THE TRUTH ABOUT ETP LIQUIDITY

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ETPs are growing in popularity, previously as a transparent and cost effective alternative to mutual funds. Because of their relatively recent adoption, misconceptions about ETPs are common and one is around an ETP's available liquidity. Although the ability to trade ETPs intraday is well known, many institutional investors believe ETPs aren't tradeable in institutional size. The reality, however, couldn't be further from this belief.

The misconception stems from investors who look at ETP trading volumes in the same way as they would a single stock, and inferring a tradable size from this metric. While trading volumes are a factor in assessing an ETP's total liquidity, this analysis misses one of ETPs' key features—that they are open ended funds which can be created or redeemed on a daily basis. This process allows the ETP to access the liquidity available in the underlying market, in addition to the liquidity provided by the ETP's daily trading volume. So how does this work? Let's take a look firstly at how the ETP market is structured.

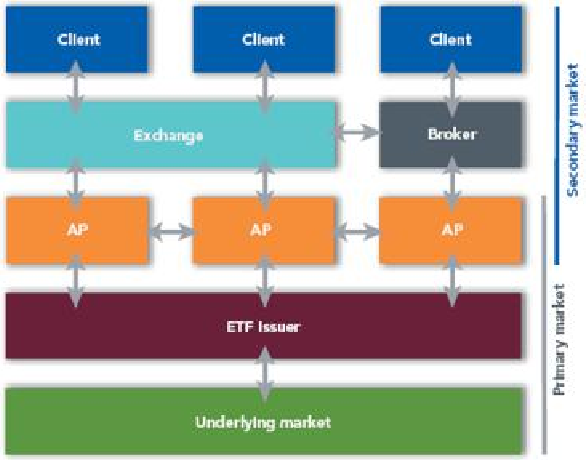
How the ETP market is structured

It's important to consider that there are two markets driving ETP liquidity—the secondary and the primary. We'll start by explaining the secondary market first because this is the market you're most likely to be more familiar with:

- **Secondary market:** The secondary market consists of ETP shares passing from investors selling to the investors who are buying. This is done via exchanges or through an OTC (over-the-counter) transaction through brokers. The liquidity available in this section of the market is driven by the trading volume in the ETP shares on any given day. All end investors will buy and sell shares in the secondary market which has almost all the same mechanics as trading single stocks—including settlement and custody.
- **Primary market:** The primary market can only be accessed by specialist market makers know as Authorised Participants (APs). This market is where APs either create ETPs to meet excess demand or redeem ETPs to remove excess supply from the market on any given day, as needed. The available liquidity in the primary market will be driven by the liquidity of the underlying basket of securities held by the ETP. For the majority of ETPs, this is the primary driver of available liquidity.

Bringing these two pieces together, we can see that the total available liquidity is driven by the secondary market turnover plus liquidity of the underlying market.

Figure 1: The ETP market structure



At present, the size and turnover of the majority of ETPs is quite small compared to the underlying market and, as such, the primary/underlying market is the major driver of available liquidity. However, for established ETPs the secondary market turnover can help to offset part or all of a trade on any given day which can help you trade inside the cost (spread) associated with accessing the underlying market. So how do these two markets work together in practice? To understand this let's first look at in detail how the creation and redemption process works.

How the creation and redemption process works

The creation/redemption mechanism allows for the increase or decrease of ETP shares based on demand without impacting other investors of the fund. If there is increasing demand for a specific ETP, new shares can be created to meet that demand in exchange for underlying assets. Alternatively, if units are sold, the number of shares can be reduced by exchanging shares for assets through an AP. What is important to highlight here is that the investor never makes the decision to create or redeem off an individual order; it is a mechanism that is used to moderate demand for the market as a whole.

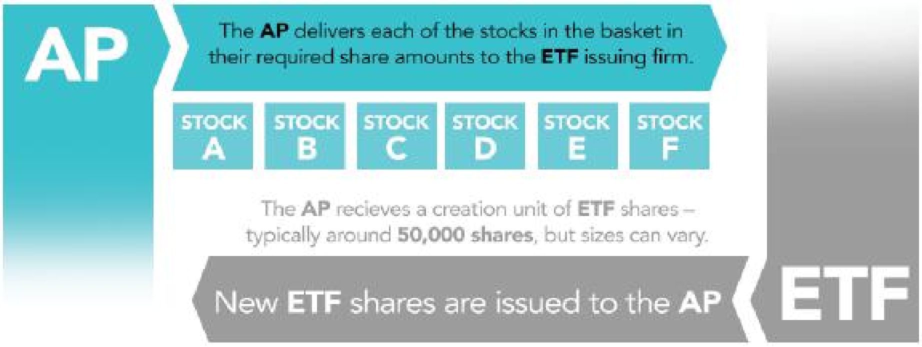
The ability for the primary market to regulate demand is driven by the intrinsic link between the ETP and the underlying market created by the creation/redemption process.

To illustrate how this process works, let's follow the lifecycle of a trade in the following simplified example. The points highlighted in blue refer to the process within the primary market and are illustrated further in Figure 2.

- An investor would like to buy 600,000 ETP shares so they approach their broker to place the order
- The broker looks at available shares in the secondary market and is able to purchase 100,000
- As the broker is also an AP, the broker sources the remaining 500,000 shares from the primary market, initiating a creation
- The broker purchases the basket of securities held by the ETP
- These securities are then delivered to the ETP issuer in exchange for the 500,000 ETP shares
- The broker delivers the full 600,000 shares to the investor.

The above example and illustration are a simplified version of the process and there are several variations that allow for operational efficiencies depending on the requirements of the trade. Regardless of the exact process used, the economics of the primary market are the same so the important takeaway is that the underlying basket is directly exchangeable for the ETP shares. This means that as much liquidity as is available in the underlying market can be utilised to create or redeem the ETP.

Figure 2: The ETF creation process



How to assess underlying liquidity using the implied liquidity metric

When it comes to assessing an ETP's liquidity understanding the liquidity of the underlying is key. The traditional way to do this is perform pre-trade analysis on the underlying basket of securities and asses any potential market impact of transacting in your desired size. Doing this rigorous analysis on each ETP's underlying basket you're interested in can be labour intensive, but luckily there is a readily available metric to take a lot of the work out of this process: ETP Implied Liquidity.

The Implied Liquidity metric is designed to answer the question "what's the maximum amount of a given ETP I could trade without having a price impact on any of the underlying securities?" This is done by identifying the least liquid security in the ETP basket, taking 25% of the ADV* and then using the securities weight in the basket to infer the ETP's Implied liquidity.

The implied liquidity of an ETP can be found on Bloomberg (via the ETFL function) or easily provided by the capital markets team of any issuer and provides a reliable indication of underlying liquidity. It's always worth taking the time to assess the underlying liquidity of an ETP before placing an order, especially if it's the first time you're trading a particular ETP. This will provide you with confidence that there will be sufficient liquidity available to support your trade.

*25% of the ADV is a conservative estimate for an amount a security that could be traded without having a price impact.

Questions?

Most ETF issuers have dedicated Capital Markets teams who are available to help with any investor queries. Alternatively, don't hesitate to get in contact with your broker or IFA to help answer your questions.

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