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3 Myths About ETF Liquidity

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About the author
Ben Quah is responsible for monitoring and ensuring the smooth trading of the firm's ETFs. He maintains trading relationships with all market participants such as broker/dealers and exchanges.

From the outside, an iPhone and an Android phone look quite similar. They have similar dimensions, features, and apps. But if you've only used an iPhone, using an Android phone feels anything but familiar and doing even basic tasks takes a while to figure out.

Likewise, on the surface, ETFs and mutual funds generally share common characteristics such as liquidity and diversification. But underneath the surface, ETF liquidity is significantly different from mutual fund liquidity.[1]

Take this brief quiz to test your knowledge about ETF liquidity and pricing. Mark each statement as True (T) or False (F).

ETF Liquidity and Pricing Quiz

T	F	
☐	☐	Trading an ETF right when the market opens helps to capitalize on market and pricing inefficiencies.
☐	☐	An ETF with low trading volume is generally illiquid while an ETF with high trading volume is generally liquid.
☐	☐	You can't get a good sense of an ETF's liquidity by looking at the number of shares that are available for trading from a market maker.
☐	☐	It's a best practice to use market orders when trading ETFs and not limit orders.[2]
☐	☐	Trading an ETF that primarily holds foreign securities during the trading hours of the underlying securities' local market (e.g., Europe, etc.) is preferred to the extent possible.

Key Points

- An ETF's liquidity is determined more by its underlying holdings than by its average daily trading volume or assets under management
- As a best practice, it is better to use limit orders when trading ETFs; avoid trading immediately after a market opens or prior to its close since pricing could be more volatile at these times
- An ETF issuer's capital markets desk is an excellent resource when you want to place large trades, discuss liquidity concerns, or need guidance on when or how to place your trades

[1] ETFs and mutual funds have other differences as well: Unlike traditional open-ended mutual funds, ETF shares are often bought and sold in the secondary market through a financial advisor and brokerage commissions may apply. ETFs trade on the major stock exchanges and their prices will fluctuate throughout the day. When buying or selling an ETF, an investor will pay or receive the current market price, which may be more or less than net asset value. Mutual fund investors buy and sell directly with the mutual fund issuer and mutual fund shares are priced once a day after the markets close. Both mutual funds and ETFs are subject to risk and volatility.

[2] A market order is an order to buy or sell a security at the best price available at that instant. A limit order is an order to buy a security at no more (or to sell it at no less) than a specific price.

An ETF is at least as liquid as the least liquid security in its portfolio.

Liquidity is the ability to buy or sell a security quickly, easily and with reasonable transaction costs

Bid is the price a buyer or market maker is willing to pay to buy a security

Ask is the price a seller or market maker is willing to accept to sell a security

Bid-ask spread is one way a market maker is compensated for quoting and being active in a security

Lead market maker is a securities dealer that facilitates the trading of a security by agreeing to both buy and sell each security in which the firm is assigned during normal trading hours

Authorized participant (AP) is a large financial institution tasked with creating or redeeming ETF shares based on supply and demand

MYTH 1: An ETF's assets under management (AUM) and trading volume are a good proxy for its liquidity

Fact: An ETF can have low trading volume and low AUM and still have high liquidity.

While it may seem counterintuitive, an ETF that only trades several hundred shares per day can still be highly liquid. Let's see why this is the case.

Look Under the Hood

An ETF's liquidity isn't primarily determined by its trading volume, but rather, by its underlying holdings. An ETF is at least as liquid as the least liquid security in its portfolio.

An ETF that holds underlying stocks in companies such as Intel, JP Morgan Chase, and UnitedHealthGroup among others would be highly liquid because these stocks trade millions of shares each day.

By contrast, bank-loan ETFs and high-yield ETFs have the potential to be less liquid in comparison because these investments are inherently less liquid than stocks, and they trade over the counter (OTC) rather than on stock exchanges. This decreased liquidity could potentially lead to greater price swings in these ETFs, which would only be exacerbated during a period of market stress.

For example, if high-yield bond prices come under pressure, you may be able to trade a high yield ETF, but the price you receive for the trade may not be favorable. And as the bid-ask spread gets wider, fewer people may trade the ETF, leading to decreased liquidity. Unfavorable pricing often leads to decreased liquidity.

Look at the Bid-Ask Spread

A tight bid-ask spread indicates that the supply and demand for an ETF is in balance, which makes it more cost effective to trade the ETF. More frequently traded ETFs are quoted with a tight bid-ask spread, while less-traded ETFs generally trade with a wider bid-ask spread.

