ETF Liquidity Myths

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Overview

Since the introduction of ETFs in 1990 there have been many myths surrounding several aspects of these relatively new products. In 2018, Bristol Gate launched actively managed ETFs and based on the feedback from advisors we wanted to provide insight into a common misconception: ***liquidity***.

Liquidity of common equities is represented by the amount of buyers and sellers in a marketplace, and to what degree they are willing to transact on a security. The more market participants willing to buy and sell a security, the faster, easier, and cheaper it becomes to complete a transaction.

Even though ETFs are traded on the secondary market, like common shares of a public company, their liquidity is often much greater than what meets the eye. This is attributed to ETFs construction and characteristics.

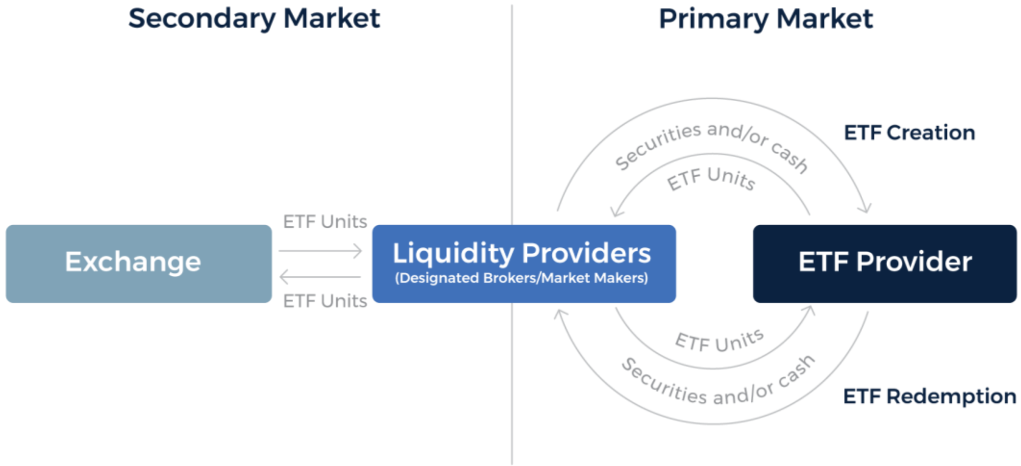
Myth #1: Low Daily Trading Volume Translates to Low Liquidity

Unlike common shares of a public company, an ETF's liquidity is not based on its daily trading volume. Rather, it is dependent on *the liquidity of the underlying basket of securities* that make up the ETF. To further distinguish the liquidity characteristics of stocks and ETFs; stocks have a fixed number of shares outstanding. Conversely, ETFs are open-ended vehicles. Their units can be created and/or redeemed on request to meet investor demand.

One of the many roles of the Designated Broker, also known as a Market Maker, is assisting in the creation of ETF units. When an investor wishes to purchase an ETF they can approach the Market Maker and request those units on demand. Then on the open market, the Market Maker will purchase the basket of stocks that make up the ETF and deliver the securities to the ETF provider (which is the creation basket) in exchange for units of the ETF. This is called the Creation of Units. As mentioned above, this process can be completed on demand.

As the ETF Unit Creation process involves the Market Maker first purchasing the underlying securities on the open market, we can see how ETF liquidity is determined by the liquidity of the individual securities, and not the daily volume traded of the ETF. In the case of Bristol Gate's ETFs, which are comprised of large cap stocks that are frequently traded, the creation of units to satisfy demand is done quickly with little market impact.

While Buyers and Sellers trade ETFs on the secondary market, the price they pay is based on the value of the basket of underlying securities that make up the ETF, not the supply and demand of the ETF itself.

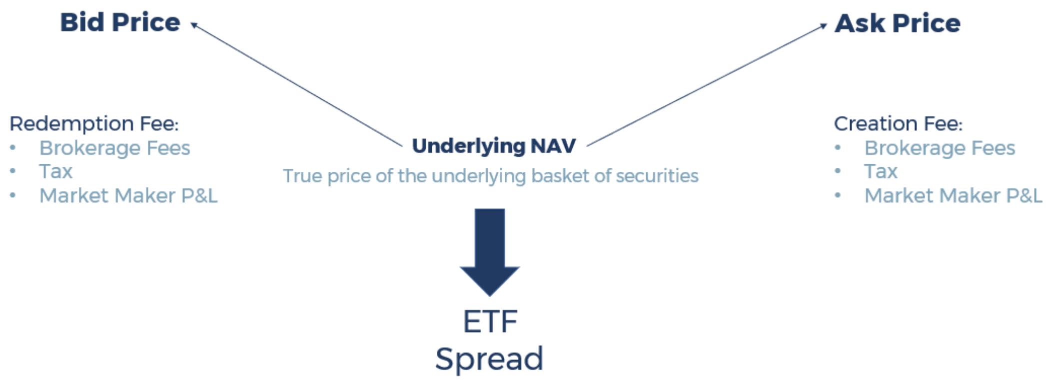


Myth #2: ETF Liquidity is Reflective Entirely by What is 'On Screen'

Further to the misconceptions surrounding the underlying liquidity of ETFs, many believe Bid/Ask sizes are limited to what is posted and seen 'on screen'. The reality is that many Market Makers will only post a fraction of their total inventory. The market makers post these smaller sizes to manage their risk and exposure to events occurring throughout the day. A Market Maker is likely willing to trade substantially more than what is represented on the order book.

Myth #3: Spreads on Actively Managed ETFs are Wider

The width of spreads (the difference between the bid and ask prices) are dependent on the liquidity of the underlying basket of securities. If the portfolio is made up of esoteric, illiquid securities, spreads will be much wider to reflect the risk to the Market Maker. However, if the underlying basket is made up of liquid, highly traded securities then spreads will be smaller. Below helps explain how an ETF spread is determined.



In the case of the Bristol Gate ETFs, the underlying portfolios are made up of S&P500 and S&P/TSX companies which are constantly traded and very liquid. Therefore, the value of the underlying basket can be as the value of the basket plus small auxiliary costs explained above. This reduces the risk to the Market Maker's exposure and results in narrow spreads.

Tips for Placing ETF orders:

- Use limit orders. Ensure the bid-ask spread makes sense and then put in an appropriate limit order.
- Due to the potential for increased ETF price volatility in the first and last 30 minutes of market hours, investors may consider avoiding trading at these times.
- For orders over 10,000 units, contact the Bristol Gate Relationship Management Team or our Market Makers.