

EGA Wealth Management Expert Series

Thinly-Traded ETFs: Competitive Advantage in Wealth Management

There has been a great deal of attention on the growth of the exchange-traded fund (ETF) industry. Yet, many investors restrict themselves to a small number of products. Some wealth managers are using thinly-traded ETFs to more accurately express their own investment point of view. They do so by executing through a dedicated ETF trading desk. These wealth managers offer both a more flexible set of choices and a differentiated practice. Understanding that a specialized ETF trading desk can unlock the true liquidity of an ETF is a competitive advantage.

Please note that this document focuses on plain vanilla equity ETFs and does not consider factors that affect derivative-based, leveraged, short, or fixed income ETFs.

Most ETFs are Small and Thinly-Traded

As of December 2011, the U.S. ETF industry included over 1,300 funds, totaling more than \$1 trillion in assets. In 2011 ETFs accounted for more than 30% of the total traded value in U.S. listed equities¹. Despite these volumes, most ETFs have few assets and trade very little. 25 ETFs account for over two-thirds of trading volume and more than 50% of assets.

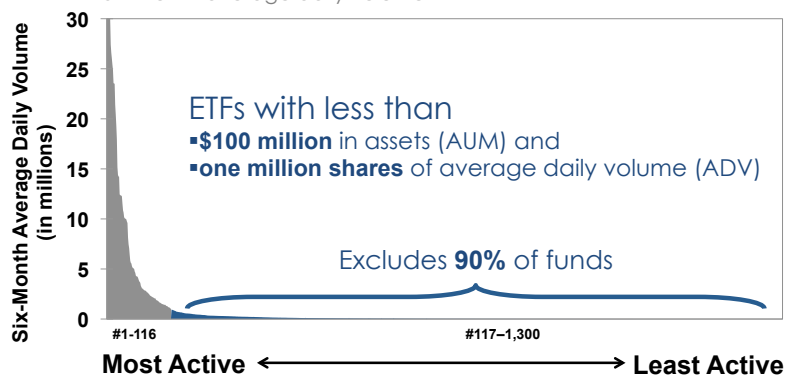
Since the majority of wealth managers believe an ETF's liquidity is tied to fund assets and volume, they tend to avoid ETFs that are small and thinly-traded. The consequence of this approach is a restricted set of choices. For example, a screen which excludes ETFs that have less than \$100 million in assets and one million shares in average daily volume (ADV) eliminates over 90% of the choices in the entire U.S. ETF universe (see figure 1).² We believe wealth managers will increasingly reject these sorts of criteria in order to improve their ability to implement investment views.

Highlights:

- Most ETFs are small and thinly-traded
- Wealth managers who avoid these funds constrain their ability to express a point of view
- ETFs do not trade "just like stocks"
- Dedicated ETF trading desks unlock liquidity

Figure 1: U.S. – Listed ETFs Ranked by Share Volume

Six-Month average daily volume



Data as of 11/11/2011. Source: Bloomberg, EGShares

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ETFs Do Not Trade “Just Like Stocks” (The Stocks They Own Do)

Since ETFs were introduced, it has often been said that ETFs trade “just like stocks.” **This claim is not true, and is in fact the root of the misunderstanding that surrounds ETF liquidity.** The supply of shares of an individual company is limited to the amount issued. Market demand for the individual security drives the price. Market participants expect large trades of a thinly-traded stock to have an effect on price.

Figure 2: Characteristics of Stocks, ETFs, and Mutual Funds

	Stocks	ETFs	Mutual Funds
Trading period	Intraday	Intraday	End of day
Share price advertised	Every trade	Every trade	End of day
Can be sold short	Yes	Yes	No
'40 Act Fund	No	Yes	Yes
Composed of a portfolio of underlying securities	No	Yes	Yes
Key driver of share value	Buying and selling demand for the security	Buying and selling demand for the underlying securities	Buying and selling demand for the underlying securities
Number of shares	Fixed ^a	Variable ^b	Variable ^c

^aUnless a corporation does new issuance. ^bETF shares are typically issued in increments of 50,000 share blocks referred to as “creation units”. ^cMutual fund shares outstanding change daily with shareholder fund flows.

