

Utilising ETF Implied Liquidity to properly position ETFs in portfolios

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Liquidity is one of the most misunderstood terms in the ETF world. So what is it anyway? In general, it's defined as the ability to quickly convert an investment into cash with as little friction or transaction cost as possible. Intra-day liquidity is one of the most important factors separating mutual funds from ETFs. And because ETFs, like stocks, are traded on exchange investors often equate volume with liquidity. This would be a mistake. The liquidity of an ETF is not defined by the volume it trades on a given day and is not indicative of the potential future liquidity of an ETF. ETF volume is a historical number. In addition, assets under management are not indicative of the potential liquidity of an ETF. **To put it simply, ETF Liquidity is a function of the accessibility of the assets in the underlying basket with an additional layer of liquidity provided by daily trading volume of the ETF on exchange.**

ETFs are open-ended vehicles, which means that new shares can be created and redeemed on demand. Because ETFs are listed on major stock exchanges (the secondary market), [but also have a robust primary market process for creation and redemption](#), investors can trade these ETFs intra-day, very efficiently, regardless of the daily volume of the ETF. New shares will be created on the primary market to fulfill demand on the secondary market. First and foremost, an ETF is a wrapper that holds a basket of underlying securities or provides exposure to an underlying benchmark. The liquidity of an ETF is derived primarily from this underlying basket of securities.

Investors should not rule out innovative and valuable strategies based on ETF volume or AUM. These are some of the traps investors may fall into:

- **Thinking all ETFs behave similarly and are best utilised in the same way**

This is important because strategic investment products tend to have lower daily volumes over tactical ones. Investors utilising strategic ETFs are typically making longer term investments. These ETFs typically don't track the main benchmarks, but rather proprietary indices positioned to help investors achieve better risk-adjusted returns over time. These products are more likely to have lower daily ETF volumes as investors are not buying and selling very often in these products. Again, this doesn't mean the product is illiquid, but rather that it trades infrequently on exchange. The liquidity will come from the underlying basket and is aided by the structural efficiencies of the ETF wrapper. These strategies should not be omitted from an investment universe based on volume metrics.

- **Using the US markets as a benchmark for comparison for Europe**

The reality is that the European ETF market is very different. It is a lot more fragmented than the US one: there are a number of issuers across many countries launching and listing products on different exchanges and in different currencies. That same ETF can then be cross listed four times and listed in four currencies. ETF volumes don't consolidate on one exchange or one ticker, unlike the US where ETFs are listed and settled in USD and a consolidated volume number is published.

It's also well known that off-exchange or over-the-counter (OTC) trading is much higher in Europe than in the US. This is unfortunate from a customer perspective, because they obscure the view of what is actually going on in the markets. In 2016 YTD, approximately 74.5% of all ETF trading on the London Stock Exchange occurred OTC[1]. These volumes don't necessarily hit the exchange in the printed volume figures which leads to a distorted market view. In this case, ETF volumes aren't actually low, they just look like they are.

So how can an investor actually quantify the underlying liquidity of an ETF?

The ETF Implied Liquidity metric is the only way for investors to gain an understanding of the potential liquidity of an ETF. Implied Liquidity is "a representation of how many shares can potentially be traded daily in an ETF as portrayed by the creation unit." This number is helping investors understand in a tangible way, how many shares (or USD, EUR, GBP or CHF) of an ETF they can trade on a daily basis without having a price impact on the underlying securities.

In the example below, you can see the WisdomTree US Equity Income UCITS ETF (DHSD LN) Implied Liquidity is over \$1bn USD (over 58m shares). This indicates to an investor that without having a price impact on any of the underlying securities, you can still easily trade over \$1bn USD of DHSD LN on a daily basis when looking at the liquidity of the underlying securities and extrapolating that into ETF terms. This presents very different understanding of potential use of the ETF than is presented from the actual trading volume of the ETF on exchange.

