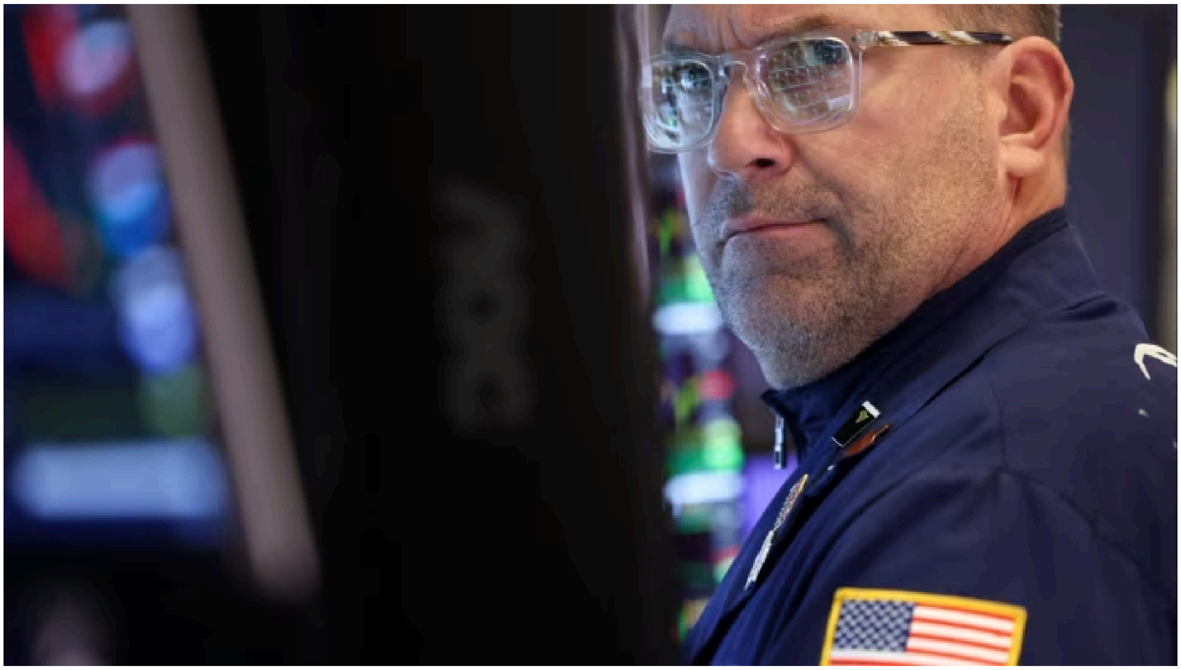
ETF Hub Exchange traded funds

Institutional ETF users fuel corporate bond volatility, IMF warns

Research found volatility is particularly marked at times of market stress



The IMF analysis feeds into a mounting debate on the impact of ETFs on financial markets © AFP via Getty Images

Steve Johnson

Published MAR 26 2025

Institutional investors are increasing volatility in the corporate bond market by aggressively trading exchange traded funds, according to analysis from the IMF.

This heightened volatility is particularly stark at times of market stress, when instability is most likely to bleed into real-world effects for corporate borrowers and the investors in their debt.

The research feeds into a mounting debate among academics and researchers on the impact of ETFs on financial markets. The debate has become ever more urgent especially as ETFs have ballooned to $15tn in assets, a fivefold increase in a decade and far ahead of the $4.5tn held in hedge funds.

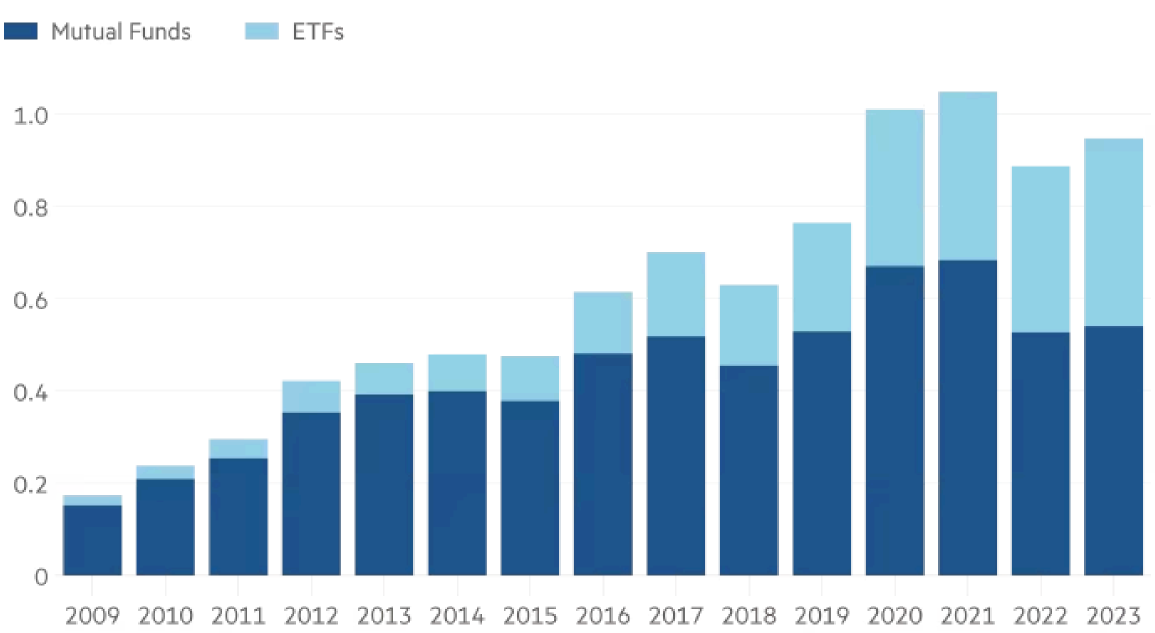
While much of the research has focused on the growth of passive, index-tracking investment that ETFs are famous for, the IMF analysis is one of the first papers to examine the impact of the growing institutionalisation of the US ETF industry: institutional ownership of US-listed corporate bond ETFs has risen from 44 per cent in 2012 to 70 per cent, the IMF found.

