
ETF INDUSTRY TERMINOLOGY

(in alphabetical order)

Arbitrage

Arbitrage is the name used for the process to keep ETF prices in check with their NAVs intraday. When a price drifts too far from the NAV, market makers step in and provide liquidity based on the cost to either create or redeem shares.

Authorized Participant

Authorized participants are broker/dealers that are permitted to create and redeem shares directly with the fund (ETF). Creations/redemptions allow for market makers to keep the premiums and discounts in-line with the ETF's NAV.

Basket file

A Basket file is published every day and reflects the basket of securities needed to create/redeem ETF shares with the fund.

Bid/Ask Spreads

Bid/ask spreads are the difference between the current offer and bid price. Some primary drivers of spreads are: underlying spread cost of the basket of securities, any taxes or commissions paid to trade the securities, market maker carrying costs, commissions to the market maker for providing liquidity, and investor activity. Each ETF has its own complex ecosystem based on its investment strategy, and the spreads between products will reflect many of nuanced differences between them. Please note: A cross-section of ETFs tracking the same asset class may not have the same spreads, even though some of the primary inputs are the same.

Fair value

Fair value is a statistical process to determine an asset's value by factoring in all of the current information about the asset, the economic and real-time market environment. For example, for an ETF holding only Asian securities, the market place will take into account the local closing prices in Asia and everything that has happened in the market since Asia has closed. If the global markets rallied 1% since the close of the Asia trading day, there is a high probability that the market place in the U.S. would price that ETF up from where the market closed in Asia hours ago (i.e., a premium to NAV).

iNAV

iNav, IIV, IOPV, all are acronyms that relate to the intraday NAV that is published to the market place. This value is published every 15 seconds and is based on either the portfolio holdings or the basket file that is published. iNAV does provide some benefit as a reference point to investors for U.S. equity-based portfolios, but it tends to be less meaningful in relation to fixed income and international portfolios given those prices tend to be either stale or less informative.

Market Makers

Market makers are firms that trade in the open market and facilitate liquidity in securities. They do this by placing bids and offers in the open market to buy or sell ETFs. Most market makers are providing a service to investors by providing liquidity, bearing the risk to hold positions, and charge a cost to provide that service. These costs are all baked into the bid and offer prices at which they are willing to buy a specific ETF.

Market price

Market price is the prevailing price that an ETF is trading in the market. Because an ETF trades all day, market prices will vary throughout the day.

NAV price

NAV price is the net asset value of the ETF. ETF NAVs are calculated the same as mutual funds, which is an end of day valuation.

Premiums/Discounts

Premiums and discounts are a measure of the cost to investors relative to the fund's Net Asset Value (NAV). When there are a large number of buyers for an ETF, that ETF will likely trade at a premium to reflect the costs to buy the underlying securities. Conversely, when there are a large number of sellers for an ETF, that ETF will likely trade a discount to reflect the costs to sell the underlying securities. The price ranges or bands within which an ETF will trade are called the arbitrage bands.

The factors that influence premiums/discounts are many of the same factors that affect bid/ask spreads. Underlying spread cost of the basket of securities, any taxes or commissions paid to trade the securities, market maker carrying costs, commissions to the market maker for providing liquidity, and investor activity will determine the range of premiums and discounts. Intraday order flow will determine where within the arbitrage band the ETF is trading and the real-time premium or discount.

Source: Legg Mason

IMPORTANT INFORMATION: All investments involve risk, including loss of principal. Past performance is no guarantee of future results. Equity securities are subject to price fluctuation and possible loss of principal. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Fixed-income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls.

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