The ABCs of ETF liquidity

Since the first U.S. ETFs came to market in the 1990s, promoters extolled the idea of their intraday liquidity and pricing. "You can trade ETFs just like stocks!," they cried. While generally true, many investors still struggle to effectively evaluate the liquidity profile of an ETF. So, let's bridge this knowledge gap.

The more popular ETFs become, the more important it is for investors to use the right trading strategies—and knowing the right trading strategies is based on a robust understanding of ETF liquidity. That's especially true of large trades, which can be complex and, if mishandled, create negative consequences for client portfolios.

When considering all the variables necessary in choosing the right ETF—liquidity being one of them—it's best to keep it simple: *Does an ETF have the right amount of liquidity for my trading needs?*

The answer for a Vanguard ETF, most likely, is yes.

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Clearing the air on defining liquidity

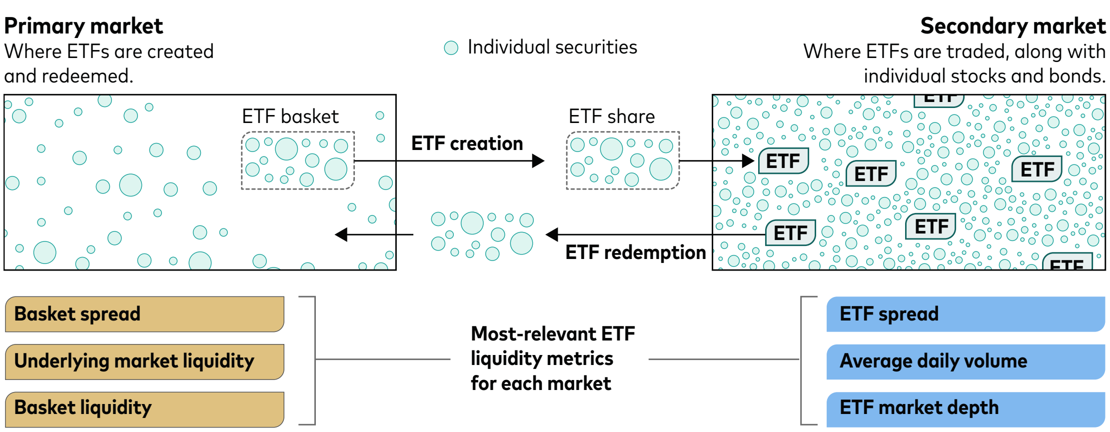
Liquidity is simply a measurement of how quickly and easily investors can enter or exit a position in the market without impacting the price of a security—in this case an ETF.

Securities with less liquidity are usually more costly to trade because there are fewer counterparties and could lead to greater market impact. Securities with more liquidity are easier and less costly to trade because they benefit from the efficiencies of higher trading volumes, which include greater pricing transparency and operational efficiency.

Unlike individual stocks, which are traded only on secondary markets, ETFs offer two distinct layers of liquidity: in the secondary market where ETFs trade along with stocks, and in the primary market, where ETFs are created and redeemed by the ETF's authorized participants.

Investors trading larger positions should effectively leverage both forms of ETF liquidity, provided they employ the appropriate trading strategy. Rigorous trading hygiene starts with an evaluation of an ETF's liquidity in the secondary market—but, if a trade is large enough, making well-mapped-out use of the primary market is essential.[1]

Primary and secondary markets of an ETF



Source: Vanguard

1 Use of the primary market invariably involves contacting and working with capital markets professionals, such as those on the Vanguard ETF Capital Markets Desk.

Unpacking the importance of average daily volume (ADV)

One common metric of ETF liquidity worth unpacking is ADV. ADV is the average amount of shares (or average daily turnover, in dollars) that change hands in the secondary market on a given day, typically based on a 30-day average. Some investors think that ETFs with lower ADVs aren't as liquid as those with higher ADVs. In fact, ADV is only a small part of an ETF's total liquidity profile.

Here are some other points to consider:

- Since ADV is based on how an ETF has traded in the past, it's not always an accurate proxy of what could be traded in the current market. It's important to take measure of how ADV compares with the current market environment, such as the ETF market depth, which we discuss below.
- ADV only focuses on how liquid the ETF is in the secondary market. If you're planning a larger trade, pay closer attention to the ETF's primary market liquidity. You might also benefit from guidance from issuers with connections to the primary market, like those on Vanguard's Capital Markets Desk.
- How liquid are the underlying securities the ETF holds? If a trade is large enough to require a market maker to create or redeem ETF shares in the primary market, the ease of trading underlying securities is more important than ADV to measure liquidity. For example, a more liquid market like Treasuries is less costly to transact in than, say, emerging market bonds.

So, let's break liquidity down, identify what's important, and provide a framework that can potentially improve investor outcomes.

