

# ANALYZING ETF LIQUIDITY

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## ETF STRUCTURE

ETF liquidity is fundamentally different from individual stock liquidity because, unlike shares in equities, shares in ETFs can be created and redeemed as needed by tapping into the liquidity of the underlying securities (See Understanding ETF Liquidity and Trading). While there are many variables that can influence an ETF's liquidity, the true liquidity of an ETF becomes apparent when the creation/redemption mechanism comes into play. The process enables ETFs to trade at or near the intraday value of underlying securities, even in small or thinly-traded ETFs (See ETF Liquidity: What Really Matters).

The asset class, market capitalization, and daily volume of the underlying components of an ETF are important factors of liquidity, and are well documented (See Inside the Trade: A Proven Tool for Managing Liquidity). In this piece, however, we will look at other influences you should consider when assessing the liquidity of an ETF.

**Creation/Redemption Fees:** Particularly in outsized trades, creation/redemption fees will have a direct impact on the trade execution price of an ETF. When an investor places a large trade, secondary market volume in the ETF becomes less relevant, because the trade is looking through to the primary markets and the creation/redemption process for execution. An Authorized Participant may have to pay a fee to create or redeem the required shares, which will be passed through to the investor.

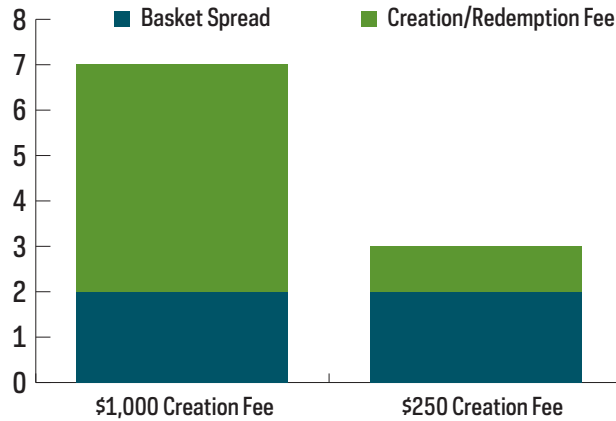
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## Exhibit 1: Impact of creation/redemption fees on a hypothetical ETF

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Assuming an ETF has a Net Asset Value (NAV) of \$40, the underlying basket of securities has a spread of two basis points, and the unit size is 50,000 shares, a creation redemption fee of \$1,000 will cost an Authorized Participant five basis points versus one basis point for a fund with a \$250 fee.

### Cost to Create (basis points)



**Unit Size:** When a market maker sells shares an ETF in the secondary market, they will either sell it from their inventory or short the ETF. If they do not have sufficient shares to meet the order, the market maker will need to create new shares or locate/purchase shares (which can be costly). When a fund trades infrequently, a market maker may be also concerned that they will need to hold extra shares in inventory for long periods (which is an additional cost). Because of these concerns, a market maker will be reluctant to create shares that may result in a large and lengthy capital outlay. Smaller unit sizes will decrease the initial capital outlay, lessen the number of shares held in inventory and ultimately improve market quality.

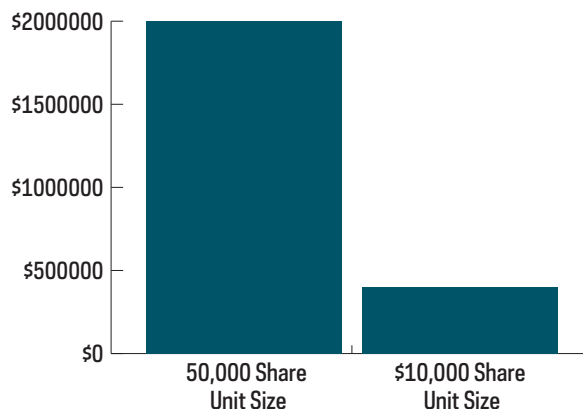
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### Exhibit 2: Impact of unit size on a hypothetical ETF

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Using the same hypothetical ETF as in Exhibit 1, with an NAV of \$40 and unit size of 50,000 shares, lowering the unit size to 10,000 shares will require a much smaller capital outlay for the Authorized Participant.

### Capital Outlay to Create One Unit



Creation fees and unit sizes are often overlooked factors that may have a direct impact on ETF liquidity. Investors should be aware of these factors and take them into consideration when evaluating an ETF.

Investors making large trades should contact the ETF issuers directly and work with their capital markets desks to help facilitate trade execution.

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## Key terms

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- **Market Maker:** An individual or intermediary that offers to buy and sell a security.
- **Authorized Participants:** Large institutions that transact directly with ETF providers to create or redeem ETF shares.
- **Creation unit:** The minimum number of ETF shares required to transact directly with the ETF issuer.
- **Primary market:** The exchange of securities for shares of an ETF that occurs directly between authorized participants and ETF providers.
- **Secondary market:** The national markets system (e.g., the stock exchanges and other venues where listed securities can be traded). Shares of ETFs are continuously bought and sold by investors throughout the day on an exchange or other trading venue.
- **Basket spreads:** The aggregate average bid/ask spread of the underlying securities in an ETF.
- **Unit Size:** A minimum block of shares that can be created or redeemed through an ETF issuer by an Authorized Participant.

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This information is not meant to be investment advice.

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