ETF SPREADS AND VOLATILE MARKETS

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On Monday, May 13, 2019, U.S. markets had their second-worst trading day of the year, with the S&P 500 down 2.41% and volatility, as measured by the Volatility Index (VIX), spiked by 28.12%. This got us thinking about a question many investors ask during times of stress: "What happens to ETF spreads?"

The key factor to remember is that an ETF is a derivative, a wrapper around a basket of securities. Spreads in the ETF are derived from multiple factors, first and foremost by spreads in the underlying securities. When volatility spikes, spreads in many underlying securities also widen, which can trickle down to spreads of ETFs. Another major factor that goes into the pricing of ETF bid/ask spreads is volatility and risk in the market. In a fast-moving market, there is more risk to market makers, that they will not be able to hedge their position fast enough at the levels they expected. This inherent risk can sometimes be reflected in widening ETF spreads to compensate market makers for the additional risk they take for providing liquidity during these market conditions.

Are wider spreads a given in volatile markets? No. Because of the exchange-traded nature of ETFs, some funds act as liquidity vehicles that market participants can flock to during times of market stress, when the underlying asset class is less accessible. Because of the natural two-way trading in these funds, spreads may be tighter than what would be expected in the underlying market. This additional added layer of liquidity that is provided via an exchange-traded wrapper can be a major benefit to investors seeking liquidity during various market conditions.

We did not see many significant changes to normal bid/ask spreads in WisdomTree Funds on said day, which is attributable to the benefits of the exchange-traded wrapper, but wanted to review the fundamentals of ETF spreads, given the market backdrop. When trading ETFs, it's best to execute under stable market conditions. However, if investors do need to trade on days like May 13, remember the fundamental factors that go into the spread you see on screen and seek advice from your trading desk or capital markets desk if you have any questions or concerns.

Unless otherwise stated, all data is Bloomberg, as of May 14th, 2019.

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You cannot invest directly in an index.

DEFINITIONS

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

CBOE Volatility Index® (VIX®) : a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. It is the premier benchmark for U.S. stock market volatility.

ETF Spread : The ETF spread is the difference between the highest price a buyer is willing to pay and the lower price a selling is selling to sell.

Bid/Ask Spread : This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

Market maker : Someone who quotes a buy and a sell price in a financial instrument.

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 asset.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.