LIBERTYSHARES

Rethinking the Bid/Ask Spread for ETF Investors

May 31, 2019

Jason Xavier
Head of EMEA ETF Capital Markets
Franklin Templeton Investments

Jason Xavier, head of EMEA ETF Capital Markets at Franklin Templeton, is on a quest to demystify exchange-traded fund (ETF) investing. In this article, he explores why some investors misunderstand the significance of bid/ask spreads in assessing the attractiveness of ETFs.

Over a series of articles, we have been trying to resolve the misconceptions some investors have about ETFs.

Previous articles have looked at the role of trading volume and size and market resilience.

In this article, we're going to look at "bid/ask spreads" and illustrate why some of the most widely used metrics can potentially be misleading.

Assessing the Spread

Remember, in many instances, ETFs display some similar characteristics to stocks and mutual funds. The bid/ask spread is one of them.

We would argue that the transparency of the bid/ask spread as it operates in the ETF ecosystem contributes to the democratisation of this style of investing.

Put simply, the bid is the highest amount at which a person is willing to buy and the offer (or "ask") is the lowest amount at which they are willing to sell. The difference between those prices is the "spread". This spread usually factors in the cost of executing the underlying basket of assets, plus any hedging costs for the market maker.

At first glance, it may seem obvious that a tighter spread is better than a wider spread. A small difference between what buyers are willing to pay and what sellers are offering implies the market is highly liquid, with intense price competition and high demand for the asset in question.

A More Nuanced Calculation

That said, the situation is a bit more nuanced. To illustrate this, let's look at two examples:

Imagine two ETFs with identical underlying securities.

ETF A has a bid price (what the buyer is willing to pay) of €21.02 and an ask price (what the seller is offering) of €21.05.

ETF B has a bid price (what the buyer is willing to pay) of €98.73 and an ask price (what the seller is offering) of €98.79.

So, the spread of ETF A is three cents, while the spread of ETF B is six cents. However, considering the spread in euro/cents terms only gives us one dimension of the story.

We get a very different view if we look at the spread in percentage terms, considering the price of the stock.

In that instance, the spreads look like this:

ETF A: 100 x (€21.05 – €21.02)/€21.05 = 0.14% or approximately 14 basis points.[1]

ETF B: 100 x (€98.79 – €98.73)/€98.79 = 0.06% or approximately six basis points.

Put more simply, a three-cent spread is a larger proportion of the lower stock price than the six-cent spread is of the higher stock price.

What Is It Worth?

However, the bid/ask spread does not reflect what the ETF is worth.

To us, this is an important aspect that merits more discussion. The price of an ETF—especially a newly launched ETF—is driven by the costs associated with assembling the underlying basket of securities.

Let's look at another example. This time we will assume two separate ETFs with identical underlying securities held at equal weights. Based on the price of the basket of securities, both ETFs are worth €27.50.

The market for ETF A: €27.39 Bid x €27.53 Ask
The market for ETF B: €27.48 Bid x €27.55 Ask

We can see the spread of ETF A (at 14 cents) is almost twice as wide as ETF B (at seven cents).

But despite the wider spread, investors might consider ETF A to be more desirable because its shares are offered closer to the price of the underlying basket.

In other words, if the two ETFs are identical and have the same underlying basket of securities, the value of the securities is also the same, so it makes sense that an investor would want to buy the one offered at a lower price – i.e., to pay less for the same security.

What does all this mean to potential investors? One of the main functions of our ETF Capital Markets team is to work with the market participants to discuss the costs of assembling the basket and what that means to the price of the ETF.

The goal is for potential investors to have confidence that shares can be purchased at levels that are in line with the price of the underlying basket.

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

To get insights from Franklin Templeton delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

To comment or post your question on this subject, follow us on Twitter @FTI_Global and on LinkedIn.

The comments, opinions and analyses are the personal views expressed by the investment managers and are intended to be for informational purposes and general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. The information provided in this material is rendered as at publication date and may change without notice and it is not intended as a complete analysis of every material fact regarding any country, region market or investment.

Data from third-party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information, and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user. Products, services and information may not be available in all jurisdictions and are offered by FTI affiliates and/or their distributors as local laws and regulations permit. Please consult your own professional adviser for further information on availability of products and services in your jurisdiction.

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.

---

1. A basis point is a unit of measurement. One basis point is equal to 0.01%.