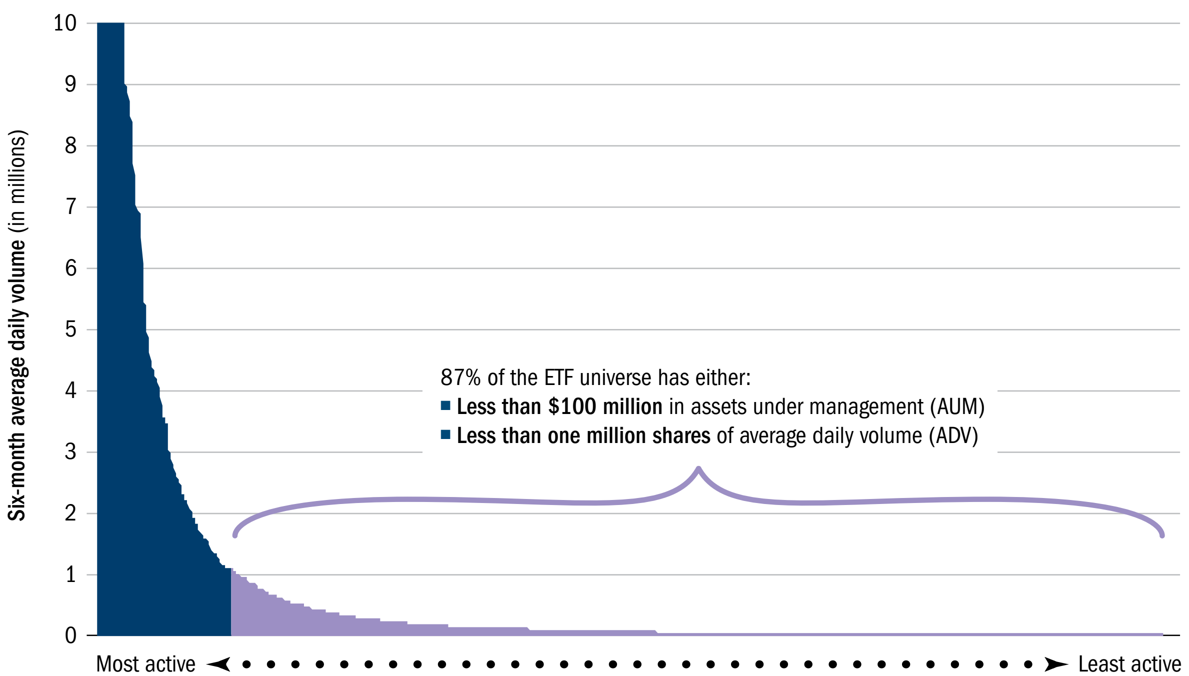
LOOKING BEYOND MYTHS AND LIQUIDITY SCREENS TO UNDERSTAND ETFs

Despite the growth of the exchange-traded fund (ETF) industry, many investors concerned about liquidity restrict themselves to a small number of products. But a closer look at the characteristics of ETF structure and the ETF universe reveals that many of the liquidity screens used — including fund size and bid-ask spread — aren't indicative of an ETF's true liquidity.

By looking beyond these screens, understanding common myths surrounding ETFs and following ETF trade execution best practices, wealth managers can gain a competitive advantage.

At year-end 2015, the U.S. equity ETF industry included nearly 1,600 funds, totaling more than $1.6 trillion in assets. In 2015, ETFs accounted for more than 29% of the total traded value in U.S. listed equities. Despite these volumes, most ETFs have few assets and are rarely traded. Twenty-five ETFs account for over 60% of trading volume and more than 40% of assets.

Figure 1: Equity ETF trading activity is highly concentrated among a handful of funds



Source: Bloomberg as of June 30, 2016. Graphic excludes ETFs with six-month ADV greater than 10 million shares.

Past performance does not guarantee future results.

ETFs are less like stocks than you may think

Since their introduction, it has often been said that ETFs trade just like stocks. This claim is not only false, but is in fact the root of the misunderstanding that surrounds ETF liquidity. ETFs are open-end funds, and like mutual funds, market demand for the underlying portfolio is what drives the price. The supply of ETF shares can expand or contract daily, limiting the effect that properly executed trades can have on the price of ETF shares. Large orders are either filled with outstanding shares or, when necessary, by creating or redeeming shares. **As a result, the screen market — the fund's assets or bid-ask spread — does not reveal the true liquidity available for an ETF transaction.**

Figure 2: Characteristics of stocks, ETFs and mutual funds

	Stocks	ETFs	Mutual funds
Trading period	Intraday	Intraday	End of day
Share price advertised	Every trade	Every trade	End of day
Can be sold short	Yes	Yes	No
'40 Act Fund	No	Yes	Yes
Composed of a portfolio of underlying securities	No	Yes	Yes
Key driver of share value	Buying and selling demand for the security	Buying and selling demand for the underlying securities	Buying and selling demand for the underlying securities
Number of shares	Fixed[1]	Variable[2]	Variable[3]

[1] Unless corporation does new issuance.

[2] ETF shares are typically issued in increments of 50,000 share blocks referred to as creation units.

[3] Outstanding mutual fund shares change daily with shareholder fund flows.

Bigger isn't always better

In order to evaluate ETF liquidity, many wealth managers will base their desired position size on the ETF's AUM or outstanding shares and avoid the fund if they deem their potential position too large. But the supply of ETF shares is not fixed, so a share of the ETF represents proportional ownership in the underlying portfolio of securities and is not an indication of accessible liquidity.

Perhaps an even more common approach to measuring liquidity is to compare order size to the current bid-ask spread for an ETF. The thought is, "My trade will move the market." Again, this screen market approach offers limited information about the available liquidity for a trade, and ETF trading desks are better equipped to access liquidity — and better prices — than managers who base their decisions solely on bid-ask spreads.

Adopting best practices may improve ETF trading execution

- **Test an ETF's liquidity — do not rely solely on screen markets.** Some wealth managers execute trades through a dedicated ETF trading desk to more accurately express their own investment point of view. All ETF trading desks have one thing in common: the ability to access greater liquidity than the screen market shows.
- **Emphasize execution price, not speed.** Limit orders are preferable to market orders because limit orders are executed based on price, whereas market orders are executed based entirely on timing — regardless of price. Placing limit orders emphasizes price, whereas market orders may be faster but don't consider the execution price.
- **Avoid the open and close.** The first and last 30 minutes of the U.S. trading session tend to be the most volatile, especially for ETFs with foreign securities.
- **Keep in mind, the intraday net asset value (NAV) for international ETFs may not necessarily be an accurate indicator of fair value.** Foreign securities exchanges may be closed during U.S. trading hours, and since most ETFs use local market prices to calculate intraday NAVs, they can be poor indicators of fair value.

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