BetaShares
Exchange Traded Funds

BETASHARES CAPITAL MARKETS GUIDE

AN INTRODUCTION TO ETF TRADING AND LIQUIDITY

BetaShares Capital Markets Services

At BetaShares we feel it's important to help our investors understand the mechanics and structure of exchange traded funds (ETFs), to learn how to properly assess the liquidity of ETFs and to determine how to efficiently and effectively trade ETF positions.

The BetaShares ETF Capital Markets Team can assist investors in this process and performs the following key functions:

Market Participant Relations

The BetaShares Capital Markets Team works alongside the various market participants, including Market Markers, Authorised Participants (the institutional brokers that trade directly with BetaShares) and the ASX to ensure markets are effectively made in BetaShares funds.

Liquidity and Execution

Our Liquidity and Execution services are designed to assist advisors, institutional clients and other investors with the ETF trading process, with a focus on helping clients enter and exit positions as efficiently as possible.

ETF Education and Content

We work directly with clients to answer any queries and continually develop materials that will assist investors with the ETF education process.

Our team regularly produces high-quality market commentary and relevant trade ideas that can be easily actioned through BetaShares ETFs. In addition, BetaShares publishes a weekly email newsletter that provides investors with a range of curated insights relevant to the global sharemarkets and ETF investing.

Introducing Exchange Traded Funds

ETFs are open-ended investment funds, similar to traditional managed funds, which are traded on a stock exchange – just like listed shares. Typically, ETFs aim to track as closely as possible the performance of a given index or asset class.

Also, like traditional managed funds in Australia, ETFs are conventional unit trust structures governed by the same regulatory framework that applies to all managed investment schemes.

The assets underlying our ETFs do not form part of BetaShares' assets. Rather, they are held on trust for the benefit of unitholders. BetaShares has appointed an independent, third party custodian to hold the assets of each exchange traded fund, which are kept separate from the assets of BetaShares, the custodian and any other fund.

What are the benefits of BetaShares Funds?

Simple Access

BetaShares' suite of exchange traded product solutions are designed to expand the universe of investment possibilities for Australian investors. We do this by providing exposures to a broad range of investment strategies across global and domestic market indices, sectors and various asset classes.

Transparent

One of the key advantages of ETFs as an investment vehicle is that investors know exactly what is going on in their portfolio. To ensure transparency, relevant investment information about an ETF, including underlying portfolio holdings, Net Asset Value, fee and distribution information, is disclosed to investors on a daily basis and can be accessed via the relevant Fund product page on the BetaShares website.

Liquidity

ETFs generally provide a high level of liquidity, as they are traded on the Australian Securities Exchange (ASX) and can be bought and sold during the trading day with intraday price transparency. The open-ended nature of the ETF structure along with the presence of dedicated market-makers seeks to ensure that the ETF remains liquid and trades at market prices that are around the Net Asset Value of the fund.

Cost-effective

Because ETFs typically aim to track the performance of an index or asset class, there are no in-built 'active management' fees to worry about. As such, they're generally more cost-effective than comparable traditional managed funds that are actively managed.

ETF Market Participants

The Primary Market for ETFs is comprised of a network of institutional investors, including:

Authorised Participants (APs) are authorised trading participants who have an agreement (AP agreement) in place which allows them to trade directly with the **ETF Issuer** (e.g. BetaShares). This gives APs the ability to create and redeem units of an ETF directly with the ETF Issuer at net asset value per unit (NAV) depending on the underlying demand in the ETF itself.

In many cases, APs will also fulfill the role of Market Maker in an ETF.

The **Market Maker's** role is to provide ongoing liquidity in the secondary market for the ETF by offering both a buy and sell price for ETF units during the trading day. Market Makers provide a service to investors by offering liquidity in ETFs and, in turn, generate their revenue through the bid-ask spread (the difference between the price at which the Market Maker is willing to buy a unit and the price at which it is willing to sell a unit). Market Maker orders are placed around the NAV of the fund and priced based on the composition of the fund's underlying assets. These prices are constantly updated throughout the trading day in line with changes in the value of the underlying securities.

Unlike investors, Market Makers do not want to take on the investment risk of the ETF. Any short-term investment risk they take on will generally be accompanied by some level of hedging to reduce this risk. For example, each time a Market Maker takes on a short position by selling ETF units to an end investor. They will try to offset that with a long position. This is done through the ETF creation and redemption process or, alternatively, they can often carry positions in derivatives – such as futures – that correspond to the exposure until they buy back the ETF units.