FIGURE 1

Bid-Ask Spread Example

Hartford Multifactor Global Small Cap ETF (ROGS)

Bid	$30.97 X 2,000
Ask	$31.07 X 2,000

In this example, the bid-ask spread is $0.10. Market makers are willing to sell 2,000 shares of this ETF at $31.07 and willing to buy 2,000 shares at $30.97. For illustrative purposes only.

Hartford Funds has partnered with some of the most experienced lead market makers and authorized participants (APs) in the country to help investors achieve better execution prices when trading Hartford Multifactor ETFs. Lead market makers are required to maintain continuous, two-sided quotes (i.e., buy and sell) on Hartford Multifactor ETFs, and APs stand ready to create additional liquidity by adjusting the supply of available shares as necessary.

Open-end investment company is a company such as a mutual fund company or ETF issuer that distributes and redeems the securities it issues

Net asset value (NAV) is the value per share of an ETF or mutual fund on a specific date or time

MYTH 2: Secondary market ETF liquidity is limited to what you see on trading systems

FACT: Market makers only display a small fraction of the volume they're willing to trade.

Most investors trade ETFs on the secondary market (i.e., a stock exchange), so it's only natural to think that the bid and ask sizes viewable on trading systems are a good representation of an ETF's liquidity. In reality, market makers typically only display a small fraction of the volume they're willing to trade.

Before we explore why this is the case, let's begin with an overview of the two key markets that impact ETF liquidity.

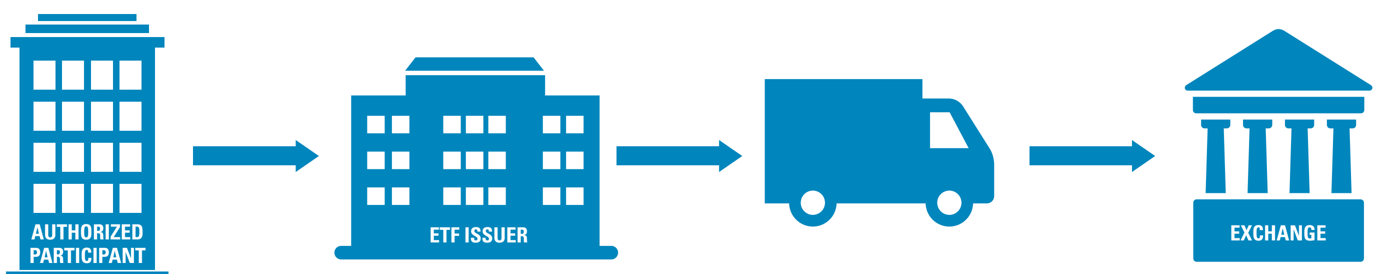
The secondary market: Like stocks and closed-end funds (funds that have a fixed number of available shares), ETFs trade on main exchanges such as the New York Stock Exchange (NYSE), NASDAQ, and Cboe. An ETF that's listed on one exchange, NYSE for example, can be traded on multiple exchanges. Market makers at the exchanges match up people who wish to buy and sell ETF shares.

The primary market: Unlike stocks and closed-end funds, but like traditional mutual funds, ETFs are open-end investment companies. This means that shares of ETFs can constantly be added into circulation or taken out of circulation. This attribute of ETFs significantly helps with their liquidity and pricing.

While closed-end funds often trade at a premium or discount because they have a fixed number of shares outstanding, market makers work with authorized participants (APs) to strive to keep the price of ETF shares close to fair value (i.e., in line with the ETF's underlying net asset value (NAV)).

FIGURE 2 provides a simplified overview of how ETFs are created.

FIGURE 2
ETF Creation Process



An AP assembles a basket of underlying securities to replicate the holdings in the ETF and delivers it to the ETF issuer

The ETF issuer gives the AP a block of equally valued ETF shares, called a creation unit, usually formed in blocks of 50,000 shares or more

The AP delivers the ETF shares to the Market Maker

The trade can now be completed Under normal market conditions, this efficient process is completed in a matter of seconds

Source: Hartford Funds. For illustrative purposes only.

There are often significantly deeper markets than what is shown on the screens.

As **FIGURE 2** illustrates, ETF issuers work closely with APs to ensure that supply and demand for their ETFs are kept in equilibrium. But what about the volume of ETF trading? If a trading system only shows several thousand shares available for trading, doesn't this mean that the ETF is relatively illiquid?

