Insights
Fixed Income

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Temporary Divergence: Tracking Differences for SPDR EM Fixed Income ETFs

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The war in Ukraine and the consequent imposition of sanctions on certain Russian debt, coupled with the closure of the onshore Russian bond market, have created some challenges to pricing Russian bonds. Nevertheless, the SPDR UCITS ETFs that had Russian exposure continued to trade throughout the unfolding crisis and the initial tracking divergences seen versus their indices have since reversed.

Russian Asset Valuations

State Street Global Advisors made certain valuation decisions in respect of Russian securities held within its pooled funds, applicable with effect from close of business on 28 February 2022. On that date, holdings of the SPDR Bloomberg Emerging Markets Local Bond UCITS ETF classified as Russian* were 2.38% by market weight. This was already a little below the Bloomberg Emerging Markets Local Currency Liquid Government Bond Index holding of 2.5%, partly because the decision to fair value the bonds resulted in a slightly lower valuation for the SPDR ETF holdings than Bloomberg was using for its index. This resulted in the tracking difference widening from -9bp at the close of business on Friday 25 February to -19bp on 28 February.[1]

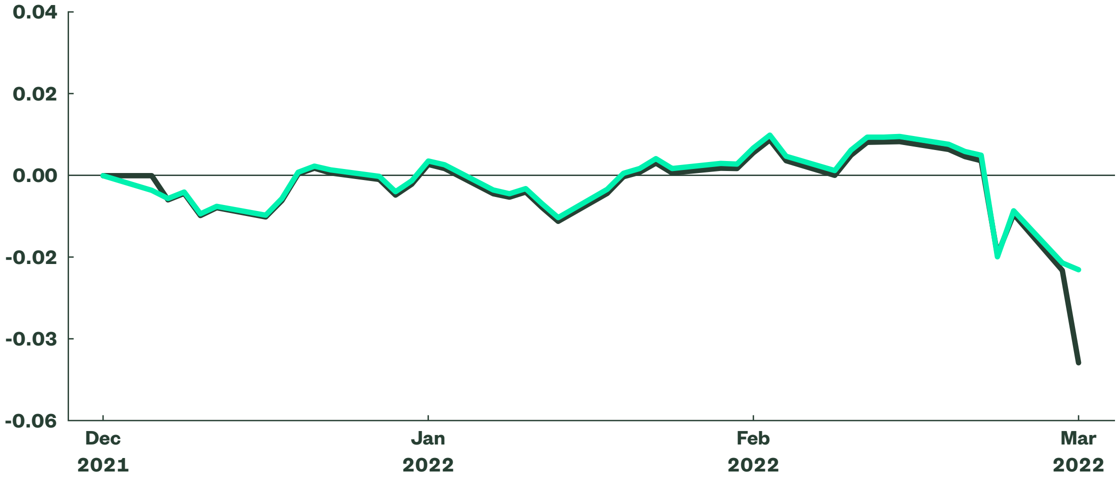
The trading of Russian local currency bonds was suspended in February and the local market closed. Coupon payments on local bonds to non-Russian investors were also banned by the Central Bank of Russia. Given this inability to trade, the likely default on coupon payments, the inability to settle transactions and overall severity of sanctions, State Street Global Advisors decided to implement fair value pricing for local Russian sovereign bonds, which included the possibility of a zero value.

This valuation was applied from the close of business on 1 March and resulted in a material underperformance for the SPDR Bloomberg Emerging Markets Local Bond UCITS ETF versus its index. As seen in Figure 1, the tracking difference widened to -2.29%, suggesting 210bp of underperformance can be attributed to the decision to fair value the bonds at zero while Bloomberg continued to try to estimate a value.

* Classified as having country of risk of Russia by Bloomberg.

Figure 1

Mind the Gap — Tracking Difference on the SPDR Bloomberg Emerging Markets Local Bond UCITS ETF widened on the Decision to Value Russian Local Currency Debt at Zero