DHSD LN \$ XD Market		L18.11 / 18.15L		3010 x 9000		
Prev 17.938 ExDiv						
DHSD LN Equity		5) Export to Excel		ETF Implied Liquidity		
WT US EQTY INCOME UCITS		Min Portfolio Weight		Variable Percentage		
		0		25		
Implied Liquidity		Creation Information				
Implied Liquidity (shares)	58.143M	Creation Unit Size	65000	Open For Creations	Yes	
Implied Liquidity (USD)	1.051B	Creation Fee (USD)	N.A.	Settlement Cycle	T+2	
Liquidity Limiting Holding	TRK US	Creation Cutoff Time	Unknown	Create/Redeem Process	In-kind/Ca...	
Holdings (9/28/2016)	Ticker	IDTS (shares)	Weight (%) ↑	Last (USD)	Volume	30 Day Avg Vol
11) AT&T Inc	T US	219,989,101	5.38	40.8500	26,340,209	20,970,038
12) Exxon Mobil Corp	XOM US	254,575,321	5.11	86.9000	28,117,871	10,825,326
13) Verizon Communications Inc	VZ US	216,751,007	4.13	52.0600	13,279,093	12,458,181
14) Chevron Corp	CVX US	242,617,060	3.68	102.1500	10,190,924	6,330,439
15) General Electric Co	GE US	381,381,477	3.32	29.9000	26,750,633	30,651,336
16) Procter & Gamble Co/The	PG US	952,912,216	3.22	89.4600	89,805,967	24,805,038
17) Wal-Mart Stores Inc	WMT US	320,785,484	2.94	71.7900	6,184,932	9,514,991
18) Pfizer Inc	PFE US	303,185,358	2.84	33.9900	14,307,758	18,340,382
19) Philip Morris International In	PM US	178,152,653	2.81	99.4100	3,974,104	3,650,759
20) Merck & Co Inc	MRK US	307,618,326	2.42	63.3000	11,794,978	8,499,731
21) Kinder Morgan Inc/DE	KMI US	204,908,450	2.40	22.7400	18,953,547	15,686,530
22) International Business Machine	IBM US	294,227,441	2.30	158.2900	3,310,008	3,096,178
23) Coca-Cola Co/The	KO US	292,329,296	2.21	42.1500	15,523,783	11,117,508
24) Cisco Systems Inc	CSCO US	512,480,995	1.99	31.5000	15,840,958	23,432,208
25) Altria Group Inc	MO US	230,104,870	1.94	63.7700	7,021,004	5,055,227
26) AbbVie Inc	ABBV US	351,242,099	1.72	64.2200	5,645,599	6,808,693
27) QUALCOMM Inc	QCOM US	416,865,063	1.49	63.4500	5,251,926	7,105,946

Source: Bloomberg

In addition to understanding Implied Liquidity, you should also ask some questions of the ETF issuer's Capital Markets team in order to understand the potential investment size that can be made in an ETF:

- How liquid and accessible are the actual underlying securities?
- How easy is the underlying basket to hedge?
- Are there correlated hedges? Are there correlated derivatives or products that can be used to provide liquidity in the ETF?
- Are there taxes or ticket charges applied in trading the underlying securities?

As the ETF industry continues to grow, there will be new innovative products brought to market. Most will not enter the market on Day 1 with large AUM or volume but savvy investors should look for those products that provide opportunities for their portfolios – those ETFs which resonate with strategy, which fill an investment need – rather than looking solely at trading volume. Ultimately, **ETFs as a structure are robust, transparent with the advantage of being able to move in and out of positions quickly and efficiently when need be** – thanks to the efficient features of the structure and of the ETF trading process.

[1] London Stock Exchange: ETF&ETP Monthly Trading Data by Security, <http://www.lseg.com/areas-expertise/our-markets/london-stock-exchange/fixed-income-markets/listed-products/etfs>

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