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Why Investors Should Think Differently About ETF Liquidity

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Liquidity can be a central consideration for investors interested in exploring exchange-traded fund (ETF) opportunities. But Jason Xavier, head of EMEA ETF Capital Markets at Franklin Templeton Investments, believes that in many cases individuals remain unsure how liquidity for ETFs is measured and are basing investment decisions on false assumptions.

Given the proliferation of exchange-traded funds (ETFs) across the globe, deciding which to invest in can be overwhelming. Within the selection process, we have found that many investors often misunderstand liquidity and how it's measured in the realm of ETFs.

We believe many investment decisions and much pre-trade analysis continue to be based on potentially misleading volume metrics. In particular, we believe it's a mistake to apply traditional mutual fund screening processes to the selection of an ETF.

Trading Characteristics of an ETF

ETFs share many of the same market structure characteristics of single stocks: both trade on an exchange, both have two-way (buy and sell) pricing, and both are centrally cleared. But in essence, the structure of the underlying investment in each is fundamentally different.

An ETF's underlying value is derived from the price of the basket/index constituents it tracks. Since the underlying basket can typically be exchanged in real-time for the ETF, the composite price of the underlying assets and the price of the ETF are typically very closely aligned.

In other words, the price of an ETF should be based on objective metrics. If the ETF price diverges from the pricing of the underlying assets, a process known as "arbitrage" tends to work to align the two.

We'll come back to arbitrage in a future post, but for now let's think of it as buying and selling the same thing at the same time at two different prices. Should the ETF trade below its composite fair market value, participants would buy the ETF and sell its underlying basket, and vice versa if the ETF were to trade above the composite value.

Different Drivers of Liquidity

By contrast, the underlying liquidity of a single stock is a function of the finite number of shares outstanding.

Let's imagine CompanyCo. has five outstanding shares of stock, of which Investor X and Investor Y own two shares each.

Liquidity is one outstanding share.

Now imagine Investor Z wants a piece of the action and wishes to purchase three shares.

Investors X and Y will need some incentive to sell shares to investor Z.

The price of CompanyCo.shares therefore starts to rise.

Conversely, let's say Investor X and Investor Y both want to sell their two shares because they fear CompanyCo. sales will disappoint. Investor Z will need some incentive to buy them, so the price of the shares will drop.

Thus, the trading volume of the stock gives an indication of the liquidity.

An ETF, on the other hand, is an open-ended fund that can issue more shares based on demand—and can terminate shares based on redemptions.

The underlying liquidity of an ETF is unrelated to volumes traded. ETF volumes tell you only what has traded, not what could be traded. To see what could be traded, an investor has to look through to the underlying stocks at the individual constituents.

For ETFs, Size is Academic

Unlike a mutual fund, an ETF doesn't need a minimum initial client investment to stay open or be liquid and it can exist regardless of any particular investor's allocation. A newly launched ETF will typically have much lower average daily trading volumes than more established or older funds. In addition, newer ETFs tend to have far fewer shareholders—on the first day of trading it's not uncommon for there to be just one. Even so, a new ETF's price will generally remain in line with the price of the underlying basket of securities.

Being the first, second, third or last investor in the fund should have no impact when considering liquidity. An ETF with low trading volume should not (and often does not) prevent smooth trade execution.

So if we think of an ETF as a window into a pool of securities, it should be clear that, in terms of liquidity, the size of an ETF is only academic.

Read Jason Xavier's previous ETF capital markets article here.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Brokerage commissions and ETF expenses will reduce returns. ETF shares may be bought or sold throughout the day at their market price on the exchange on which they are listed. ETFs trade like stocks, fluctuate in market value and may trade above or below the ETF's net asset value. However, there can be no guarantee that an active trading market for ETF shares will be developed or maintained or that their listing will continue or remain unchanged. While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

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