



## The Key to Trading and Investing in ETFs

By Paul Weisbruch

September 15, 2009

*Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives*

An ETF does not require a certain amount of trading volume in order to be liquid. The underlying securities of the ETF determine its liquidity. Many within the industry do not grasp this reality and are missing out on a lot of quality ETFs.

When evaluating the quality of an ETF offering or its suitability for a client, the issues of trading volume and liquidity come up often. Due to a general shortage of information on the nuances of ETFs and a lack of education about ETFs in the investment advisor community, these issues have become driving forces in determining which ETFs are best tailored for client portfolios.

The ETF industry is guilty of misleading institutional investment managers, investment advisors, and individual investors. Registered investment advisors and institutional money managers have offered me accounts of ETF-provider sales representatives explaining very little about their products or the investment strategies, and simply declaring, "Volume matters! Case closed." The often-repeated "volume matters" statement has become one of the most misused and abused notions in the ETF industry. Articles and blogs proclaim that when evaluating ETFs one should exclude those issues with less than 100,000 shares of average daily trading volume. This forces the investor or portfolio manager to wear blinders and severely narrows the universe of acceptable ETFs to consider.

Rules like "investing only in ETFs that trade at least 100,000 shares" daily will filter out dozens, if not hundreds of potentially powerful and effective investment products. Trading volume is important, but it's not the driving force that makes products ultimately successful for investors. The positive results that ETFs can create for investors within their portfolios should be the only story that matters.

From a fund provider standpoint, if the majority of the trading volume in ETFs is new buyers, that is an excellent sign for the viability of the firm. Many frequently traded ETFs go days or months with the majority of the volume being made up of sellers or short sellers, and this punches holes in the system of evaluating the merits of an ETF on trading volume alone. If we blindly assume that the most frequently traded ETFs were the best ETFs, we would be forced to assume that the mutual funds with the highest level of net redemptions are also the best mutual funds, since they have the most trading associated with them. This is simply flawed thinking.



## **All ETFs not are created equal**

The first line that needs to be drawn is that not all ETFs are the same. I will focus on equity index ETFs, long-only investment products that invest in a defined index made up of equity securities. Over the years the ETF industry, has moved from offering plain vanilla index ETFs that track the S&P 500 or the Russell 2000 to products that are either commodity linked (tied to Oil futures, agricultural products, platinum, etc.) or use leveraged or inverse strategies. Because these subcategories of ETFs are not all the same, using broad, sweeping statements like “trading volume matters for all ETFs” is an overly simplified and imprudent way to evaluate ETFs.

## **How to measure ETF liquidity**

When evaluating an ETF, simply ask one question, “What is IN this index?” In other words, “Where does this ETF invest?” Is it a highly liquid and well-benchmarked index like the S&P 500, S&P 400 or S&P 600? Or is it an index that tracks a narrow slice of the market like solar energy, wind, or the ophthalmology industry? This should be the core of any ETF evaluation process, not relying on average daily trading volume to screen out potential investments.

Why is understanding what is in an index so vitally important? Because the liquidity of an ETF has everything to do with the liquidity of the underlying stocks that the ETF’s index tracks and little to do with the average daily trading volume of the ETF itself.

A clear cut example can be made using a well known, broad based, heavily traded ETF like SPDR S&P 500 Fund (SPY) and comparing it to RevenueShares Large Cap Fund™ (RWL). Both SPY and RWL track the same S&P 500 index and invest in the same 500 stocks; however, the weightings within the indexes differ slightly because RWL weights the S&P 500 by top line company revenue, not market cap as in the case of SPY.

Both of these ETFs invest in the same stocks, from the same well known and highly liquid benchmark, except they employ different weighting methodologies. Potential investors, following conventional wisdom, will look at the average daily trading volume of SPY (260 million shares) versus RWL (31,000 shares) and make a black-and-white judgment that RWL’s lower liquidity level could present a problem should they decide to exit their position. This is a case of the tail wagging the dog. Investors will incorrectly deem an ETF illiquid and therefore “uninvestable” because its average daily trading volume hasn’t reached a certain level. Dozens, if not hundreds of ETFs are disqualified by investors every day because of this misconception.



