Understanding ETF liquidity

Nick Good of iShares looks at some of the key issues when it comes to understanding liquidity in relation to ETFs, and addresses some of the common misconceptions.

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Interview

Nick Good

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- Liquidity is an important issue with ETFs because investors want to be able to get their money back
- A key form of liquidity is the creation and redemption mechanism to enable units to either be created or redeemed to match overall market demand
- Investors who want to buy or sell an ETF with low liquidity can access the underlying liquidity of the securities
- A common misconception among investors when it comes to liquidity of ETFs is that they look at the trading volume on the screens and assume this is the only source of liquidity

Liquidity is an important issue with ETFs, said Nick Good in an interview, for the simple reason that investors want to be able to get their money back.

There are two factors investors and advisers should consider in relation to liquidity, he explained. The first is having a multiple market-making model. This means there are many people offering a price, so that when people want to buy more, or exit, they don't have to go back to the same place where they bought it in the first place.

The second factor, said Good, is the overall liquidity – which is based both on what people can see trading in the market as well as on the underlying liquidity of the portfolio which the ETF is tracking through the creation and redemption mechanism.

What to consider when assessing liquidity

According to Good, an ETF offers both the benefits of a stock and a fund, and its liquidity comes from these two sources.

One way for an investor to buy an ETF is on an exchange, like any stock. They will pay the trading costs, but essentially they are buying it on the market.

iShares maintains a capital markets team to ensure there are many market-makers who are competing to make the most attractive bid and offer spreads for investors, explained Good, even in low-liquidity environments.

A second form of liquidity, which is a key aspect of ETFs, he added, is the creation and redemption mechanism.

This means that if there are more buyers than sellers, or vice versa, units can either be created or redeemed to match the overall demand, explained Good. This is different from stocks, which need as many buyers as sellers to trade.

For investors, he added that this means when they want to buy or sell an ETF with low liquidity, they can access the underlying liquidity of the securities.

Misconceptions with ETF liquidity

Good said that a common misconception among investors when it comes to liquidity of ETFs is that they look at the trading volume on the screens and assume this is the only source of liquidity.

This is clearly an important part of liquidity, he said, in that an ETF which trades more heavily on an exchange benefits from the market liquidity – working in a similar way to a stock.

But it is still possible to buy into an ETF or sell a position on an ETF regardless of whether it is trading heavily on the exchange, he added.

The creation and redemption mechanism helps investors overcome this, explained Good, so it is not necessary to have a liquid product on the exchange to be able to sell it relatively easily.

Enhancing ETF liquidity

Even in low-liquidity products, Good said that iShares, through its efforts to provide depth in the market with multiple market-makers, can help ensure there are tight spreads and good pricing.

An example he gave of this liquidity support was a client who wanted to buy 800,000 shares of three of iShares' less frequently-traded products. That client was able to execute the entire trade at the net asset value of the fund in the pre-market session, he said.