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The impact of innovation: Evidence from corporate bond exchange-traded funds (ETFs)

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ABSTRACT

Using distinct features of corporate bond exchange-traded funds (ETFs), I find that financial innovation has a significant and long-term positive valuation impact on the systemically important underlying securities. A one standard deviation increase in ETF ownership reduces high-yield and investment-grade bond spreads by 20.3 and 9.2 basis points, respectively, implying an average monthly price increase of 1.03% and 0.75%. Two novel quasi-natural experiments exploit exogenous changes in ETF eligibility to confirm the effect. Examining theoretical explanations for the effect, I find that ETFs decrease liquidity trader participation, increase institutional ownership, and insignificantly or negatively impact the liquidity of individual bonds.

JEL Classification: G23, G29, G12

Keywords: Exchange-traded funds, corporate bonds, liquidity, liquidity traders

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