How does liquidity affect your ETF holdings?

Assess liquidity and then apply simple trading rules

March 20, 2016

By Kim Inglis

The independent research and consultancy firm ETFGI confirms 2015 was another banner year for the global ETFs/ETPs industry, with US$372.0 billion in net new assets – a 10% increase over the 2014 record of US$338.3 billion. Global assets under management grew from US$2.784 trillion to US$2.992 trillion; the number of ETFs/ETPs increased from 5,550 to 6,146; and the number of providers expanded from 239 to 276.

E&Y says institutional investors outside the U.S. have been responsible for most global ETF industry growth in recent years. The trend appears to have legs. An E&Y survey showed clear potential for stronger institutional take-up of ETFs, especially among pension funds and insurers. Active and enhanced beta funds are areas of interest, and E&Y notes that strong liquidity is key to attracting institutional money.

Investors often misunderstand ETF liquidity. Many believe an ETF's daily trading volume indicates its liquidity, thinking that small volumes could create difficulties entering and exiting positions. However, trading volumes have a negligible effect on ETF liquidity.

ETFs have three levels of liquidity with the natural first one occurring on the stock market exchange where buyers and sellers match up. The second is through the activity of designated brokers responsible for ensuring an orderly market. The third level involves underwriters who create or redeem ETF units; either offsetting increased demand or tightening supply if demand falls. An ETF's true liquidity is linked to that of the underlying securities, not trading 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 usually doesn't trade many shares in a day, the bank stocks regularly trade in the millions. The daily trading volume of the banks is so huge, significant trade orders can be placed for the ETF without affecting its price.

Granted, not all ETFs are liquid. A quick way to assess an ETF's liquidity is by checking the spread between buying and selling prices. A large spread between bid and ask generally indicates that its underlying securities may be less liquid. ETFs must publish all of their holdings on a daily basis which means investors can examine the individual securities and assess their liquidity. Investors should be particularly mindful of this with ETFs exposed to the junk bond space or emerging markets debt and bank loans.

Regardless of liquidity, prudent ETF investors will follow simple rules like using limit orders on ETF trades. These allow them to set limits on the prices at which they are willing to buy or sell, affecting profitability.

Investors 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 prices different than the ETF's net asset value (NAV).

© Copyright 2016 Kim Inglis

How does liquidity affect your ETF holdings?

Continued from Page 1

Trading ETFs near the open or close of the market should be avoided. An ETF's price depends on the value of its portfolio content, and it can be a few minutes after market open before the underlying securities start trading. Investors buying ETFs at market open risk purchasing them before ETF prices reflect changes in the underlying securities' prices. Similarly, movement in the underlying portfolio can be volatile near market close and pricing may not be accurate.

Kim Inglis, CIM, PFP, FCSI, AIFP is an Investment Advisor & Portfolio Manager. The views in this column are solely those of the author. www.kiminglis.ca

© Copyright 2016 Kim Inglis