ETF Trading Primer

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Understanding ETF Liquidity

Trading liquidity is a measure of an investor's ability to buy or sell an investment without significantly affecting the price, which is a function of supply and demand. Common stock investors often look at trading volume or market capitalization as a measure of liquidity. If the trading volume for a common stock is low, there is a risk that a sizeable sell order will cause the price to drop, or a buy order will drive the stock price higher. For this reason, many investors actively avoid stocks with low trading volumes or small market capitalization.

It's a common misconception that the same measures apply to ETFs – but this is not the complete picture. Unlike individual stocks, the market capitalization or trading volume of an ETF is only one of three layers of trading liquidity that investors can access.

1 Secondary Market

This form of liquidity is provided by other investors who are willing to buy or sell an investment at given price. An ETF's on-screen trading volume on the exchange is a measure of secondary market liquidity. For common stocks, which have fixed numbers of shares outstanding, this liquidity measure is very important. For an ETF, secondary liquidity is actually a less important source of liquidity compared to other avenues.

2 Market Depth

This form of liquidity is provided by market makers (one or more securities dealers engaged by the ETF manager to continuously post bids and offers on the exchange). Market Makers estimate the NAV of the ETF throughout the trading session, and they post bids and offers that bracket the NAV estimate. Investors can access Market Depth liquidity by buying an amount equal to or less than the amount offered by the market maker, or similarly by selling an amount equal to or less than the amount bid by the market maker.

3 Primary Market

Market makers providing Market Depth liquidity typically only display a small fraction of the ETF volume they are willing to trade. If a Market Maker receives an order for a greater number of shares than is available through their Market Depth quote, they can provide more liquidity by accessing the Primary Market: the ETF creation or redemption process. Approved market makers can request that the ETF create or redeem shares at NAV, which means that liquidity provided through the Primary Market is limited only by the liquidity available for each security in the ETF's portfolio.

The three liquidity mechanisms available to ETF investors means that they can often access significant liquidity beyond what is directly observable by the volume or the bid and offer sizes posted on a stock exchange.

Tips for Trading ETFs

Here are some best practices for trading ETFs to source liquidity and facilitate efficient trade execution.

1 Use Limit Orders

A good rule of thumb for ETF investors is to enter orders as limit orders and not market orders. A limit order helps protect against the risk that the trade is fulfilled at a price that deviates significantly from NAV.

For example, when placing an order to buy an ETF, look for the offer price where there is the most amount of size quoted, and place your limit order at or slightly above that posted offer price. When placing an order to sell an ETF, look for the bid price where there is the most amount of size quoted, and place your limit order at or slightly below the posted bid price. Also, you can refer to www.bromptongroup.com for the previous day's closing NAV on the ETF if you are interested in a general benchmark as to where the ETF's NAV should be.

2 Avoid Trading Near Market Open/ Close

In general, it's a good idea to avoid buying or selling during the first and last 15 minutes of the trading day.

When the market opens, it may take some time for the underlying ETF investments to begin trading and have their value reflected in the price of the ETF. Before all of the ETF portfolio investments are trading, market makers may demand wider spreads as compensation for price uncertainty.

Market makers will keep the ETF's trading value in line with its NAV throughout the day but they may step back from the markets to limit their risk headed into the close. At this point, spreads tend to widen as there are fewer market participants actively quoting prices.

3 Look at Consolidated Quotes

There are many venues on which Canadian-listed ETFs may trade. Depending on your market data feed, you may be seeing only a fraction of the total trading volume, along with stale pricing data. A consolidated view will provide the most up-to-date bid, offer, and last price based on trading of the ETF on all trading venues. A list of consolidated quote tickers for Brompton ETFs can be found on our website.

4 Liquidity Providers Can Fill Large Orders

As discussed above, deep and liquid markets can exist for an ETF even when the volumes shown on the exchange do not appear to be liquid. Because authorized participants can always create new shares of an ETF by buying up the underlying securities and submitting them to an ETF issuer, an ETF can be considered as liquid as its underlying holdings.

If you are looking to place an ETF order that is significantly larger than the bid or offer size posted on the exchange, contact your dealer's ETF trading desk to take advantage of the wider range of liquidity options available. Your ETF trading desk will help you locate ETF liquidity and trade efficiently. A list of contact information for ETF desks at various dealers can be found on our website. If your dealer is not listed or if you have further questions, contact Brompton Funds at 1-866-642-6001.

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