## **Bid/Ask spreads**

Advisors need to take ETF evaluation a step further. Given the disparity of average daily trading volume between SPY and RWL, the bid/ask spread in SPY is 1 penny whereas the spread in RWL is 2-3 cents. Most investors would be perplexed by this. How is it possible an ETF that trades a small fraction of the average daily trading volume of SPY has a similar bid/ask spread? Both SPY and RWL track the same highly liquid index, the S&P 500. The price movements of an ETF's underlying stocks determine its pricing, whether it is SPY, RWL or IVV regardless of the ETFs' trading volume activity during a given session.

ETFs are not closed end funds and they do not trade, nor are they priced like closed end funds. This fact can be tested on any financial data system - Reuters, Bloomberg, or even Google Finance. Readers can launch this [link](#) and enter the symbol RWL.IV, to display the real-time indicative value of this ETF – roughly the equivalent of its NAV. Now compare this to the current bid/ask spread for RWL. Is the IV roughly in between the bid/ask? If the answer is yes, then the ETF is efficiently priced. If the bid/ask spread tight - within a few pennies - it cuts down on transaction costs. Consider using a limit order when buying or selling ETFs, placed within a few pennies of the IV, to ensure fair execution regardless of the bid/ask spread.

## **Testing pricing efficiency**

In addition to running the IV test, I encourage ETF investors to watch the IV on the screen, on Google Finance or elsewhere, and cross reference it with the bid/ask over the course of a few minutes. An ETF like RWL may not even trade over this time frame, but rest assured the IV and Bid/Ask will change in real-time, ticking up or down as the underlying stocks in the S&P 500 index move.

This point is unfortunately lost on too many investors in our industry. Trading volume is not dictating the price changes in the ETFs. The driving force is changes in the market via the underlying securities. Unlike a closed end fund, which is driven by buyers or sellers in the market, an ETF's value will fluctuate all day, every day regardless of volume.

## **Effective trade execution**

Now that we can determine whether an ETF is efficiently priced, we need to address the execution of trade orders. Always use limit orders. Sending a market order for even one of the most frequently traded ETFs will often result paying an unnecessarily high price or selling for too little relative to the ETF's real value. Large liquid indexes and all of the products trading on exchanges that are linked to them have daily turnovers in the billions of dollars, so it is highly unlikely that one investor is going to move the IV of an ETF like RWL, even with an order of a few hundred million dollars.



Is it possible to receive poor execution on a market order, whether buying or selling? Absolutely. Some fiduciaries shy away from ETFs that don't trade millions of shares on a daily basis because of a poor execution experience. Market orders will catch up with an investor eventually, even with high volume ETFs. Investors could be losing pennies on larger orders and not even realize it due to poor execution. Marketable limits when buying or selling are a necessity, and set the highest price an investor is willing to pay or the lowest price at which they will sell to get the order filled.

### **Large orders**

Large investment advisors who trade exclusively using block orders and large institutional money managers will want to work with a trading desk or ETF liquidity provider directly when entering or exiting ETF positions. The guidelines I laid out earlier are still important, as investors should be aware of an ETF's IV as well as the price they are willing to pay or take to get order filled in its entirety. Contact an ETF liquidity provider directly if you have the resources or call your trading desk. Specify the size and side of the order, and note any specific instructions. For instance, a large advisors might want to purchase 120,000 shares of an ETF, but in pieces because he had no strong view of how the market was going to perform from midday until the end of the session. You can ask your trading desk to "work the order the best way." If an ETF tracks a highly liquid index, and an investor properly works through a trading desk and/or uses limit orders, he or she can effectively enter or exit positions and receive fair execution without moving the IV of the ETF.

The following example defies the ETF industry mantras of "Trading volume matters" and "Trading volume and liquidity are the same."

### **Scenario**

The RevenueShares Small Cap fund, RWJ, on average only traded 15,000 shares per day through May 1, 2009. Most investment advisors and portfolio managers would have dismissed RWJ as a potential investment due to the erroneous perception of low trading volume equaling low liquidity.

On May 1, the first block trade occurred at 11:30 AM ET with a bid of \$18.84 for 1,000 shares and an ask of \$19.00 for 1,000 shares. Most investors would turn and run the other way if they saw a 16 cent spread and only 1,000 shares on the inside bid/ask because the perceived illiquidity would present a barrier to effectively getting in or out of a position. However, a portfolio manager bought 50,000 shares at 18.90, which was *in between* the bid/ask spread. Keep in mind, 50,000 shares at the time was more than three times the average trading volume in the ETF!



