LOOKING BEYOND MYTHS AND LIQUIDITY SCREENS TO UNDERSTAND ETFs

Despite the growth of the exchange-traded fund (ETF) industry, many investors concerned about liquidity restrict themselves to a small number of products. But a closer look at the characteristics of the ETF structure and the ETF universe reveals that many of the liquidity screens used — including fund size and bid-ask spread — aren’t indicative of an ETF’s true liquidity.

By looking beyond these screens, understanding common myths surrounding ETFs and following ETF trade execution best practices, wealth managers can gain a competitive advantage.

As of September 30, 2019, the U.S. equity and fixed-income ETF market included more than 1,700 funds, totaling more than $3.2 trillion in assets. Despite the number of funds, most ETFs have few assets and are rarely traded. The 50 most actively traded equity and fixed-income ETFs account for more than 74% of trading volume and more than 38% of assets.

Figure 1: ETF trading activity is highly concentrated among a handful of funds (six-month average daily trading volume 04/01/19 – 9/30/2019)

Source: Bloomberg as of September 30, 2019. Graphic excludes ETFs with six-month ADV greater than 10 million shares.

Past performance does not guarantee future results.
ETFs are less like stocks than you may think

Since their introduction, it has often been said that ETFs trade just like stocks. This claim is not only false, but is in fact the root of the misunderstanding that surrounds ETF liquidity. ETFs are open-end funds, and like mutual funds, market demand for the underlying portfolio is what drives the price. The supply of ETF shares can expand or contract daily, limiting the effect that properly executed trades can have on the price of ETF shares. Large orders are either filled with outstanding shares or, when necessary, by creating or redeeming shares. As a result, the screen market — the fund’s assets or bid-ask spread — does not reveal the true liquidity available for an ETF transaction.

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Stocks</th>
<th>ETFs</th>
<th>Mutual funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading period</td>
<td>Intraday</td>
<td>Intraday</td>
<td>End of day</td>
</tr>
<tr>
<td>Share price advertised</td>
<td>Every trade</td>
<td>Every trade</td>
<td>End of day</td>
</tr>
<tr>
<td>Can be sold short</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>'40 Act Fund</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Composed of a portfolio of underlying securities</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Key driver of share value</td>
<td>Buying and selling demand for the security</td>
<td>Buying and selling demand for the underlying securities</td>
<td>Buying and selling demand for the underlying securities</td>
</tr>
<tr>
<td>Number of shares</td>
<td>Fixed(^1)</td>
<td>Variable(^2)</td>
<td>Variable(^3)</td>
</tr>
</tbody>
</table>

1 Unless corporation does new issuance.
2 ETF shares are typically issued in increments of 50,000 share blocks referred to as creation units.
3 Outstanding mutual fund shares change daily with shareholder fund flows.

Bigger isn’t always better

In order to evaluate ETF liquidity, many wealth managers will base their desired position size on the ETF’s AUM or outstanding shares and avoid the fund if they deem their potential position too large. But the supply of ETF shares is not fixed, so a share of the ETF represents proportional ownership in the underlying portfolio of securities and is not an indication of accessible liquidity.

Perhaps an even more common approach to measuring liquidity is to compare order size to the current bid-ask spread for an ETF. The thought is, “My trade will move the market.” Again, this screen market approach offers limited information about the available liquidity for a trade, and ETF trading desks are better equipped to access liquidity — and better prices — than managers who base their decisions solely on bid-ask spreads.

Adopting best practices may improve ETF trading execution

- **Evaluating an ETF’s liquidity** — consider not relying solely on screen markets. Some wealth managers execute trades through a dedicated ETF trading desk to more accurately express their own investment point of view. All ETF trading desks have one thing in common: the ability to access greater liquidity than the screen market shows.

- **Execution price and timing**. Limit orders are preferable to market orders because limit orders are executed based on price, whereas market orders are executed based entirely on timing — regardless of price. Placing limit orders emphasizes price, whereas market orders may be faster but don’t consider the execution price.

- **Understanding the open and close**. The first and last 30 minutes of the U.S. trading session tend to be the most volatile, especially for ETFs with foreign securities.

- **Keep in mind, the intraday net asset value (NAV) for international ETFs may not necessarily be an accurate indicator of fair value**. Foreign securities exchanges may be closed during U.S. trading hours, and because most ETFs use local market prices to calculate intraday NAVs, they can be poor indicators of fair value.
About Columbia Threadneedle Investments

Columbia Threadneedle Investments is a leading global asset management group that provides a broad range of investment strategies and solutions for individual, institutional and corporate clients around the world. With more than 2,000 people, including over 450 investment professionals based in North America, Europe and Asia, we manage $469 billion* of assets across developed and emerging market equities, fixed income, asset allocation solutions and alternatives.

Investing involves risk including the risk of loss of principal. ETFs may trade at a discount to NAV, are subject to tracking/correlation risk and shareholders bear additional ETF expenses.

ETF shares are bought and sold at market price (not NAV) and are not individually redeemable. Investors buy and sell shares on a secondary market. Shares may trade at a premium or discount to the NAV. Only market makers or “authorized participants” may trade directly with the Fund(s), typically in blocks of 50,000 shares.

* In U.S. dollars as of September 30, 2019. Source: Ameriprise Q2 Earnings Release. Includes all assets managed by entities in the Columbia and Threadneedle group of companies.

Contact us for more current data.

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