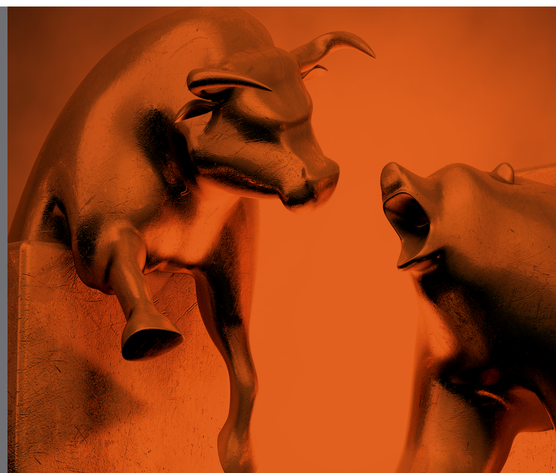
HOW TO TRADE ETFS

BetaShares
Exchange Traded Funds



As investors around the world continue to adopt exchange traded funds (ETFs), there has been an increased focus on the most appropriate way to trade these instruments. Conveniently there is a very simple rule of thumb to make sure you get what you expect when trading ETFs.

Open-ended funds: unlisted

Along with being exchange traded and passive in nature, ETFs are also notable in being "open-ended" investment funds. As such, the supply of units available to investors is able to expand or contract in line with demand - meaning investors should usually be able to buy or sell units at prices close to the net-asset value per unit (NAV) of the underlying securities that the fund holds.

In the case of unlisted open-ended funds, end-investors are effectively only able to obtain or redeem fund units in direct dealings with the fund manager only once per day, and at prices set at the fund's closing NAV (adjusted for buy and sell spreads to cover administrative costs).

The supply of ETF units can also adjust with investor demand. In the case of ETFs, however, professional market-makers (via institutional trading partners) transact directly with the ETF provider on a daily basis, creating or redeeming units to meet demand for these units on the ASX. In turn, this means that market makers are usually able to offer end-investors trades in ETFs during the trading day at prices close to the prevailing intra-day NAV.

So far, as you may have noted, there's not much practical difference between unlisted open-ended funds and ETFs at least as regards structure - both enable investors to trade in funds usually at prices quite close to NAV. On days of extreme market weakness, it's likely that the net-asset value of both unlisted funds and ETFs will decline - and investors seeking to sell out of either form of managed fund will not be spared from the market's wrath.

Accordingly, just as it would be nonsensical to blame unlisted managed funds for the market's decline, so it would be nonsensical to blame ETFs - both are just alternate conduits through which end-investors express their trading views.

Market vs limit orders and bad ETF fills

That said, there are some important differences between ETFs and unlisted open-ended managed funds that present both challenges and opportunities for the ETF investor.

Being traded on an open exchange, ETFs offer a higher level of liquidity in that, unlike unlisted funds, they can be bought and sold continuously through the trading day if desired, but being on an open exchange also means that there is no requirement for ETF investors to trade only with market-makers nor is there a requirement that trades take place only at (or even near) an ETF's prevailing NAV. As for any traded security, ETFs usually have a range of bid and offer prices placed into the market at any given time.