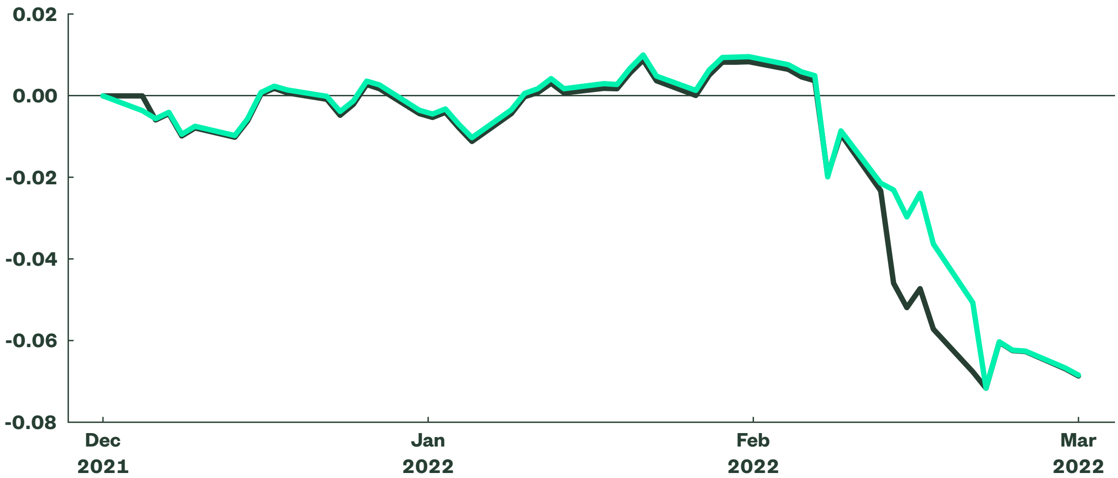
Source: Bloomberg Finance L.P., as of 1 March 2022. Past performance is not an indication of future results.

The decision by Bloomberg to maintain valuations of Russian government bonds at their 1 March 2022 levels meant that the tracking difference remained wide for a number of days (see the company's **recent press notice**). This pause in pricing was in order to hold a consultation with market participants on the eligibility of Russian debt for the Bloomberg fixed income indices. The consultation concluded: "All index securities with a country of risk of Russia will exit the indices, including applicable high yield and emerging market indices, at March month-end at a valuation of near zero. Current index pricing will be updated accordingly." The notice can be viewed **here**.

As the value of Russian bonds within the Bloomberg index was reduced to $0.000001, the value of the index moved back in line with the SPDR Bloomberg Emerging Markets Local Bond UCITS ETF until the gap was close to just -1bp by 8 March.

Figure 2

Convergence — Tracking Difference on SPDR Bloomberg Emerging Markets Local Bond UCITS ETF Narrowed as Bloomberg Wrote Its Valuations for Russian Local Currency Debt Down to Zero



Source: Bloomberg Finance L.P., as of 15 March 2022. Past performance is not an indication of future results.

Other SPDR emerging market debt ETFs were also affected by this inconsistency in the timing of price changes. The SPDR Bloomberg EM Inflation Linked Local Bond UCITS ETF held around 1.9% of its exposure in Russian inflation-linked securities on 28 February 2022.[2] These are ruble-denominated linkers and, as their value was written down to zero, the tracking difference widened from -38bp for the year to 28 February to -207bp on 3 March. The spread versus the Bloomberg EM Inflation Linked 20% Capped Index has since narrowed back in to -5bp.[3]

Carry on Trading

In order to assess the impact on trading costs for the SPDR Bloomberg Emerging Markets Local Bond UCITS ETF, the most obvious comparison would the COVID crisis in 2020, when we saw a similar evaporation of liquidity in many fixed income exposures.

Figure 3 shows a direct comparison between these two periods. On-exchange volumes were much lower coming into this crisis and did not see a similar spike in activity during the crisis, with on-exchange daily traded values hovering at around the $1 million mark. We saw a significant widening out in spreads on this ETF, with the bid-ask spread touching 700bps at the peak of the crisis, due to the uncertainty around the Russian exposure in the fund and whether these bonds would be tradeable.

In comparing the current situation to the COVID crisis, when spreads also widened significantly due to the volatility in markets, it is worth noting that although the spreads peaked at a much higher level, they also fell back lower at a much faster rate after the initial peak. Spreads fell back below 100bps within 10 trading days after crossing that threshold, compared to 25 days above that level during the COVID crisis.

