A great deal of attention has been focused on the growth of the exchange-traded fund (ETF) industry. Yet many investors restrict themselves to a small number of products. Some wealth managers are using thinly traded ETFs to more accurately express their own investment points of view. They do so by executing through a dedicated ETF trading desk. These wealth managers offer both a more flexible set of choices and a differentiated practice. Understanding that a specialized ETF trading desk can unlock the true liquidity of an ETF is a competitive advantage.

Please note, this article focuses on plain vanilla equity ETFs and does not consider factors that affect derivative-based, leveraged, short, or fixed-income ETFs.

**Most ETFs are Small and Thinly Traded**

As of December 2011, the U.S. ETF industry included more than 1,300 funds, totaling more than $1 trillion in assets. In 2011, ETFs accounted for more than 30 percent of the total traded value in U.S. listed equities. Despite these volumes, most ETFs have few assets and trade very little. Twenty-five ETFs account for more than two-thirds of trading volume and more than 50 percent of assets.

Because the majority of wealth managers believe an ETF’s liquidity is tied to fund assets and volume, they tend to avoid ETFs that are small and thinly traded. The consequence of this approach is a restricted set of choices. For example, a screen that excludes ETFs with less than $100 million in assets and 1 million shares in average daily volume (ADV) eliminates more than 90 percent of the choices in the entire U.S. ETF universe (see figure 1). Wealth managers increasingly will reject these sorts of criteria to improve their ability to implement investment views.

**ETFs Do Not Trade Just Like Stocks (But the Stocks They Own Do)**

Since ETFs were introduced, it has been said often that ETFs trade “just like stocks.” This claim is not true, and it is in fact the root of the misunderstanding that surrounds ETF liquidity. The supply of shares of an individual company is limited to the amount issued. Market demand for the individual security drives the price. Market participants expect large trades of a thinly traded stock to affect the price.

ETFs, however, are open-end funds and—like mutual funds—market
demand for stocks in the underlying portfolio drives the price. The supply of ETF shares is not fixed and can expand or contract daily, limiting the effect that properly executed trades can have on the price of ETF shares. Large orders either are filled with outstanding shares or, when necessary, by creating or redeeming shares. As a result, the “screen market”—the fund’s assets under management (AUM), bid-ask spread, or ADV—will not reveal the true liquidity available for an ETF transaction (see figure 2).

The Screen Market is Not the Market

When trading in ETFs, investors should look beyond the screen market and avoid being fooled by the following situations:

Don’t wait for the fund to be large enough. To evaluate ETF liquidity, many wealth managers compare a desired position size to the ETF’s AUM or shares outstanding, avoiding the fund if they deem the potential position too large. Because a share of the ETF represents proportional ownership in the underlying portfolio of securities, the screen market (in this case the shares outstanding) offers limited information about the accessible liquidity. Figure 3 highlights the second day of trading for the EGShares Emerging Market Consumer ETF (ticker: ECON). At the market opening only 100,000 ECON shares were outstanding (about $2 million in AUM). That afternoon an investor purchased more than 234,000 shares (almost $5 million) of ECON—more than twice the fund’s total size. This investor (with the help of the investor’s own ETF trading desk) understood that additional ETF shares could be created by accessing the liquidity of the underlying stocks. The existing fund size offered little help in evaluating the true liquidity. This $5-million trade was insignificant relative to the more than $200-billion market cap of the underlying index.

Don’t expect that your trade will move the market. Perhaps an even more-common approach than using fund assets to measure liquidity is to compare order size to ADV or current bid-ask spread for an ETF. Again, the screen market offers limited information about the available liquidity. Figure 3 highlights the second day of trading for the EGShares Emerging Market Consumer ETF (ticker: ECON). At the market opening only 100,000 ECON shares were outstanding (about $2 million in AUM). That afternoon an investor purchased more than 234,000 shares (almost $5 million) of ECON—more than twice the fund’s total size. This investor (with the help of the investor’s own ETF trading desk) understood that additional ETF shares could be created by accessing the liquidity of the underlying stocks. The existing fund size offered little help in evaluating the true liquidity. This $5-million trade was insignificant relative to the more than $200-billion market cap of the underlying index.

FIGURE 3: ECON VOLUME AND SHARES OUTSTANDING

30-minute trading intervals, Monday 9/13/2010 to Friday 9/17/2010

FIGURE 4: ECON SCREEN MARKET

Market snapshot, 12/15/2011 11:59:42 EST

Total Fund Assets: $276 million
Shares Outstanding: 13,050,000
ADV (6-month): 112,321

Bid Statistics | Ask Statistics
--- | ---
Exchange | Size | Price | Price | Size | Exchange
ARCX | 12,900 | 21.21 | 21.28 | 1,700 | ARCX
NSDQ | 2,000 | 21.21 | 21.28 | 100 | NSDQ
BATS | 2,000 | 21.21 | 21.30 | 1,500 | BATS
CBSX | 400 | 21.06 | 21.43 | 400 | CBSX

For illustrative purposes only.

Source: Bloomberg data as of December 15, 2011

A wealth manager may use one or more types of ETF trading desks. They all have one thing in common: the
ability to access greater liquidity than the screen market shows. Some access liquidity as an aggregator, on an agency basis. Others provide liquidity on a principal basis. In either case, using a specialist ETF trading desk often leads to tighter markets and better execution. These desks also can offer guidance for managing smaller orders for single accounts or portfolio cash flows.

An ETF’s true liquidity can easily be tested. A wealth manager may choose a thinly traded ETF that might have been avoided because of perceived illiquidity. The wealth manager’s dedicated ETF trading desk can provide a two-way, indicative market for a large order of that ETF. Wealth managers who are new to this process may be surprised by the execution improvement that is possible.

Conclusion

Wealth managers who use thinly traded ETFs can more precisely express their investment views. An ETF trading desk can reveal the true liquidity of an ETF, accessing tighter markets than the screen market shows.

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Endnotes

3 Agency desks vary by type. Examples include dedicated desks within large broker–dealers and specialist agency ETF firms.

Disclosures: Fund Objective: The EGShares Emerging Markets Consumer Exchange-Traded Fund (ETF) seeks to achieve its investment objective of total return by investing in the constituent securities of the Dow Jones Emerging Markets Consumer Titans Index. The index measures the stock performance of 30 leading emerging market companies in the Consumer Goods and Consumer Services Industries as defined by the Industry Classification Benchmark (ICB). Performance data quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor’s shares, when sold or redeemed, may be worth more or less than the original cost. Current performance data may be higher or lower than actual data quoted.

Investors should carefully consider the investment objectives, risks, charges, and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, please visit EGShares.com to view or download a prospectus. Read the prospectus carefully before investing.

Emerging market investments involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, from economic or political instability in other nations or increased volatility and lower trading volume. This fund will concentrate its investments in issuers of one or more particular industries to the same extent that its underlying index is so concentrated and to the extent permitted by applicable regulatory guidance. Concentration risk results from maintaining exposure to issuers conducting business in a specific industry.

ETF shares are not individually redeemable securities. As is true of other listed equities, there is no assurance that an active liquid trading market for fund shares will develop or be maintained. The statements and opinions expressed are those of the author and are as of the date of this report. All information is historical and not indicative of future results and subject to change. Reader should not assume that an investment in the securities mentioned above was or would be profitable in the future. This information is not a recommendation to buy or sell. Past performance does not guarantee future results.