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Understanding the Role of Trading Volume and Size in Assessing an ETF

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Although exchange-traded funds (ETFs) display some similar characteristics to stocks and mutual funds, there are some significant differences. Jason Xavier, head of EMEA ETF Capital Markets at Franklin Templeton, explains why he believes investors should think differently when considering their ETF allocations.

Our last ETF Capital Markets article explored ETF market resilience and tried to dispel the myths around the roles of some market participants. In this article I'm going to try to quash some other misconceptions. This time around I will discuss ETF selection.

Most importantly, our team feels some of the selection criteria used in screening mutual funds—notably trading volume and size (assets under management or AUM)—are not as important as other considerations in the ETF world.

ETF Trading Volume

Let's start with ETF trading volume. In our experience, many investors still use the average daily trading volume of an ETF as the sole metric of its liquidity.

We take a different view and recognise ETFs have two sources of liquidity: the ETF itself and the liquidity of the underlying assets.

To explain that more clearly, remember the trading and market structure of ETFs share similar characteristics to stocks, but the way the units are issued is very different.

The underlying liquidity of a single stock is a function of the finite number of shares outstanding. 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.

When there are more existing shareholders looking to sell than there are new investors looking to buy, market participants known as authorised participants and/or market makers would step in as buyers. The price at which those market participants would purchase the ETF would be driven by the price at which they could sell the underlying basket of securities, since they would most likely need to redeem shares. This dynamic only gets exacerbated when there is extreme selling pressure.

Remember: the volume of ETF shares traded is not an accurate measure of the underlying liquidity of an ETF. 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.

Hence the liquidity of an ETF, be it a newly issued or established product, is always a function of the liquidity of the underlying assets.

Many investors set a lot of stall on understanding the liquidity of any asset in which they're investing. They want to be reasonably confident they can successfully liquidate positions, even in times of stressful market conditions.

Arbitrage: Keeping Prices in Line

The purchaser of an ETF expects its price to be in line with the value of its underlying basket of securities. The concept of arbitrage is what keeps those two values in line. Arbitrage involves buying and selling essentially the same asset at the same time at two different prices in attempt to take advantage of the price discrepancy between these identical (or nearly identical) products selling in different markets or platforms. The difference in prices between the two similar assets is known as the spread.

The ETF's arbitrage mechanism facilitated by market makers and authorised participants keeps the price of the ETF in line with its basket of underlying securities.

For ETFs with liquid underlying baskets (like US large-cap stocks, for example), we would expect the price of an ETF with high average daily volume to trade at similar levels as an ETF with low average daily volume because of the high liquidity in the underlying basket of large-cap US stocks.

For a select few liquid ETFs with slightly less liquid underlying baskets (think US small-cap stocks or high-yield bonds) there is a potential benefit for some market participants to transact within the spread of the underlying securities.

However, when liquidity is needed quickly (particularly when investors look to sell) virtually all ETFs—those with both high AND low average daily volumes—trade at price levels more closely in line where market participants could sell the underlying basket. That's because of the arbitrage mechanism explained above—when prices between the ETF and its underlying basket are out of sync, these arbitrage-minded traders (market makers and authorised participants) will step in, causing prices to move back in line.

Looking Beyond AUM Size

The second selection criteria that we often see misapplied to ETFs is size. Again, we believe the reason people misunderstand this is because they are applying traditional mutual fund considerations to ETFs.

It's true that an investor looking to put €15 million into an ETF with an AUM of €5 million will represent 75% of the fund. But should that be a cause for concern?

To offer an answer for that, let's think back to how an ETF is created. Before the first day of trading, typically there is one firm (the seeding counterparty) that delivers the underlying basket to the ETF issuer in exchange for the first ETF shares.

This seeding counterparty is often 100% of the fund. If those seeding firms are comfortable owning such a limit, then, in our view, there is no reason any investor should have concerns about the viability of an ETF based on its AUM.

What's more important is to determine how the ETF fits in terms of asset allocation of an investor's broader portfolio.

In our view, there are much more important considerations for investors than obsessing about the relative proportion of an ETF's AUM that they own.

We believe investors should be more concerned with choosing an ETF that gives them the exposures they want, and then making the appropriate investment to deliver the investment goals.

View Jason Xavier's previous articles here: http://global.beyondbullsandbears.com/author/pm-xavier/

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