

INTRODUCTION TO EXCHANGE TRADED FUNDS (“ETF”) LIQUIDITY AND TRADING



KEY TAKE AWAYS

- Most ETFs are small and thinly-traded¹
- Thinly traded ETFs do not equate to illiquid ETFs, the way stocks do
- ETFs do not trade “just like stocks”
- Wealth managers who avoid small and thinly traded ETFs may limit their ability to implement investment views
- For large orders, a wealth manager should use a trading desks to access greater liquidity than the screen market shows
- Using a specialist ETF trading desk often leads to tighter markets and better execution

MOST ETFS ARE SMALL AND THINLY TRADED

In July 2016, the U.S. equity ETF industry included nearly 1,400 funds, totaling more than \$1.9 trillion in assets.² ETFs accounted for roughly 30% of the total traded value in U.S. listed equities.³ Despite these volumes, most ETFs have few assets and trade very little: 25 ETFs account for over 55% of trading volume and more than 50% of assets.⁴

[1] “Thinly-traded” resecurities in the financial markets are exchanged in low volumes and often have a limited number of interested buyers and sellers

[2] https://www.ici.org/research/stats/etf/etfs_07_16

[3] <http://www.bloomberg.com/news/articles/2016-01-08/that-giant-sucking-sound-you-hear-is-the-etf-options-market>

[4] Bloomberg Data, as of 08/08/16

ETFs POSSESS TWO DIFFERENT SOURCES OF LIQUIDITY

1. VISIBLE LIQUIDITY (Secondary Market)

ETF shares are bought and sold on an exchange. The resulting average daily volume of shares traded between buyers and sellers in the secondary market contribute to an ETFs liquidity. However, while trading activity is the most visible to investors, it is not the only source of liquidity for ETFs.

2. LIQUIDITY FROM UNDERLYING SECURITIES (Primary Market)

Most of an ETF’s liquidity comes from its underlying securities, due to their unique creation and redemption process. Demand for stocks in the underlying portfolio drives the price. The supply of ETF shares is not fixed and can expand or contract daily. Thus, large orders are either filled with outstanding shares or, when necessary, by creating or redeeming shares.

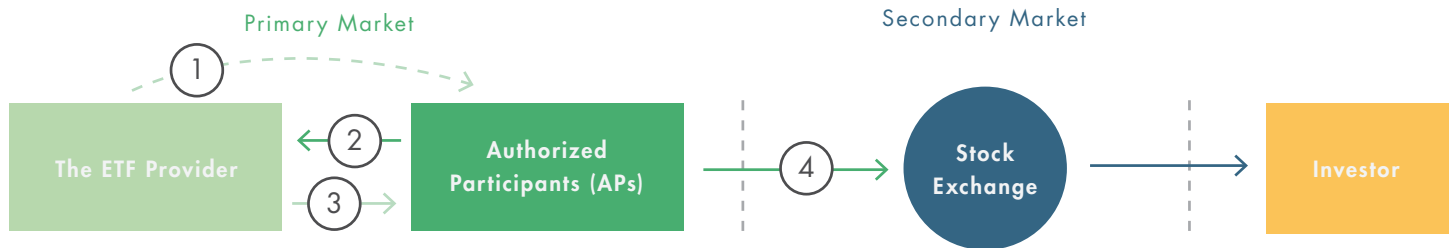
Figure 1.
The Two Sources of ETF Liquidity



The result: An ETFs assets under management (AUM), bid-ask spread, or average daily volume (ADV)—will not reveal the true liquidity available for an ETF transaction.

THE ETF CREATION/REDEMPTION PROCESS

Figure 2.



- ① The ETF provider publishes a list of holdings (Creation Basket)
- ② The Authorized Participant (AP) delivers cash or buys and delivers the basket of securities to the ETF provider.
- ③ Once the ETF provider receives the cash or basket of securities, he exchanges a block of the equally valued ETF shares with the AP, called a creation unit. (Usually formed in blocks of 50,000 shares)
- ④ The AP sells the ETF shares to investors on the stock exchange at market value.

Note:

The exchange takes place on a one-for-one, fair-value basis. The AP delivers a certain amount of underlying securities and receives the exact same value in ETF shares, priced based on their net asset value (NAV), not the market value at which the ETF happens to be trading.

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