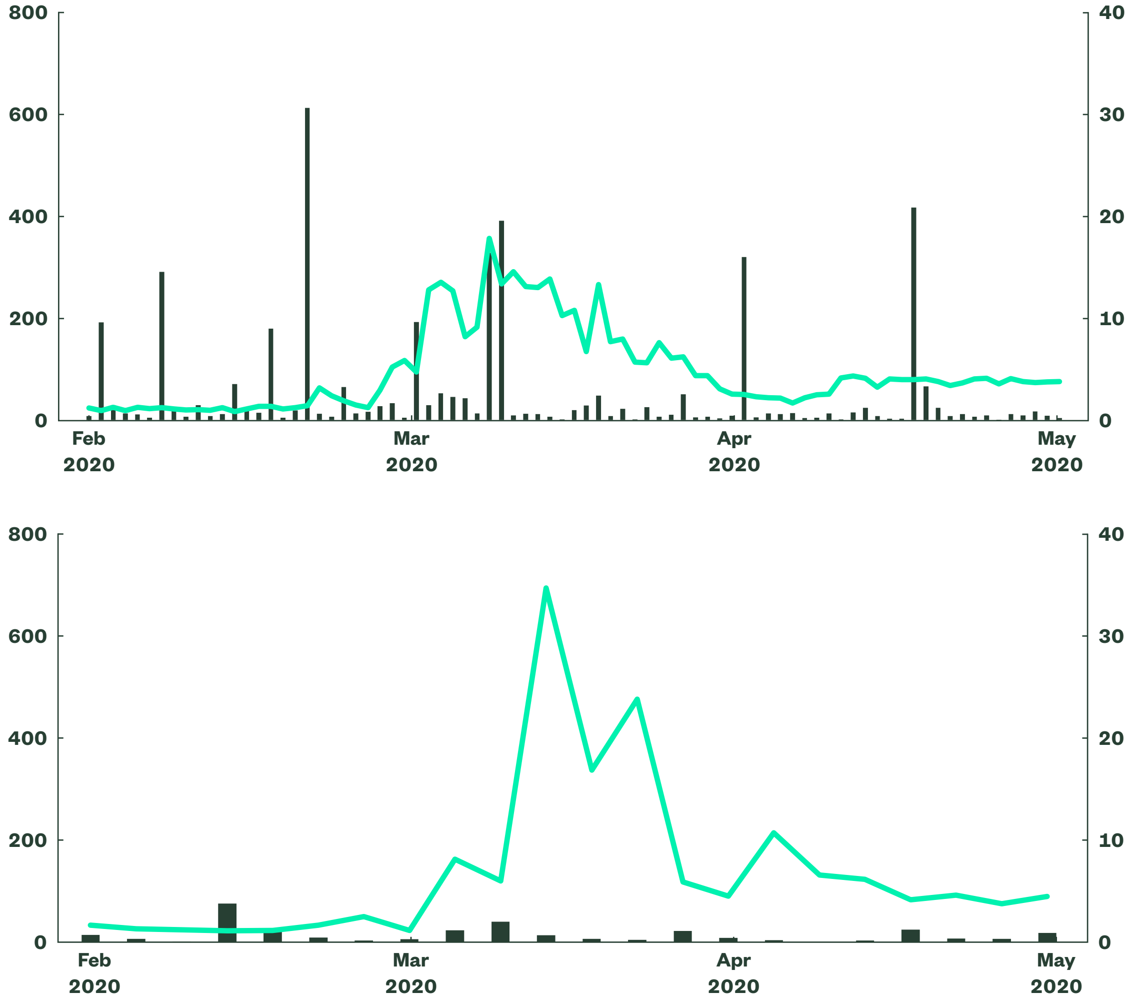
Therefore, although in the immediate period of the crisis it became more expensive than during the peak of COVID to trade this exposure, investors would have seen trading costs come back in line at a much quicker rate, and would have been able to trade at normal levels much sooner after the peak.

Figure 3
Comparing Trading Volumes and Spreads to the COVID Crisis
During Covid Crisis

Daily Volume Traded (USD Mn) — RHS
Daily Average Spread

During Russia-Ukraine Crisis

Daily Volume Traded (USD Mn) — RHS
Daily Average Spread



Source Bloomberg Finance L.P., as of 15 March 2022.

Month-End and Beyond

With Russian bonds being valued at close to zero by both the ETFs and the index provider, the tracking difference for the SPDR local currency ETFs remained close to zero into the final week of March 2022. The approach of month-end coincided with a limited re-opening of the market for ruble-denominated bonds and meant that some selling of those bonds was possible ahead of them exiting their respective indices at month-end.

This outcome resulted in the development of a positive tracking difference as the bonds were sold for a higher price than they were reflected at in the index. As at 31 March, the tracking difference versus their respective indices had widened to +5bp for the SPDR Bloomberg Emerging Markets Local Bond UCITS ETF and to +1bp for the SPDR Bloomberg EM Inflation Linked Local Bond UCITS ETF.

As of the close on 31 March, both the SPDR Bloomberg Emerging Markets Local Bond UCITS ETF and the SPDR Bloomberg EM Inflation Linked Local Bond UCITS ETFs and their respective indices had no Russian bond holdings. With no Russian debt creating volatility in the fund, the tracking difference has remained tight and, as at the end of April 2022, was just -2bp for the SPDR Bloomberg Emerging Markets Local Bond UCITS ETF and -12bp for the SPDR Bloomberg EM Inflation Linked Local Bond UCITS ETF.[4]

Please see the **State Street Global Advisors notice** for further information on Russian securities held in SPDR ETFs.

Endnotes

1 Source: Bloomberg Finance L.P., as of 15 March 2022.

2 Source: State Street Global Advisors, as of 28 February 2022.

3 Source: Bloomberg Finance L.P., as 17 March 2022.

4 Source: Bloomberg Finance L.P., as of 29 April 2022. The Total Expense Ratio for both funds is 55bp, so over the first 4 months of the year this in itself should have accounted for close to -18bp of tracking difference.

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