While there still isn’t complete clarity surrounding the Federal Reserve’s purchases of exchange-traded funds (ETFs), it did recently release a bit more information. David Mann, our Head of Capital Markets, Global ETFs, attempts to solve the mystery of which ETFs the Fed might be buying—and when.

I have talked a lot recently in these pages about the Federal Reserve’s (Fed’s) range of measures to support the financial markets during these times of coronavirus-driven turmoil, including the buying of fixed income ETFs. What I had intended to be my final article on the topic applauded the inclusion of ETFs in the Fed’s Secondary Market Corporate Credit Facility (SMCCF) program, but I also thought it was a shame that, without specific guidance from the Fed, the market simply assumed that only the largest ETFs would be included.

There was recently a bit more news on the subject. On May 4, the Fed released a document titled “FAQs: Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility.” There was no further clarity on which ETFs would be included beyond the initial guidance, but the Fed did state that ETF purchases would begin in early May. Additionally, there was one FAQ that did grab my attention:

At what price will the SMCCF purchase ETFs?

The SMCCF will generally not purchase shares of an ETF that are trading at a premium above the lower of the following limits relative to the prior end-of-day official net asset value (NAV): \( (a) \) 1%, or \( (b) \) the 1-standard deviation level of the ETF’s premiums to end-of-day NAV observed over the prior 52 weeks, on a rolling basis.

Some quick thoughts, given the market has expected purchases of the largest fixed income ETFs:

- Most likely, \( (b) \) will determine the premium threshold.

Looking at the 12 months ending in April, the top five largest ETFs that invest in investment-grade corporate bonds had an average 1-standard deviation premium of 69 basis points (bps).\(^2\) To get a sense of how chaotic the months of March and April were, removing those two months reduces the average 1-standard deviation premium to 9 bps!

- Since both \( (a) \) and \( (b) \) are elevated, the Fed can essentially buy those largest ETFs whenever they want.

Put to the side the flexibility provided by the word “generally” at the beginning of that sentence. Looking at April alone, that huge spike to the 1-standard deviation premium means the Fed could have bought those top five ETFs approximately 61% of the time.

Taken together, the market can still only speculate on which investment-grade (and high-yield) ETFs will be purchased but, because the 1-standard deviation premium threshold is so high, the bar as to when to buy ETFs is set incredibly low. I highlighted above that the Fed could have bought those top five ETFs 61% of the time in April.

The percentage of days that the Franklin Templeton fixed income investment-grade ETF could have been bought by the Fed was even higher at over 80% for April.

The market expects the Fed to purchase the largest funds—and inflows since March 23 offer proof of that line of thinking. We now have some clarity that the Fed has a tremendous amount of price flexibility as to when they should buy any of the eligible funds.

The next few weeks should show if the market got it right in its assessment of which ETFs the Fed chose to buy.

1. Net Asset Value (NAV) represents an ETF’s per-share-value. The NAV per share is determined by dividing the total NAV
of the fund by the number of shares outstanding.

2. A basis point is a unit of measurement. One basis point is equal to 0.01%.

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