ETFs, however, are open-end funds and—like mutual funds—market demand for stocks in the *underlying portfolio* drives the price. The supply of ETF shares is not fixed and can expand or contract daily, limiting the effect that properly executed trades can have on the price of ETF shares. Large orders are either filled with outstanding shares or, when necessary, by creating or redeeming shares. As a result, **the “screen market”—the fund’s assets (AUM), bid-ask spread, or ADV—will not reveal the true liquidity available for an ETF transaction** (see figure 2).

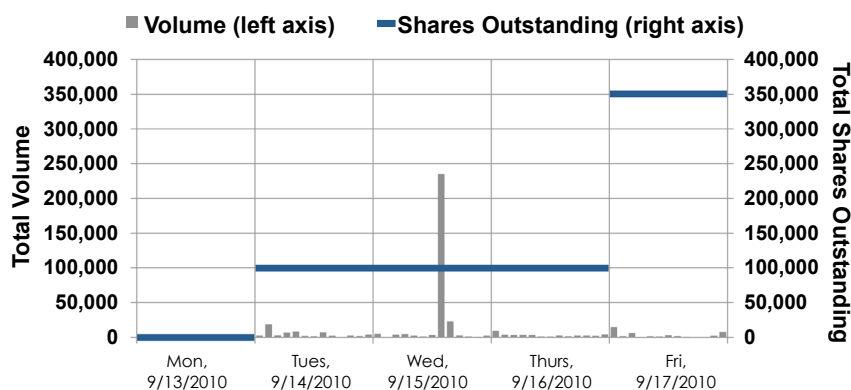
The Screen Market is Not the Market

“I’ll wait for the fund to be large enough.”

In order to evaluate ETF “liquidity” many wealth managers will compare a desired position size to the ETF’s AUM or shares outstanding, avoiding the fund if they deem their potential position too large. Since a share of the ETF represents proportional ownership in the underlying portfolio of securities, the screen market (in this case the shares outstanding) offers limited information about the accessible liquidity.

Figure 3: ECON Volume and Shares Outstanding

30-minute trading intervals, Monday 9/13/2010 to Friday 9/17/2010



See endnotes for fund objective and standardized performance. Source: Bloomberg data

Example

Figure 3 highlights the second day of trading for the EGShares Emerging Market Consumer ETF (ticker: ECON). At the market opening there were only 100,000 ECON shares outstanding (about \$2 million in AUM). That afternoon an investor purchased over 234,000 shares (almost \$5 million) of ECON—more than twice the total size of the fund. This wealth manager (with the help of their ETF trading desk) understood that additional ETF shares could be created by accessing the liquidity of the underlying stocks. The existing fund size offered little help in evaluating the true liquidity. **This \$5 million trade was insignificant relative to the over \$200 billion market cap of the underlying index.**

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“My trade will move the market.”

Perhaps an even more common approach than using fund assets to measure liquidity is to compare order size to ADV or current bid-ask spread for an ETF. Again, the screen market offers limited information about the available liquidity for a trade. On the other hand, a dedicated ETF trading desk has the ability to access much more liquidity than the screen indicates—with potential price improvement. For thinly-traded ETFs, the screen market is generally only useful for small orders.

Example

Figure 4 shows the screen market for ECON just before 12pm EST on December 15, 2011. The screen market indicated that there were 12,900 shares bid at \$21.21. At that time a wealth manager sold more than 445,000 shares at \$21.22—a penny better than the screen market. This wealth manager utilized a dedicated ETF trading desk to sell a large position relative to the ADV and advertised bid size, possibly saving their clients a significant amount of money (see figure 5). Given the screen market during this trade, a market order would have swept the book³, executing at an average price much lower than the best bid price advertised. Unless the order is small (less than the screen market size) working with an ETF trading desk has clear advantages.

Figure 4: ECON Screen Market

Market snapshot, 12/15/2011 11:59:42 EST

Total Fund Assets: \$276 million
Shares Outstanding: 13,050,000
ADV (6-month): 112,321

Bid Statistics			Ask Statistics		
Exchange	Size	Price	Price	Size	Exchange
ARCX	12,900	21.21	21.28	1,700	ARCX
NSDQ	2,000	21.21	21.28	100	NSDQ
BATS	2,000	21.21	21.30	1,500	BATS
CBSX	400	21.06	21.43	400	CBSX

For illustrative purposes only. Source: Bloomberg data as of 12/15/2011.