Many advisors gauge ETF liquidity by looking at exchange order books, which provide a listing of open bid and ask orders, including price and size, for securities. But market makers only display a fraction of the volume they're willing to trade; they do this because displaying small quote sizes makes it easier for them to manage risks such as dramatic price changes.

Managing Large ETF Trades

Advisors who want to place large ETF trades but who are concerned about liquidity have several options:

1. A Bloomberg Terminal, a computer system that provides real-time financial data, provides a more complete picture of ETF liquidity. Specifically, the ETF Implied Liquidity screen tells an advisor how many shares or dollars they can trade without impacting the market as shown in **FIGURE 3**.

FIGURE 3
Implied Liquidity Example

Hartford Multifactor Developed Markets ETF (RODM)

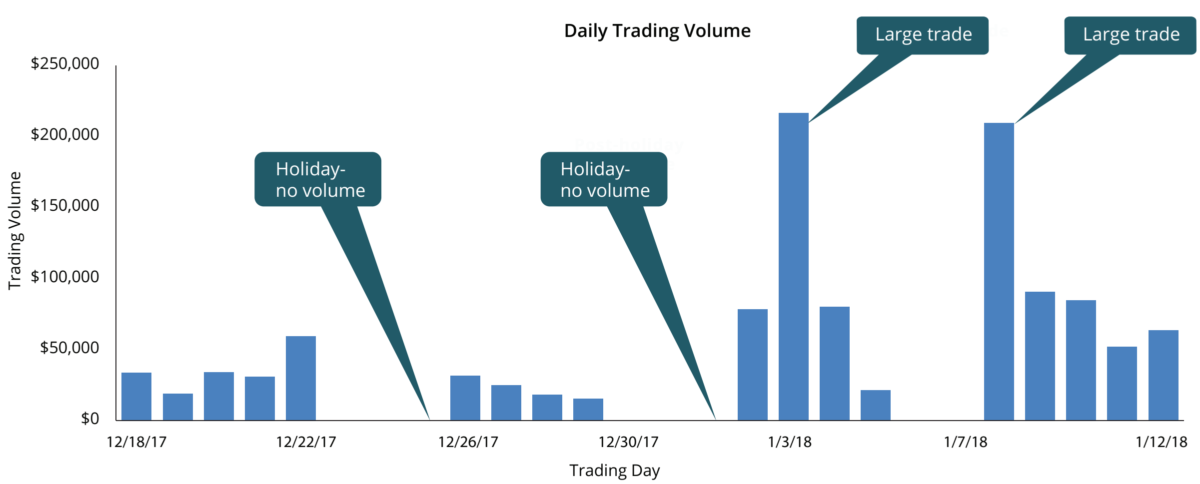
Implied Liquidity (shares)	1.5 M
Implied Liquidity (USD)	$47 M

In this example, an advisor could place a trade of 1.5 million shares or more than $47 million US dollars (USD) before he or she would need to be concerned about moving the market. For illustrative purposes only.

2. An advisor could also call the capital markets desk at the ETF issuer to discuss the trade to ensure it can be executed at a reasonable price without moving the market.

   FIGURE 4 shows several large trades in the Hartford Multifactor Developed Markets ETF (RODM). The ETF had an average daily trading volume of 36,000 shares in December 2017. A financial advisor called our capital markets desk in January 2018 for guidance on how to trade based on his trade size, and the end result was two large trades that were well within or at the bid-ask spread.

FIGURE 4
Large Trades in Hartford Multifactor Developed Markets ETF (RODM)



Source: Bloomberg, as of 1/26/2018. For illustrative purposes only.

Limit orders can help protect investors from being surprised by the price they get and provide a level of control over how they trade.

MYTH 3: It doesn't matter when you trade an ETF

FACT: ETF pricing fluctuates during the day and could be more volatile after the market opens and before it closes.

You may be tempted to trade an ETF right when the US market opens because Dow Jones and S&P futures[3] point to the market being sharply higher or lower, but this may not be the best strategy when it comes to ETFs.

US equity markets tend to be more unsettled during the first 15 to 20 minutes after the market opens as the overnight news and orders are being digested. Market makers keep their spreads wider at the beginning and end of trading hours to hedge against this uncertainty.

At the end of the day, pricing (which affects liquidity) could be constrained as closing orders flood in prior to the market close.