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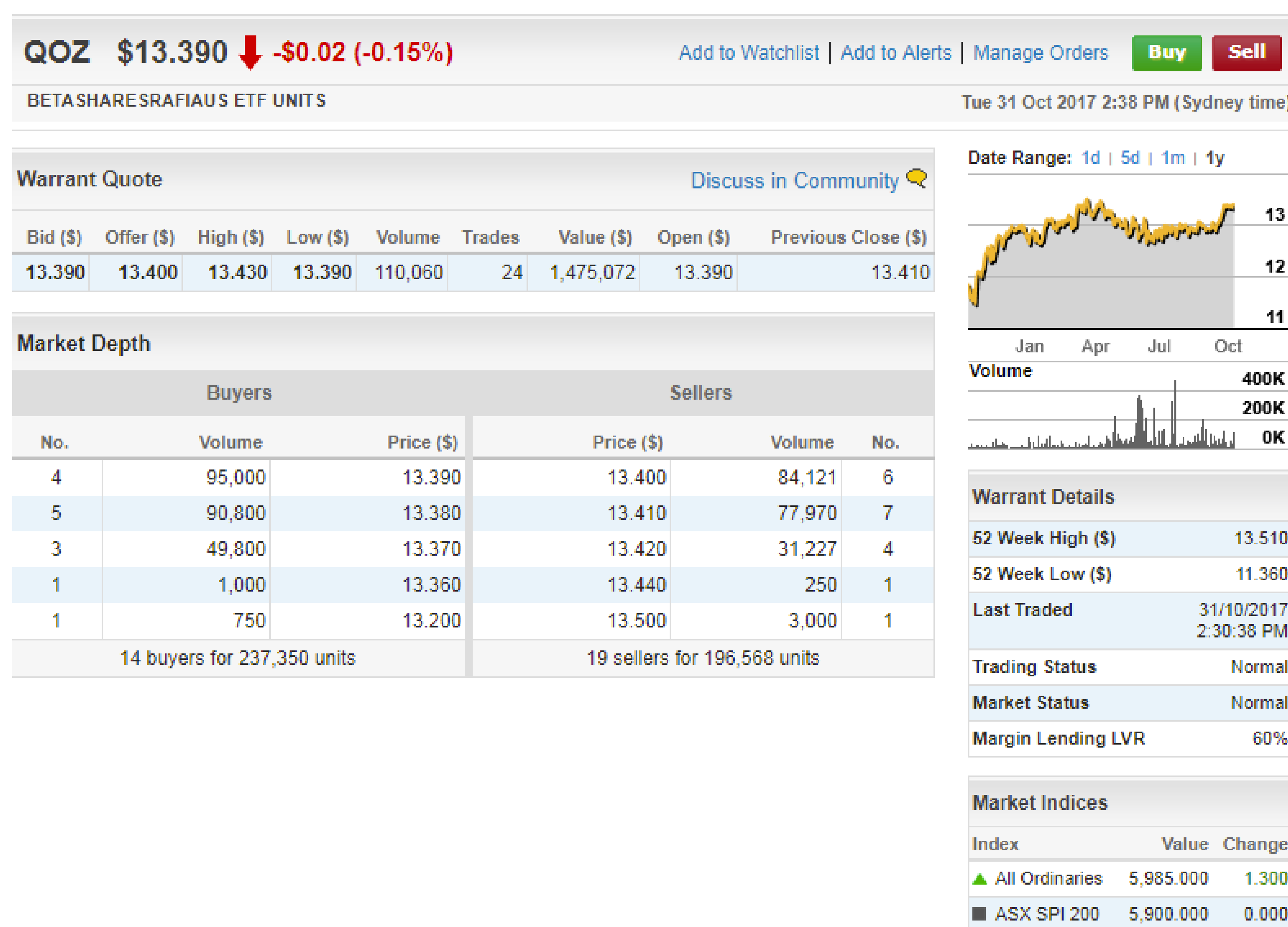
The image below shows the prevailing range of orders in the market for the BetaShares FTSE RAFI Australia 200 ETF (ASX Code: QOZ) as at 2.28pm on 31 October 2017. At this time, there were just over $1 million worth of QOZ units for sale or on offer at $13.39 and $13.40 respectively - at a (tight!) 1 cent spread. At the time, placing "Y" in front of the code QOZ on an online share trading website would have told you the ETF's indicative NAV was $13.392. So it's fair to say the best bid and offer prices were truly very close to the ETF's prevailing NAV. What's more, were an investor to buy or sell a big chunk of QOZ - the market maker would likely to able to quickly show the same previous quantities available at bid or offer at the same NAV, providing market prices had not changed in the interim.



