpetual Suitability™ is incredibly powerful, and a "must-have" if you are intending to be compliant under RegBI moving forward in 2020 and beyond.

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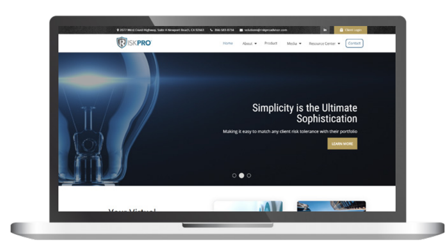

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