This matters because "US corporate bond ETFs with a high share of institutional ownership show larger trading volumes during periods of stress", the IMF found in its paper.

The IMF paper, which looked at global financial stability, found that overall the growth of ETFs, at the expense of more traditional mutual funds, has reduced volatility in the corporate bond market.

ETFs are now big owners of corporate bonds

Combined holdings, by fund type ($tn)



Sources: EPFR, FactSet, Bloomberg, IMF staff calculations

It largely attributes this to a belief that "the guaranteed redemption of mutual fund shares at the funds' net asset value can incentivise run-like behaviour by investors". Mutual funds suffered average net outflows of 10 per cent of their assets during the Covid turmoil of February and March 2020, worsening the ongoing market sell-off.

In contrast, redemptions from ETFs do not necessarily lead to fire sales of the underlying bonds as the specialist market-makers that service ETFs may instead trade "in-kind" — taking the bonds on to their own balance sheets and temporarily shielding the market from the full impact.

However, the paper found that this reduced volatility was entirely the work of retail investors, with institutional ETF investors increasing volatility, a divergence not observed for mutual funds.

Specifically, the IMF researchers found that, while a 1 percentage point increase in the share of a bond held by retail ETF investors is associated with an 85 basis point decrease in volatility, a 1 percentage point increase in the share held by institutional ETF investors leads to a 27bp increase in volatility.

This effect became more pronounced at times of market ructions, the researchers found, noting: “the role of institutional investors is amplified during periods of stress.”

The IMF attributed this to ETFs with high levels of institutional ownership exhibiting “larger trading volumes during periods of stress”, suggesting that “institutional investors use ETFs to manage risks and liquidity shocks that materialise during stress episodes, which are then passed on to the underlying markets”.

The fact that ETFs could be traded intraday, unlike mutual funds, also encouraged more aggressive short-term institutional investors, who were more likely to sell during periods of stress, the IMF said, while institutions were also more likely to take short positions in bond ETFs.

ETFs and mutual funds hold about $1tn of US corporate bonds between them, 12 per cent of outstanding issuance.

The research builds on work by academics from a trio of US business schools in 2023 that found fixed income ETFs can suck the liquidity out of corporate bonds during times of market stress, potentially worsening price dislocations during crises.

The IMF team believe the volatility induced by trigger-happy institutional ETF investors in the corporate bond market may not necessarily be replicated in government bonds or equities, as these markets are more liquid.

However, some previous work has suggested the effect was visible in equities too. Analysis by a team led by Valentin Haddad, associate professor of finance at UCLA Anderson School of Management, in 2022 concluded that the rise of passive investing — which ETFs are at the forefront of — was distorting price signals and pushing up the volatility of the US stock market.

Other researchers, though, have found the rise of ETFs to be beneficial to underlying markets, for instance by increasing their efficiency.

Kenneth Lamont, principal of research at Morningstar, said of the IMF paper that "it is not surprising to hear that sophisticated investors are more likely to use ETFs tactically — going short etc — and for cash management purposes and that this results in higher levels of trading than retail investors, most of whom don't have time or skills to trade around market events".

However, Lamont added that "if you look at the Covid-19 market crash, ETFs performed admirably under extreme pressure and proved to be an invaluable source of liquidity when the market needed it most".

Andrew Clare, professor of asset management at London's Bayes Business School, said the findings were "interesting", and suggested that institutional investors' volatility-inducing behaviour could stem from them holding bond ETFs for hedging purposes, and their sheer size.

"It could be that when they trade they trade a greater scale than retail investors, causing bigger ripples in the ETF bond market," Clare said.

This heightened trading activity might not necessarily be to institutions ultimate benefit, however.

“There is a well-known result in the finance literature that found that overconfident traders, or those that think they ‘know’ something, tend to trade more than less confident traders,” Clare added. “It could be that the institutions are ‘overtrading’ these instruments because they ‘know’, while retail investors are happy to buy and hold.”

Follow the topics in this article

Investing in funds

Passive Investing

Financial services

Financial & markets regulation

Exchange traded funds