

VOICES

Colby Wright on the Pricing Mystery of ETNs: Why Market Value is Higher Than Indicative

Colby Wright, assistant professor of finance at Central Michigan University, discusses his academic work on exchange-traded notes, including examining the “price puzzle” of indicative versus market value of the securities. Wright spoke with Matt Robinson in a telephone interview on Sept. 19.

How did you get started looking at ETNs?

“Funny story, my department chair here is a good friend of mine, Jim Felton, and he walked into my office in early 2008 and said, ‘Hey, do you know what exchange-traded notes are?’ And I said, ‘I have no idea, why?’ ‘Cause I just bought some, but I don’t know what they are.’

“It was RJA. My department chair is all about diversification and the efficient frontier and always thought it was impossible to get into some of these asset classes that he wanted to get into just for the sake of diversification. So we pulled up the index and were laughing about it. RJA’s return was tied to this index that had your standard commodities – corn, wheat, cotton – but also lumber, milling wheat, rubber, canola, rice, orange juice, rapeseed, greasy wool. I’m like ‘Wow Jim, yeah, you really are getting closer to the efficient frontier if you’re now invested in greasy wool.’

“We had no idea what an exchange-traded note was. So he and I looked at each other, and he said, ‘You know if I bought these things, I bet there are a lot of other people out there buying them. Because he thought it was an ETF. That’s when I started to explore what they are. The more I got into it, the more interesting it became.’

What piqued your interest?

“All the possibilities, meaning from both the issuer and from the investor perspective. I was also intrigued because I got the sense the investment companies wanted these things to be lumped with ETFs. So I thought somebody’s got to start highlighting what the exact differences are, which is what my first paper was all about, basically how are these

things different from ETFs.”

Can you talk about your second paper, “The Indicative Value-Price Puzzle in ETNs?”

“There are two numbers that matter when you’re talking about exchange-traded notes, indicative value – that’s what the issuer says your note is worth – but there is also market price. They don’t have to be the same. You would expect that in an efficient market, the market price should be relatively close to the indicative value. There are mechanisms in place to try to make that happen since most ETNs allow investors to redeem the notes at any given time for the indicative value.”

“The problem is that even if you have that mechanism, we expected a little bit of a discount to account for the risk factors that are inherent. The biggest is default risk and the closest after that is liquidity risk. The effect of any risk should be a decrease in price, so we had originally thought that we should see ETN prices pretty consistently below indicative value just to account for risk inherent in the securities.”

“What we found, generally speaking, was the opposite. The market was actually putting a price premium on those ETNs. At first, we really had a heck of a time trying to explain it.”

“ETN investors have the privilege of redeeming the notes anytime they want, but investors cannot create shares in ETNs. If you think about that, imagine a market price way above the indicative

value. Investors should want to create shares of the ETN at the indicative value, then go sell it on the market. If this mechanism was in place, we think arbitrage would fix some of that mispricing.”

“I understand why issuers don’t want to do that. It’s precisely because these are notes. So, if UBS lets investors create shares at will, you could imagine the potential liability. But there’s got to be some solution. We’ve got to figure something out to get rid of this mispricing.”

What are you working on now?

“We’re trying to figure out if markets effectively price in default risk inherent in ETNs. Four years ago, people would have stopped and said, ‘You don’t even need to look at that because investors can redeem these any day for the indicative value.’ But there’s usually a delay, two to five days, sometimes up to 10 days.

“On the days when the CDS prices spike for those issuers, do we see a change in the ETN prices? Specifically, we would expect ETN prices to go down because default risk is getting higher.”

What do you think the market should focus on?

“I understand they need to focus on the hot assets and the hot indices. I would like a more sustainable model, which would focus on what are the indices or the assets retail investors have a difficult time accessing through any other security. That’s the sustainable arena to get into.”

Colby Wright



Age: 35

Education: Brigham Young University, BS in accounting. Florida State University, PhD in Finance.

Family: Wife, Misty. Three sons: 10, 9, and 4. A daughter, 6.

Hobbies: “Right now I’m coaching my 9-year-old son’s football team, which is a lot of fun, but takes a lot of time... It’s amazing how emotionally involved you can get in 9-year-old football. No one else cares, the kids don’t even care if they lose, they’re smiling.”

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