

The Exchange-Traded Advantage: ETFs Can Trade at Less than Cost

DID YOU KNOW?

The exchange-traded advantage of exchange-traded funds (ETFs) provides investors with the potential to trade at less than the cost to trade the underlying portfolio.

The starting spread¹ of an ETF is a transparent reflection of the costs associated to transact in the underlying market, at the quoted size. This spread also is paid by portfolio managers of mutual funds or separately managed accounts (SMAs)² on comparable portfolios, but it is not transparent to the investor.

What makes an ETF different, and gives it a distinct advantage, is the fact that it is traded on an exchange. The exchange allows not only for transparency of spreads, but, more importantly, it creates another layer of liquidity where buyers and sellers can meet to transact and exchange their risk of a fund. Because of this added layer of liquidity³, the ETF spread can collapse to inside of underlying costs. This is because there are enough natural buyers and sellers in the fund that a market maker does not have to transact in the underlying market for every trade done on the exchange. This is the efficiency of the exchange listing.

¹ ETF Spread: The ETF spread is the difference between the highest price a buyer is willing to pay and the lowest price for which a seller is willing to sell.

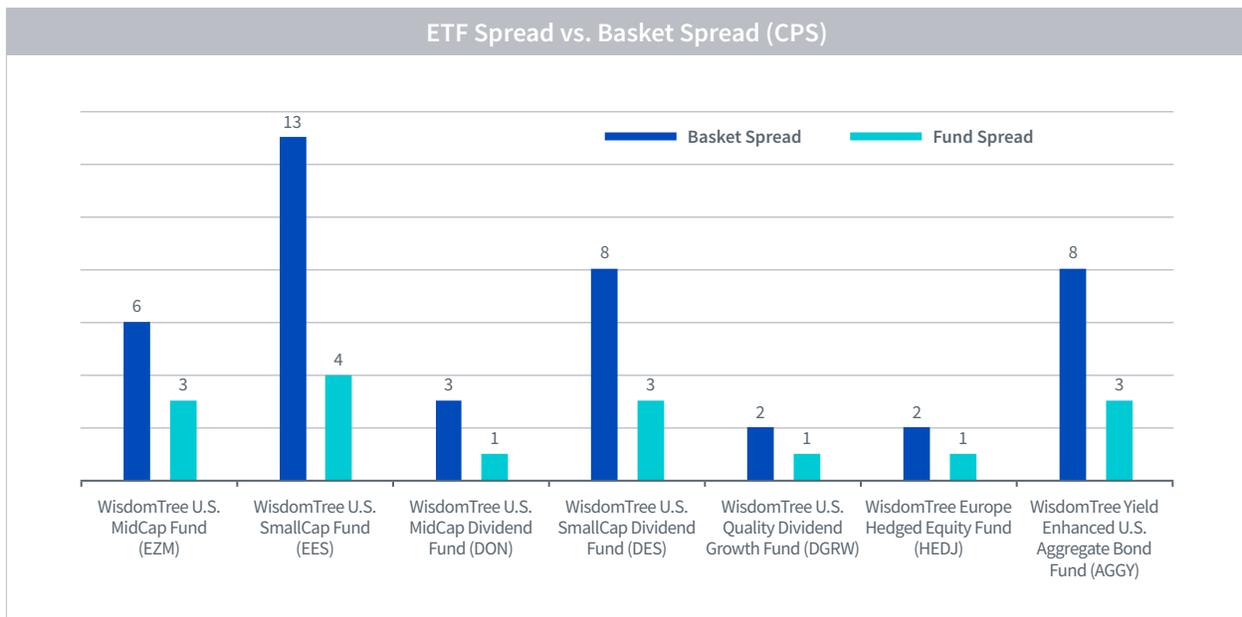
² Separately managed account: A privately managed investment account owned by an investor seeking to manage a pool of individual assets. Separate accounts are typically opened through a brokerage or financial advisor. They may also be held at a bank or opened with an insurance company.

³ Liquidity: The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.



THE ADVANTAGES OF THE ETF STRUCTURE

Below are several examples of WisdomTree Funds where the Fund's spread on the screen is tighter than the spread of the underlying basket. It is important to understand this advantage of the ETF structure and to keep it in mind when reserving judgment for ETF spreads.



Source: Bloomberg, June 2019.

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