APR 2016

CLIENTS WORRIED ABOUT TRADING ETFS?

Help ease their minds

Brandon Clark
Director
Legg Mason

We've come a long way from the early days of exchange traded funds (ETFs), with only a handful on the markets. Today, there are many options available to investors, and more compelling solutions to clients' needs.

Yet even with all the advancements the industry has made, when it comes to understanding ETF liquidity and trading, we've had the same conversations for more than 10 years: "I like your product, but it isn't liquid enough to use," investors say. "How do I know I can get out of it?" "If it only had more volume." "It's hard to trust something that isn't trading."

These are real concerns — and good old fashioned bunk.

It's entirely normal for clients to be concerned about liquidity, in any of their investments, but all financial instruments do not work the same way. Sometimes they focus on the wrong things.

Investment exposure should be the main priority. Making trade-offs between "low-volume" ETFs that fit your clients' needs, and "high volume" products that can compromise clients' needs could be the difference between their success or failure.

ETF liquidity

Having had a hand in launching more than 50 ETFs over the last 10 years, I can report that it is very rare for any ETF to launch with meaningful volume in the beginning months. ETFs that now trade millions of shares a day traded much less when they launched.

Even now, more than 90 percent of ETFs trade fewer than 500,000 shares per day, and 75% trade less than 100,000 shares per day,[†] yet many of these products have significant assets. The reality is most clients use ETFs as asset allocation tools, not trading vehicles.

"An ETF is as liquid as its underlying holdings" has become a mantra. I too have been guilty of saying that, almost as a reflex, but what does it really mean? We must be careful to put these issues into context for our clients.

This article previously appeared in Investment News on April 20, 2016.

Access the article at:
http://www.investmentnews.com/article/20160420/BLOG09/160429992/how-to-ease-clients-minds-about-etf-liquidity-concerns

InvestmentNews

IN THE U.S. – INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

Trading an individual stock is easy to understand; that's what retail investors usually bring to mind think of when they think of "liquidity." But just as ETFs effectively represent a large basket of individual stocks, the ETF itself trades more like a big basket than one stock. Trying to trade 20% of an individual stock typically will result in pushing a stock price. An ETF, as a basket of stocks, means smaller trades in those individual stocks.

To comprehend this requires understanding how liquidity in ETFs is formed. An ETF is simply a wrapper around a basket of stocks. That's it. The concept is not complicated. The stocks in that particular ETF basket continue to actively trade in the market. Nothing changes with regard to the individual stocks by bundling them together into an ETF: Apple is still Apple.

While an ETF may report low daily volumes, trading activity in its underlying stocks — think large-caps like Google, IBM and Exxon — can be leveraged by market makers in order to facilitate trading orders. This can create instant liquidity for the ETF. It's not that different than buying other investment products, where a portfolio manager ("PM") has to go to the market with the cash coming in from investors and buy the mandated securities. In the case of ETFs, a market maker, or "Authorized Participant" plays the role of the PM.

In many cases, the bid/ask spread of an ETF generally will be less than the cost to acquire the basket of stocks it represents. A small cap ETF may have a spread of 10 basis points ("bps") or less, where the basket of securities bid/ask spread may be 20–30bps. Clients can potentially get a very good deal using ETFs.

How does it work?

Most stocks in an ETF trade hundreds of millions, or billions of dollars a day. Thus a $10 million trade in many U.S. or international equity ETFs represents a small fraction of the underlying stocks trading activity. Regardless of the ETF's average daily volume, in normal market conditions many client ETF trades can usually be quickly facilitated, small or large.

This sounds counter-intuitive. If an ETF trades only a few thousand shares on most days, why would a $10 million trade be easy to execute?

Because the liquidity necessary to make the trade is built into the underlying stocks. They trade actively, sometimes furiously, and on most days market makers can easily buy and sell the necessary stocks when ETF orders are placed. Investors rely on the large-scale liquidity of the broad market of the stocks held in their ETF basket to provide the leverage they need to trade.

It's not until clients start to trade very large blocks or more illiquid assets classes that they have to consider putting a trading plan together. Regardless of how large or small your ETF trade size, working with a knowledgeable ETF trading desk can help maximize an ETF's liquidity. This happens every day in a landscape where many ETFs can trade 10 or 20 times their average daily volume — or more.

That's not alchemy; it's liquidity in action.

ETF trading best practices

In seeking fair execution and access to the full potential liquidity when buying and selling ETFs, take the below best practices into consideration:

- Use limit orders. Most of the bad client experiences I have seen resulted from market orders (order made through a broker to buy or sell immediately) and stop orders (order to buy or sell when a price surpasses a particular point). Opting for limit orders, which is an order placed with a brokerage to buy or sell a set number of shares at a specified price, instead avoids many pricing problems.
- Utilize a broker's block desk. These experienced traders can better maximize an ETF's underlying liquidity, quickly and efficiently, by working their network of market makers.
- Avoid trading at market open. Prices tend to swing in the early hours. Not giving the market time to settle in can have a meaningful (negative) impact on execution quality.

So the next time you are looking for an ETF solution to solve a client's need, do not eliminate what may be the best solution simply because of how little it trades. Talk to the ETF sponsor about liquidity. Most can quickly assess how it matches both your client's investment goals and liquidity needs. A little time and discussion could make the difference in the success of your client's investment plan.

† Source: Bloomberg.

Retail investors buy and sell shares of ETFs at market prices (not NAV) in the secondary markets through the trading day, not directly from the ETFs. Authorized participants (APs) acquire shares in the primary market from the ETF and tender their shares for redemption directly to the ETFs, at net asset value per share only in Creation Units or Creation Unit Aggregations. Once created, shares of the funds trade in the market in amounts less than a Creation Unit.

Brandon Clark is a Director in ETF Product Management at Legg Mason. His opinions are not meant to be viewed as investment advice or a solicitation for investment.

All investments involve risk, including loss of principal. Past performance is no guarantee of future results.

Diversification does not guarantee a profit or protect against a loss. Equity securities are subject to price fluctuation and possible loss of principal. Dividends may fluctuate and a company may reduce or eliminate its dividend at any time.

Equity securities are subject to price fluctuation and possible loss of principal.

Authorized participants ("APs") may acquire shares in the primary market directly from the ETFs and may tender their shares for redemption directly to the ETFs, at net asset value per share only in Creation Units or Creation Unit Aggregations. Once created, shares of the funds generally trade in the secondary market in amounts less than a Creation Unit.

© 2016 Legg Mason Investor Services, LLC. Member FINRA, SIPC. Legg Mason Investor Services, LLC is a subsidiary of Legg Mason, Inc. 616720 CORP265609 4/16