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The Liquidity Provided by ETFs Is No Mirage

The following ICI Viewpoints post is an adaptation of an ICI response to a June 15 article in InvestmentNews titled, "The ETF Liquidity Mirage."

The article above ignores fundamental information about ETFs, the behavior of investors, and the effects of market structure on the ETF product. Let's quickly examine a few facts.

To begin with, the author mischaracterizes the events of August 24, when substantial selling pressure in the U.S. equity markets early in the day revealed weaknesses in market structure that affected some domestic equity ETFs as well as some very large U.S. stocks. As has been widely documented, poor price transparency at the open of the markets, volatility limits imposed after the 2010 "flash crash," and improper use of market and stop-loss orders by investors demanding liquidity at any price were the factors that temporarily affected the arbitrage mechanism behind these ETFs—rather than anything having to do with the nature of the ETF product itself. In fact, the majority of U.S. equity ETFs were unaffected, as was the entire domestic bond ETF market and ETFs that invest in international securities.

The article also dismisses the benefits of ETF trading in the secondary markets, where the funds act as a source of liquidity because they provide an efficient and cost-effective mechanism for investors to reduce or increase their exposure to a particular asset class or investment strategy. In these cases, only the ETF shares change hands among investors who want to buy or sell, depending on their differing viewpoints of the future rate of return on that asset class or investment strategy—not shares in the underlying securities. Thus, in times of stress, secondary-market trading in ETFs actually relieves pressure on the underlying securities held by the ETF.

This benefit has been tested repeatedly, particularly in ETFs that primarily hold less-liquid assets. The most recent example of ETFs´ resilience during times of volatility occurred late last year, when sellers of high-yield bond ETFs found willing buyers in the secondary market, and ETF shares were not redeemed en masse back to the funds. Indeed, ICI Research has demonstrated that the vast majority of ETF trading occurs on the secondary market, where a variety of investors buy and sell to each other directly, rather than through creation or redemption of ETF shares by authorized participants (APs).

Those interested in finding out how ETFs actually work and how investors use and benefit from them can visit ICI's ETF Resource Center, which is full of fact-based research and analysis, rather than speculation and incomplete information.

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