What are the measures of ETF liquidity?

Investors often mistakenly look only to ADV to assess ETF liquidity. To ensure they fully understand an ETF's comprehensive liquidity profile, investors should focus on the following key measures:

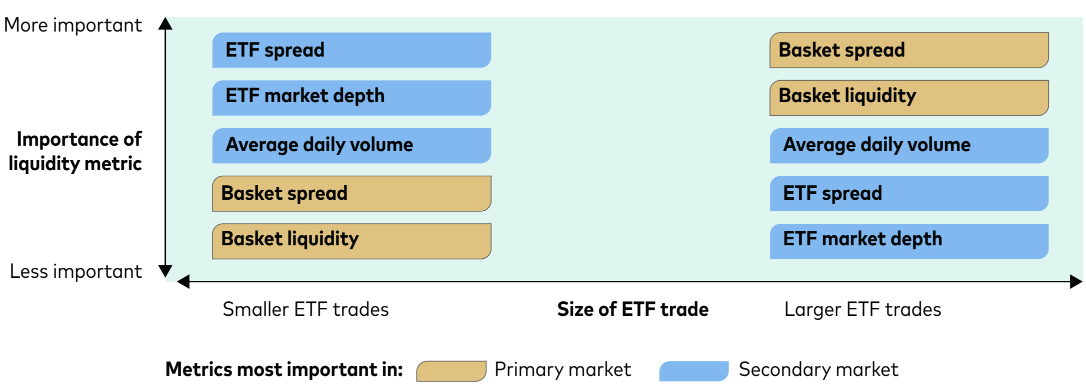
- **ETF bid-ask spread:** The average cost to trade ETFs is represented by their quoted spread on the secondary market. This metric can be viewed as the price for liquidity in the secondary market.
- **ETF market depth:** The number of shares available to trade at or near the quoted spread. Unlike ADV, this metric provides a better glimpse into the current inventory market makers have available at the quoted price.
- **Basket spread:** The cost to acquire underlying holdings, which is often indirectly passed through to clients. When your trade is large enough to require creating new shares or redeeming them in the primary market, the basket spread may be a better indication of the cost to trade an ETF.
- **Basket liquidity:** The liquidity of the underlying securities within an ETFs basket, including their volumes and spreads. Again, relatively liquid securities like large-cap equities or Treasuries can be expected to have tighter spreads than, say, small-cap equities or emerging markets bonds.

With all these variables to consider, which metric is the right one to reference?

The factors to prioritize depends on two aspects: the size of the trade and the liquidity of a particular ETF's underlying securities.

Notice in the diagram that ADV, while important, is in the middle of the pack of considerations in each of these scenarios. That's because ADV serves to identify which cost factor to focus on: ETF spread for smaller trades or the basket spread for larger trades.

Liquidity considerations in smaller and larger trades



Source: Vanguard

Have low cost and liquidity too with Vanguard ETFs®

Taking into consideration all these liquidity factors, it's worth noting that Vanguard's lineup of 88 low-cost ETFs looks relatively attractive compared with similar strategies offered by competitors. Among those attributes:

- **Vanguard ETFs have sufficient liquidity for most investors' trading needs.**
  Over 90% of Vanguard ETF assets have spreads and ADV in the 90th percentile of their respective Morningstar categories. In addition, 27 of our ETFs trade with an ADV over $100 million per day.[2]
- **More Vanguard ETFs have low spreads than do iShares and State Street ETFs.**
  Seventy-six percent of Vanguard ETFs trade with a spread below 6 bps, compared to only 51% for iShares and State Street. This means you can have more confidence knowing that an ETF you're choosing from Vanguard is designed not just to be a great long-term investment, but to be liquid too.[3]
- **Industry-leading total cost of ownership (TCO).**
  Combine our average spreads of 1.8 bps with our low average expense ratio of 5.2 bps across our ETF lineup, and your total cost of owning a Vanguard ETF is an industry-leading 6.9 bps. You can truly have your low- cost and liquidity too with Vanguard ETFs.[4]

2 **Source:** Vanguard, based on data from Bloomberg, analyzing Vanguard's lineup of ETFs, as of September 30, 2024.

3 **Source:** Vanguard, based on data from Bloomberg, analyzing Vanguard's lineup of ETFs, as of September 30, 2024.

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Vanguard ETF Shares are not redeemable with the issuing Fund other than in very large aggregations worth millions of dollars. Instead, investors must buy and sell Vanguard ETF Shares in the secondary market and hold those shares in a brokerage account. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

All investing is subject to risk, including possible loss of principal. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of a client's account. There is no guarantee that any particular asset allocation or mix of funds will meet a client's investment objectives or provide the client with a given level of income. Diversification does not ensure a profit or protect against a loss.

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