**Did you know? An ETF that trades 1 million units a day has the same liquidity as an ETF with the same underlying securities or index that trades zero units a day**

One of the most commonly cited benefits of ETFs is liquidity, with many ETF investors attracted to the ability to buy and sell ETF units at any time throughout the trading day. When it comes to ETFs however, liquidity is also one of the most widely misunderstood concepts.

In the case of shares, investors are able to evaluate liquidity by looking at average daily trading volumes/values and market capitalisation. Due to their familiarity with shares, some investors mistakenly use the same approach to analyse ETFs. Although ETFs trade like shares, one cannot use the same criteria to evaluate ETF liquidity.

**Low trading volume for an ETF does not mean low liquidity**

The daily trading volume (or value) of an ETF is not an accurate reflection of the liquidity of the ETF. In order to understand this better, it is helpful to understand the basic structure of ETFs.

In the case of shares, there will always be a fixed number of outstanding shares available for trading. As a result, it is the average daily trading volume of these shares that reflects the trading liquidity available at any time on the exchange.

ETFs, on the other hand, are open-ended funds with the ability to issue or redeem units on a daily basis according to investor demand. All BetaShares ETFs have one or more designated market makers. Their core responsibility is to maintain an inventory of units of the ETF and provide liquidity so investors can buy or sell when they choose to do so. Market makers provide liquidity by quoting bid and ask prices and volumes on the exchange. They seek to ensure there is always a buyer or seller for the investor’s trade. Should investor demand exceed what is currently available ‘on screen’, the markets makers can simply ‘create’ more units (issued by the ETF issuer) to meet the demand (and can also ‘redeem’ units should supply exceed supply). This enables them to quote higher volumes ‘on screen’.

The market makers will attempt to also maintain a tight bid/ask spread so that the price of the ETF closely approximates the net asset value (NAV) per unit throughout the trading day.

**ETFs are as liquid as their underlying holdings**

It is the mechanism described above that makes ETFs as liquid as their underlying holdings. So long as sufficient liquidity exists in the underlying holdings there will always be an ability to ‘create’ more ETF units to supplement existing ‘on screen’ liquidity. That is why, from a liquidity point of view, trading BetaShares ETFs should be considered as essentially equivalent to trading the underlying holdings. This is also why the average daily volume of an ETF is often a meaningless statistic by which to determine ETF liquidity. Investors would get a better sense of the ‘true’ ETF liquidity by examining the average daily volume of the ETF’s underlying assets.

The below example provides an illustration of this, using the BetaShares FTSE RAFI Australia 200 ETF (ASX: QOZ). At the time the example was created, there was approximately $3.3m of liquidity ‘on screen’. However, the ‘true’ liquidity of the underlying was actually $4.3B!
Generally then, the primary factor which could affect the liquidity of an ETF is the liquidity of the underlying portfolio of securities/assets held by the ETF. That is to say, if the ETF invests in securities or assets that are difficult to buy or have low supply, then the buying and selling required to implement the creation/redemption process may be more difficult.

All BetaShares ETFs have underlying portfolios that are highly liquid, which contributes to robust liquidity levels and generally ensures that the price of the ETF closely reflects the value of the underlying portfolio.

Trading ETFs: Real life example of ETF liquidity

ETFs that track liquid asset classes are themselves liquid regardless of trading volume.

Below is a ‘real life’ example of a market maker assisting in filling a ~$5m order (traded in several tranches) of BetaShares U.S. Dollar ETF (ASX: USD), that represents ~5x its average daily trading volume with virtually no impact on bid/ask spread.

Source: Bloomberg as of 8 January 2013. Past performance is not an indicator of future performance.

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