As a result, we advise investors to avoid trading at the market's open or close to the extent possible. If you can't avoid trading at these times, we recommend using limit orders to the extent possible.

In fact, Hartford Funds and many other ETF issuers inform clients that it is generally a best practice to use limit orders when placing ETF trades. Limit orders can help protect investors from being surprised by the price they get and provide a level of control over how they trade.

If you're worried about your trade not getting executed due to a limit order, you can set your limit order at the current bid or ask. Setting limit orders well within the bid-ask spread means that your trade could take a while to execute or may not be executed at all.

FIGURE 5

Setting A Limit Order

Hartford Multifactor US Equity ETF (ROUS)

Bid	$30.90 X 1,100
Ask	$30.97 X 1,700

In this example, setting your limit order at the current bid ($30.90) for a sell order or the current ask ($30.97) for a buy order would help ensure execution. Setting the limit order at $30.94, well within the bid and ask spread, could result in a significant delay in execution until the price of the security moves enough for the trade to be executed (if at all). For illustrative purposes only.

If you're trading ETFs with heavy weightings in international securities, we suggest trading when markets are open for the underlying securities to the extent that this is possible and practical. For example, if the ETF holds European equities, then try to trade when Europe's stock market is open because pricing for European equities could generally be more advantageous than it would be when the European stock market is closed.

A capital markets desk at an ETF issuer can help guide you through your first few ETF trades until you become comfortable using limit orders or placing trades on ETFs with international holdings.

[3] Dow Jones futures and S&P futures are futures contracts on the Dow Jones Industrial Average (an unmanaged, price-weighted index of 30 of the largest, most widely held stocks traded on the NYSE) and S&P 500 (a market capitalization-weighted price index composed of 500 widely held common stocks) Indices, respectively. The quoted price movements of these futures contracts in early trading is used by some investors as a gauge for how the overall exchanges will perform when the market opens and throughout the trading day. Indices are unmanaged and not available for direct investment.

Summary

As ETFs continue to grow in popularity with financial advisors and their clients, it's important to keep in mind the following, which we believe are ETF best practices:

- ✓ Evaluate an ETF's underlying holdings to determine its liquidity, not its average daily trading volume or assets under management
- ✓ Avoid trading ETFs when the markets initially open or prior to the close when pricing may not be optimal and liquidity could be limited
- ✓ Use limit orders when trading ETFs—not market orders
- ✓ Trade when local markets are open for ETFs that hold international securities to the extent possible
- ✓ Contact the ETF issuer's capital markets desk for questions about ETF liquidity, trade execution, and for assistance placing large trades

Answers to Quiz on Page 1

1. Trading an ETF right when the market opens help to capitalize on market and pricing inefficiencies.

   False Security prices could be more volatile when the market initially opens and prior to the close, which could impact ETF pricing and, by extension, liquidity.

2. An ETF with a low trading volume is generally illiquid while an ETF with a high trading volume is generally liquid.

   False An ETF's liquidity is determined more by its underlying holdings than by its trading volume and/or assets under management.

3. You can't get a good sense of an ETF's liquidity by looking at the number of shares that are available for trading from a market maker.

   True Markets are often significantly deeper than what can be seen on most trading screens.

4. It's a best practice to use market orders when trading ETFs and not limit orders.

   False Using limit orders when trading ETFs is a best practice.

5. Trading an ETF that primarily holds foreign securities during the trading hours of the underlying securities' local market (e.g., Europe, etc.) is preferred to the extent possible.

   True When it's possible or practical to do so, trading an international ETF during the trading hours of the underlying holdings could result in better pricing.

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ETFs from Hartford Funds

Human-centric investing means having choices

Multifactor ETFs

ROAM	Hartford Multifactor Emerging Markets ETF
RODM	Hartford Multifactor Developed Markets (ex-US) ETF
ROGS	Hartford Multifactor Global Small Cap ETF
RORE	Hartford Multifactor REIT ETF
ROUS	Hartford Multifactor US Equity ETF
LVIN	Hartford Multifactor Low Volatility International Equity ETF
LVUS	Hartford Multifactor Low Volatility US Equity ETF

Active Fixed-Income ETFs

HMOP	Hartford Municipal Opportunities ETF
HSRT	Hartford Short Duration ETF
HTAB	Hartford Tax-Aware Bond ETF
HTRB	Hartford Total Return Bond ETF

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