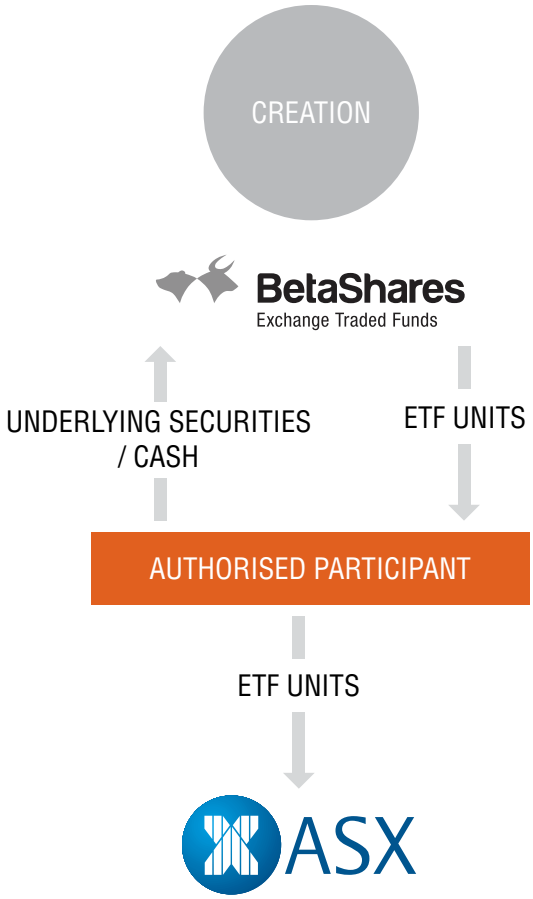
ETF Creation and Redemption

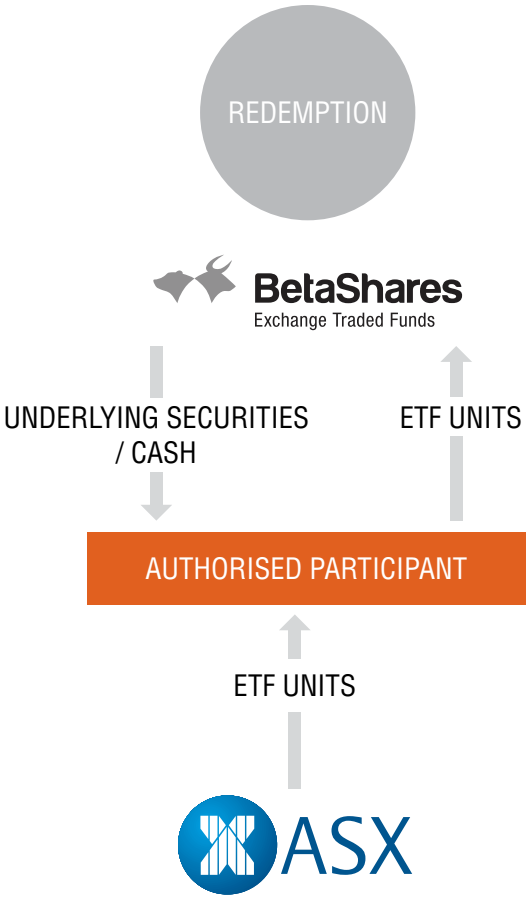
Like traditional managed funds, ETFs are open-ended vehicles, capable of adjusting units on issue on a daily basis according to investor demand. However, the creation/redemption process for an ETF is different to that of other open-ended funds and is the key to understanding the nature of ETF liquidity.

The primary market creation and redemption process gives APs the ability to deliver baskets of the underlying security in exchange for new ETF units and to redeem units in exchange for baskets of the underlying security. ETF creation is the process which enables additional units to be offered into the secondary market. APs assemble the underlying securities of the fund in their appropriate weights to make "creation units" and they then deliver those securities to the ETF issuer. In return, the AP receives units in the ETF from the ETF issuer.

Once this is done they can then sell in the secondary market (i.e. on the stock exchange) and increase supply.

APs also have the ability to redeem units through the same process in reverse, whereby they deliver ETF units back to the ETF issuer and receive payment in the form of a basket of the underlying securities, when demand in the market decreases.



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Understanding ETF Liquidity

When assessing an ETF for a particular exposure, investors will often want to consider its liquidity. However, inexperienced ETF investors can often misinterpret the true liquidity of the ETF by assessing the ETF as though it were a single stock rather than an open-ended fund.

In contrast to listed stocks and listed investment companies (LICs), volume "on-screen", daily trading value (or volume) or the total AUM of a fund are not accurate reflections of the liquidity of an ETF. These measures often vastly understate their effective liquidity. Volume on screen, for example, can be adjusted up or down by Market Makers, but for risk management purposes what they show on screen will often substantially understate what they are prepared to show.

ETFs are as liquid as their underlying holdings

The truest measure of an ETF's liquidity is considered to be the liquidity of the underlying assets owned by the ETF (i.e. for equity ETFs the stocks the ETF holds). This feature is a result of the ETF's open-ended structure, which enables the ETF to adjust the supply of units according to demand on a daily basis. As long as sufficient liquidity exists in the underlying holdings there will normally always be an ability to create and redeem ETF units.

