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Understanding ETFs and their liquidity

Liquidity issues are a common misconception

Research and consultancy firm ETFGI reports that globally listed assets of ETFs and exchange-traded products reached a new record high of US$2.55 trillion at the end of May 2014. Canada represents US$63.2 billion of those assets. This remarkable growth has also brought changes.

ETFs started out quite broad-based. However, an influx of specialty products has helped grow their number, with many having smaller assets under management and lower trading volumes. According to BMO Financial Group, 134 ETFs in Canada have assets of $30 million or less, and 191 are trading fewer than 10,000 shares per day.

This has led to a major misconception. Many investors believe that an ETF's daily trading volume indicates its liquidity because small volumes could create difficulties getting in and out of positions. However, ETF trading volumes have a negligible effect on liquidity.

ETFs have three levels of liquidity. The first, and natural, level occurs on the stock market exchange where buyers and sellers match up. The second is through the activity of designated brokers who are responsible for ensuring an orderly market. The third level of liquidity involves underwriters who create or redeem ETF units either offsetting increased demand or tightening supply if demand falls. The true liquidity of an ETF is linked to that of the underlying securities, not the volume.

The BMO S&P/TSX Equal Weight Banks Index ETF (ZEB) is a good example. Its underlying holdings are the six major Canadian banks. Although the ETF often trades as little as 20,000 shares in a day, the banks regularly trade in the millions. Since the daily trading volume of the banks is so large, significant trade orders can be placed for the ETF without impacting its price.

Granted, not all ETFs are liquid and a quick way of assessing an ETF's liquidity is to check the difference between its buying and selling prices. A large spread between the bid and ask generally indicates that its underlying securities may be less liquid. ETFs are required to publish all of their holdings on a daily basis which means investors can look up the individual securities and assess their liquidity.

Regardless of liquidity, ETF investors should follow some simple rules. As with equity trading, it's always prudent to use limit orders on ETF trades. These allow investors to set limits on the prices at which they are willing to buy or sell, affecting profitability.

Those trading in international, commodity, or currency ETFs should make certain the underlying markets are open. If trades are made when the underlying market is closed, investors risk buying or selling at pricing that is at variance with the ETF's net asset value (NAV).

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Investors should avoid trading ETFs at either the open or close of the market. An ETF's price depends on the value of its underlying holdings and it can take a few minutes after market open for the underlying securities to start trading. Investors buying ETFs on market open risk purchasing the ETF before the price changes in the underlying securities have been reflected in its price. Similarly, movement in the underlying portfolio can be volatile near the close and pricing may not be accurate.

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