ETF LIQUIDITY, EXPLAINED

1 WHAT ARE THE COMMON MISCONCEPTIONS AROUND LIQUIDITY IN ETFs?

A common misconception around investing in ETFs is that the volume and size of an ETF is the best indicator of the liquidity available when considering an investment. In fact, the secondary market volume is just the tip of the iceberg and it is more informative to look at the total liquidity profile of the ETF.

- The fundamental driver of an ETFs liquidity is the underlying securities which the ETF tracks
- Secondary market volume of the ETF acts to supplement underlying liquidity allowing additional efficiencies
- AUM is a measure of the popularity of an ETF more than its potential liquidity

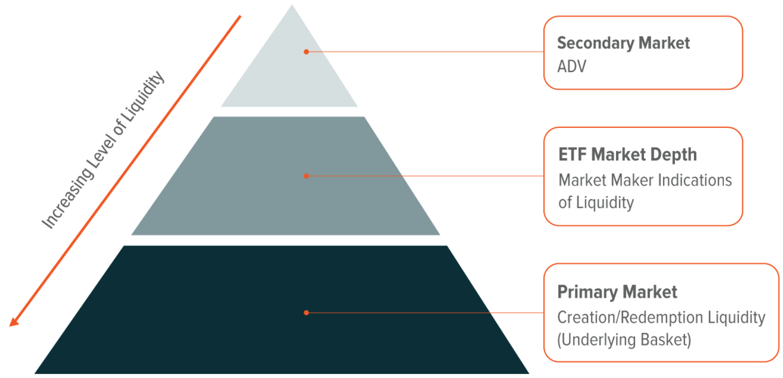
2 WHAT IS ETF LIQUIDITY?

For an ETF investor liquidity means how quickly and cheaply can they buy or sell their position and how much will it impact the asset's price. Because ETFs trade on exchange they are often compared to equities however there are some fundamental differences when assessing liquidity. When looking at a stock a fixed number of shares is in issue so buying or selling a significant amount of the stocks Average Daily Volume (ADV) can affect the price. Unlike a stock, ETFs are open ended so can adjust the supply of shares in the secondary market to meet demand via creation and redemption in the primary market.

3 HOW DOES ETF LIQUIDITY WORK?

It can be helpful to think of ETF liquidity in layers. The Secondary market is where ETF investors buy and sell shares and is the more visible layer of the ETFs liquidity. Activity is transacted on exchange or subsequently reported to an exchange or venue and is visible in the trading volume of the ETF. In Europe it is important to remember that most ETFs are listed across multiple venues and also that a substantial amount of ETF transactions takes place off exchange. As such when looking at the ADV of an ETF this may not be giving you the full picture of the secondary market . Where possible it is best to look at aggregated trading information which captures as many of the sources of liquidity as possible, this data is available on Bloomberg. Market Makers also play an important role in the secondary market by providing liquidity throughout the trading day by offering to buy and sell ETFs on a continuous basis. The secondary market offered by ETFs can be looked at as an additional layer of liquidity to that of the underlying securities the ETF tracks, evidenced by the fact ETFs can trade in more volume and with tighter spreads than their underlying securities.

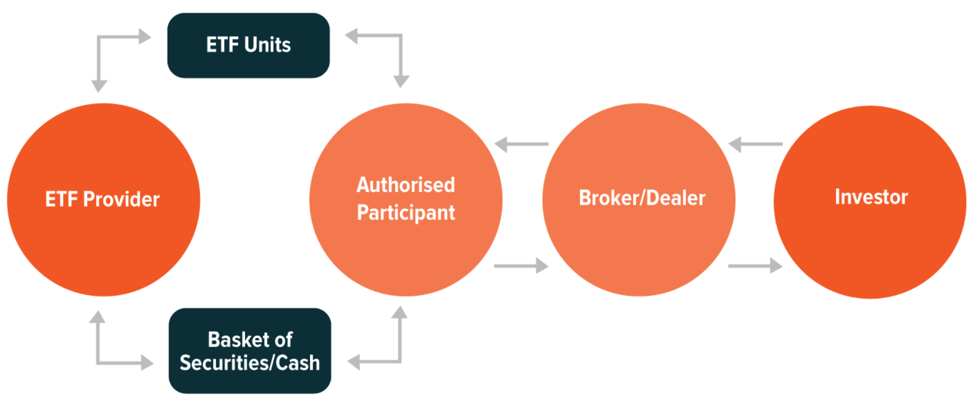
Figure 1: Different Levels of ETF Liquidity

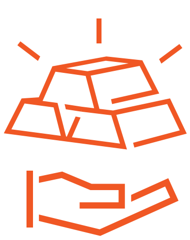


The primary market is what underpins the ETFs liquidity. On a basic level an ETF is a wrapper for holding a basket of securities such as stocks or bonds. When there is an imbalance in the secondary market of supply or demand for an ETF, the ETF issues new shares in exchange for the basket of securities the ETF tracks. Institutional broker dealers known as Authorised Participants create new ETF units with the issuer in order to meet market demand and in return deliver the securities that the ETF tracks. In the case of a redemption the opposite occurs with ETF units being delivered back to the ETF to be cancelled and the corresponding securities given back to the Authorised Participant or sold.

Due to this an ETF that is tracking a basket of small cap stocks for example has less primary liquidity than an ETF that is tracking a basket of highly liquid stocks such as the S&P500. This said when an ETF issuer constructs the ETF and selects their index composition they will often do so with liquidity in mind and therefore it is very common to see a liquidity filter in the index construction of the ETF ensuring a minimum level of liquidity.

Figure 2: ETF Ecosystem in Primary and Secondary Markets





4 DOES AUM MATTER?

While AUM may mean that the secondary market is more active, AUM is not an accurate measure of ETF liquidity and can often be skewed due to legacy products or a few large investors holding a fund. As such it is not an accurate guide to liquidity.

For further help investors should look to ETF capital markets teams and ETF liquidity providers to help them better understand the full liquidity picture.

The value of an investment in ETFs may go down as well as up and past performance is not a reliable indicator of future performance.

Trading in ETFs may not be suitable for all types of investors as they carry a high degree of risk. You may lose all of your initial investment. Only speculate with money you can afford to lose. Changes in exchange rates may also cause your investment to go up or down in value. Tax treatment depends on the individual circumstances of each client and may be subject to change in the future. Please ensure that you fully understand the risks involved. If in any doubt, please seek independent financial advice. Investors should refer to the section entitled "Risk Factors" in the relevant prospectus for further details of these and other risks associated with an investment in the securities offered by the Issuer.