If, for example, the AUM of a particular fund was $5 million and an investor wanted to purchase $10 million worth of ETF units. They could contact the BetaShares Capital Markets Team, who would advise a Market Maker. The Market Maker could then increase the supply available on the secondary market and then arrange to create, through an AP, the necessary number of additional units with BetaShares as the ETF issuer.

Typically, the underlying securities are liquid instruments and readily available for the creation or redemption process. The BetaShares FTSE RAFI Australia 200 ETF, for example, holds securities of 200 of the largest companies listed on the ASX. If an ETF is invested in securities that are difficult to transact in or have a low supply, then the buying and selling required to facilitate the creation or redemption process may be more difficult.

Misunderstanding liquidity

Misunderstanding the actual liquidity of many Australian ETFs may lead investors to look to U.S. listed funds which may have higher daily trading volumes in the secondary market, yet often hold similar underlying assets. This may give rise to potential adverse tax consequences for investors, and further administrative burden, such as requirements for U.S. W8-Ben forms. An Australian investor trading a Japanese equities ETF, for example, could see benefits from trading that fund in Australia relative to an equivalent exposure in the U.S. by having the ability to access liquidity while the underlying Japanese securities market is open.

Why prices should stay close to the NAV

Market prices in ETFs typically remain close to the net asset value per unit (NAV) of the underlying assets owned by the fund.

This is due to a number of factors, including the market making specifications agreed between the ETF issuer and appointed ETF Market Makers, natural competition between ETF Market Makers trading the same fund as well as the possibility that these market makers could make arbitrage profits if prices offered were too far away from 'fair value'.

To understand this, consider the situation whereby, hypothetically, an ETF was trading well above the NAV of its underlying portfolio of securities. In this circumstance, an ETF Market Maker could buy up parcels of the underlying securities and exchange them for ETF units with the ETF provider, which they could then sell on the secondary market for a profit, or vice versa.

Through this process, if premiums or discounts to NAV arose, they could be expected to be arbitraged away, keeping prices closely in line with NAV.

ETF Trading Best Practice

There are a few considerations and simple practices to keep in mind when trading ETFs to ensure best execution and potentially minimise your transaction costs.

Using limit orders

Limit orders, particularly for large orders, give you price control and act as an important safe-guard against overpaying, for example, by your order being matched at a price over and above that of the Market Makers.

Bid/Ask Spread

When evaluating the cost of an ETF an investor may look to invest in one fund over another based solely on lower management fees – however, it is important to consider the size of the bid/ask spread as part of the cost of entering and exiting the position, when assessing the total cost of the investment, taking into account the expected investment timeframe.

It's important to note that, depending on market conditions and the underlying securities in an ETF, at times – for example, where there is a high degree of uncertainty in the market - Market Makers may set a wider bid-ask spread to compensate for the risk it faces in that trade due to the difficulty they face in hedging their own position.

Avoid trading near market open and close

During times when some, but not all, of an ETF's underlying securities are open for trading on the relevant market, it can be more difficult for a Market Maker to accurately price an ETF. Where possible, it is considered prudent to time the execution of your ETF trade when the maximum number of the underlying securities are open. All things being equal, spreads should be tightest during these times.

Volatility

Be aware that spikes in volatility in the underlying securities can cause the bid/ask spread in an ETF to widen.

For international ETFs and futures markets: Mind the clock

It's important to know when the underlying securities for these indices are trading on offshore exchanges. Market Makers will have a better idea of how to price the ETF during these times. It's also worth noting, for U.S. securities for example, that the unit price during our trading day will be based on information constantly disseminated in markets after the U.S. market has closed, and will often not be exactly what was seen at the close of Wall Street.

Always refer to the NAV or iNAV unit price

For valuation and for historic performance analysis it is important to refer to the ETF's official NAV or iNAV, rather than the last traded price or closing price. For BetaShares funds, historical NAVs of each fund are available on our website, as well as iNAVs for relevant funds.

The BetaShares Capital Markets Team

ETF Trade Assistance

Our Capital Markets Team has direct access to Market Makers and Authorised Participants, during market hours, and is available to provide dedicated trading and liquidity support to advisers, institutional clients and other investors.

For assistance please feel free to contact us directly.

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BetaShares
Exchange Traded Funds

Learn more about BetaShares

BetaShares is a leading manager of ETFs and other Funds that are traded on the Australian Securities Exchange ('ASX'). Our aim is to provide intelligent investment solutions for Australian investors.

Visit our website and explore our full range of Funds that can help you achieve your financial objectives.

Important Information:

www.betashares.com.au