For those who would expect the ETF's price to immediately rise since a buyer is present in an "illiquid" market, this myth was also dispelled. The 50,000 share order, while large for RWJ, was a drop in a bucket in the context of the S&P 600 index, and did not cause a ripple in terms of price impact. Thus, the price of RWJ following the 50,000 share block order was not affected.

The portfolio manager bought another 50,000 shares at 12:22 PM with a bid of 18.90 for 100 shares and an ask of 18.93 for 1,000 shares. Think about that: 100 by 1,000 shares. Most institutional money managers wouldn't touch RWJ if they saw this on their screen. The portfolio manager bought 50,000 shares through his trading desk AT 18.93. That's correct - the execution took place *on* the ask without any adverse price impact.

A few hours later, at 3:18 PM, the portfolio manager wrapped up his buy order with a final 20,000 share block order with the market in RWJ looking like this: Bid \$18.81 for 2,000 shares and Ask of \$18.93 for 100 shares. Here, the 20,000 shares were executed at \$18.91, again in between the visual bid/ask on the screen.

One portfolio manager bought 71 percent of the entire day's trading volume of RWJ on May 1, 2009 without moving the price of the ETF away from the IV. Going into May 1, there were only 800,000 shares of RWJ outstanding, and this portfolio manager purchased approximately 15 percent of the shares outstanding without moving the ETF's price. This is virtually impossible in the world of closed-end funds and illustrates why it is vitally important to draw a line between closed end funds and ETFs.

Why was this possible and why does the equity index ETF space work this way? ETFs like RWL, RWK, and RWJ are open-ended index funds based on highly liquid and well-benchmarked S&P indexes that can create an unlimited number of shares as new buyers in the marketplace demand them. Think of equity index ETFs like a clown car that, no matter how many passengers step into it, the car never has a capacity problem, and never shuts the door on any one given passenger who wants to get inside, take a seat, and get comfortable. Yet the car doesn't need to "make room" for all of the passengers as they get into the car since the car is an open-end index fund with the ability to create or redeem an unlimited number of shares.

Unlike an individual stock or a closed-end fund, where there indeed be liquidity problems, when everyone needs to get out of the car, or sell, the ETF will still trade near the value of the underlying index due to these same characteristics. Understanding how ETFs trade, and the best way to receive proper execution whether you are managing the orders yourself or working through a trading desk is of the utmost importance and will translate to real dollars added to your bottom line.



## The Golden Rules of ETF investing

I will leave you with a few Golden Rules:

1. Do not evaluate the quality of an ETF or its suitability for a client based on volume alone. Metrics such as the percentage of volume that represents new buyers and sellers need to be taken into consideration. Volume alone is largely noise.
2. Ask where the ETF is invested. Is it a straight forward, long-only equity index ETF? Or is it something more esoteric that relies on futures, options or leverage of some sort? These major differences are much more important than questioning volume.
3. Understand IV (NAV), how it relates to the real time pricing in terms of an ETF's bid/ask in the open market, and how to use IV to one's advantage in the pursuit of proper trade order execution.
4. Utilize trading desks for larger block sized orders and always use limit or "marketable limit" orders to provide protection on buy and sell orders.
5. Buyers, sellers and trading volume do not dictate price fluctuations for equity index ETFs, but rather the up and down ticks of the securities within the index that the ETF tracks.

*Paul Weisbruch is the Director of Institutional ETF Sales at RevenueShares™ Investor Services. Paul has experience as an institutional ETF trader, both on the floor of the Philadelphia Stock Exchange (PHLX) and on an upstairs OTC ETF trading desk. He was actively involved in trading and making markets for institutional portfolio managers in products such as the DIAMONDS Trust (DIA) and SPDR S&P 500 (SPY) over the past decade when misinformation regarding ETFs was rampant and the education on trading ETFs was even more lacking than it is today. You can reach him at [paul.weisbruch@revenuesharetfs.com](mailto:paul.weisbruch@revenuesharetfs.com) or 877-738-8870 x 202 to discuss ETFs and how to effectively trade them.*

[www.advisorperspectives.com](http://www.advisorperspectives.com)

For a free subscription to the Advisor Perspectives newsletter, visit:  
<http://www.advisorperspectives.com/subscribers/subscribe.php>