UNPACKING ETFS: FIVE FUNDAMENTAL QUESTIONS ANSWERED

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ETFs are simple products to understand, but sometimes, the behind-the-scenes on how they are brought to market and traded is a bit confusing. To address this possible confusion and in the spirit of Financial Literacy Month, I have answered below five of the most commonly asked questions about ETFs by investors.

1. What is the ETF primary market?

The ETF creation and redemption processes take place in the primary market. A creation or redemption takes place between the ETF issuer and the authorized participant ("AP"). These transactions occur away from an exchange and are not accessible to regular investors. An AP is a financial institution that offers basket liquidity in the primary market, which is different from a market maker's role as a liquidity provider in the secondary market. In times when an ETF market price is not trading close to its intrinsic value, the AP also hopes to profit from an ETF via arbitrage when the ETF share price is different from the underlying basket's value.

2. Is liquidity just on-screen trade volume?

No. The "true" liquidity of an ETF is based on its underlying assets and is as liquid as its least liquid underlying security in the basket. Hence, by themselves, the ETF's average trading volume and total assets do not paint the full liquidity picture.

3. What is the cost of an ETF?

The cost of an ETF is not just the annual expense ratio but also the bid/offer spread, premiums/discounts to the NAV and commissions.

4. What exactly is the ETF's bid/offer spread?

Simply, it incorporates all the trading costs (create/redeem fees, spreads of underlying securities in the basket, hedging costs, trade financing costs and taxes) and gets passed on to the investor. Numerically, the investor should view the spread as a fraction of the ETF price. For example, an ETF with a spread of 20 cents and a share price of $50 will be considered to be more expensive (0.20/50 = 0.40% or 40 bps) than one with a share price of $100 (0.2/100 = 0.20% or 20 bps).

The wider the spread, the more expensive it is to trade the ETF and the underlying basket. The tighter the spread, the less expensive it is to trade the ETF and the underlying basket.

As an ETF grows and becomes more actively traded, its costs reduce, and generally, spreads tighten.

5. What are some ways to seek "best execution" for a trade?

It is always good to monitor the National Best Bid and Offer ("NBBO"), as it represents the tightest bid/offer spread for a given ETF. Also, it is good to know the implied liquidity of that ETF to know if a client's trade will be easily absorbed into the market without any spike in price. When placing a trade order, a client should always place a "limit order," which tells the broker to transact the trade at a given price or better. A limit order differs from a market order because if the requirements of the limit are not met, then the order does not have to be filled, whereas market orders rely on immediate execution at the trade arrival's price. Also, it is recommended to avoid trading at the open or close of a market session, as those times generally correspond to lower liquidity.

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DEFINITIONS

Primary Market : The primary market is the market where shares of an ETF are created or redeeme.

Baskets : The composition of an ETF in terms one creation/redemption unit.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Intrinsic value : Value of a firm based on its operations, business practices and profitability, which may or may not be closely related to the value of that same firm based on its equity share price.

Arbitrage : The simultaneous purchase and sale of the same asset in different markets in order to profit from tiny differences in the asset's listed price.

Bid/Ask Spread : This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

Premium : When the price of an ETF is higher than its NAV.

Discount : When the price of an ETF is lower than its NAV.

Basis point : 1/100th of 1 percent.

Limit Orders : An order placed with a brokerage to buy or sell a set number of shares at a specified price or better.