Warrant Quote — Discuss in Community

Bid ($)	Offer ($)	High ($)	Low ($)	Volume	Trades	Value ($)	Open ($)	Previous Close ($)
13.390	13.400	13.430	13.390	110,060	24	1,475,072	13.390	13.410

Market Depth

Buyers			Sellers		
No.	Volume	Price ($)	Price ($)	Volume	No.
4	95,000	13.390	13.400	84,121	6
5	90,800	13.380	13.410	77,970	7
3	49,800	13.370	13.420	31,227	4
1	1,000	13.360	13.440	250	1
1	750	13.200	13.500	3,000	1
14 buyers for 237,350 units			19 sellers for 196,568 units		

Warrant Details

52 Week High ($)	13.510
52 Week Low ($)	11.360
Last Traded	31/10/2017 2:30:38 PM
Trading Status	Normal
Market Status	Normal
Margin Lending LVR	60%

Market Indices

Index	Value	Change
All Ordinaries	5,985.000	1.300
ASX SPI 200	5,900.000	0.000

That said, as also should be evident from the example, there are also a number of other bid and offer prices in the market - at prices relatively further from the ETF's prevailing indicative NAV. As noted above, this is as true for ETFs as with other tradeable securities, like company shares.

It is at this point that the difference between market and limit orders - when trading on an exchange - needs to be noted. A market order is one in which an investor offers to buy or sell a given number of ETF units (or other security) at whatever price is required to fill the order. A limit order by contrast has a price limit attached to it - it is an order to buy or sell a given number of ETF units (or other security) but at no more or less than a set price respectively. For relatively small orders in relatively normal market conditions, the distinction between limit and market orders usually does not matter. But in times of market volatility and panic, the difference between these types of orders can matter greatly.

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In the example above, an investor wishing to sell 10,000 units of QOZ (worth $134,000) could place either a limit or market order - it would not likely matter - and they would likely be filled at the best prevailing price of $13.39. If it were a larger sell order, however, (say for $2 million worth of units in this fund), the investor could place an order for around 150,000 units of stocks at a limit of $13.39 - and see if the market maker meets it. As a side note, if necessary this hypothetical investor could contact the ETF provider (i.e. BetaShares) for assistance to see if market makers could make available more volume on screen at current prices.

But if this investor left a large market order for 150,000 units, they would instantaneously end up selling 95,000 units at $13.39 and the remaining 55,000 units at $13.38 - or a lower average price. Of course, even in this latter case the lower price is not too bad (1 cent) - but it would start to matter in times of high market panic and volatility where there may be a lot more sellers at the same time. In such a situation, using market orders to sell down units creates the risk of being filled at prices well below prevailing NAV - indeed the recorded trade price of an ETF would gap down whenever such "bad fills" take place, as was evident for some ETFs during the US "flash crash" market turbulence in 2010.

The lesson: Use limit orders!

Market panics are never easy for any investor to handle, irrespective of the particular investment structure (direct shares, ETFs or unlisted managed funds) they are using. In the case of direct shares and unlisted funds, investors are likely to face weakening NAV prices should they decide to sell during market volatility - a decision they may (or may not) come to regret.

In the case of ETFs, investors also face the likelihood of selling at depressed NAV valuations, but have the added - but easily avoided - challenge to ensure they don't also unwittingly accept prices well below NAV through the injudicious use of sale market orders. That said, compared to unlisted funds, ETFs still retain better flexibility to enter and exit the market relatively more quickly.

In the worst case scenario, in which the price of some ETFs may momentarily go down in price (only to rebound), it would be unfair to blame them for a much broader bout of market weakness which may be unfolding. It is the decision of investors to sell exposure to underlying securities - not the conduits through which they choose to hold this exposure - that is ultimately always responsible for market declines.

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NOVEMBER 2017

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