Accessing True Liquidity Using a Dedicated ETF Trading Desk

A wealth manager may use one or more types of ETF trading desks. They all have one thing in common: the ability to access greater liquidity than the screen market shows. Some access liquidity as an aggregator, on an agency basis.⁴ Others provide liquidity on a principal basis. In either case, using a specialist ETF trading desk often leads to tighter markets and better execution. These desks can also offer guidance for managing smaller orders for single accounts or portfolio cash flows.

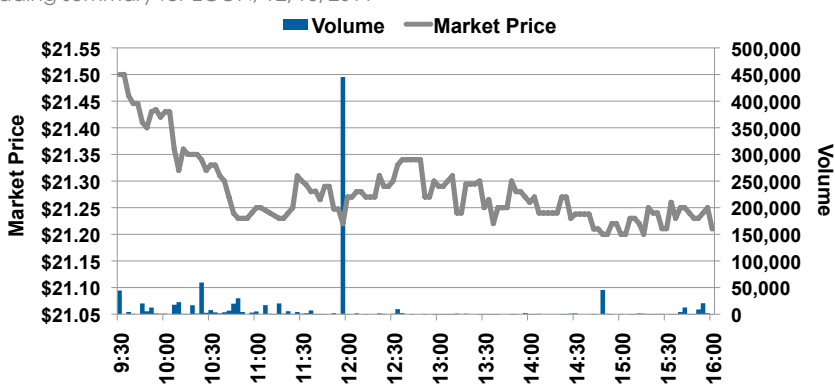
The true liquidity of an ETF can easily be tested. A wealth manager may choose a thinly-traded ETF that might have been avoided because of perceived illiquidity. Their dedicated ETF trading desk can provide a two-way, indicative market for a large order of that ETF. Wealth managers who are new to this process may be surprised by the execution improvement that is possible.

Conclusion

Wealth managers who use thinly-traded ETFs can more precisely express their investment views. An ETF trading desk can reveal the true liquidity of an ETF, accessing tighter markets than the screen market shows.

Figure 5: ECON Volume and Market Price

Trading summary for ECON, 12/15/2011



Data captured 12/15/2011. Source: Bloomberg

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For questions on this paper, more information on trading ETFs, or to understand your own access to dedicated ETF trading desks, contact Bart Smith or John Penney at EGShares Capital Markets (+1 888 800 4347 x2).

EGShares Capital Markets is committed to working with market participants such as wealth managers, ETF trading desks, market making firms, authorized participants, and securities exchanges to promote best practices in ETF trading and execution.

¹ Data Compiled by ETF Industry Association as of 12/31/2011, <http://www.etf-ia.com>

² Bloomberg data as of 12/29/2011

³ Sweeping the book refers to an order that executes by buying (selling) at all the available offer (bid) prices on the market's book up to a specific number of shares, possibly at a price that is higher (lower) than the best offer (bid) displayed.

⁴ Agency desks vary by type. Examples include dedicated desks within large broker-dealers and specialist agency ETF firms.

Disclosures

Fund Objective: The EGShares Emerging Markets Consumer Exchange Traded Fund (ETF) seeks to achieve its investment objective of total return by investing in the constituent securities of the Dow Jones Emerging Markets Consumer Titans Index. The index measures the stock performance of 30 leading emerging market companies in the Consumer Goods and Consumer Services Industries as defined by the Industry Classification Benchmark (ICB).

Performance	1-Month (%)	3-Month (%)	Year-to-Date (%)	1-Year (%)	Since Inception (%)
Total Returns (Net Asset Value)	-0.17	8.85	-4.99	-4.99	7.87
Total Returns (Market Price)	-1.55	10.97	-5.28	-5.28	7.95
Dow Jones Emerging Markets Consumer Titans Index	0.06	8.97	-4.51	-4.51	9.64
MSCI Emerging Markets Index	-1.21	4.42	-18.47	-18.47	-6.89
All data as of 12/31/2011					

Performance data quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than the original cost. Current performance data may be higher or lower than actual data quoted.

For the most current month-end performance data please visit www.egshares.com or call +1 888 800 4347.

Market price returns are based on the midpoint of the bid/ask spread at 4 pm ET and do not represent the returns an investor would receive if shares were traded at other times.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, please call +1 888 800 4347 or visit EGShares.com to view or download a prospectus. Read the prospectus carefully before investing.

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