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The ABCs of Trading a New ETF

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As the name implies, ETFs are mutual funds that trade on an exchange. Like mutual funds, they offer diversification benefits and exposure to a specific asset class. Similar to stocks, they allow for intraday trading on an exchange.

Many of the world's largest and oldest ETFs can trade hundreds of thousands—and sometimes millions—of securities on any given day. As new investors look to purchase the ETF, there are numerous existing investors who could potentially sell. These ETFs typically have high average daily trading volumes and tight bid/ask spreads, the difference between the price a buyer is willing to pay (bid) for a security and the seller's offering price (ask).

This is usually not the case for newly introduced ETFs. These ETFs typically have much lower average daily trading volumes and wider bid/ask spreads. Furthermore, newer ETFs have far fewer securityholders—typically on the first day of trading there is only one.

Innovations in the ETF landscape have made many new strategies available that meet a wide range of needs. Yet some investors may be apprehensive about purchasing newly introduced ETFs on the mistaken belief that their small asset size, and/or low trading volumes, could mean inefficient trading. In reality, an ETF's small size or low trading volume should not (and often does not) prevent smooth trade execution.

Let's review the basics of ETF trading as well as some tips for investing in new ETFs.

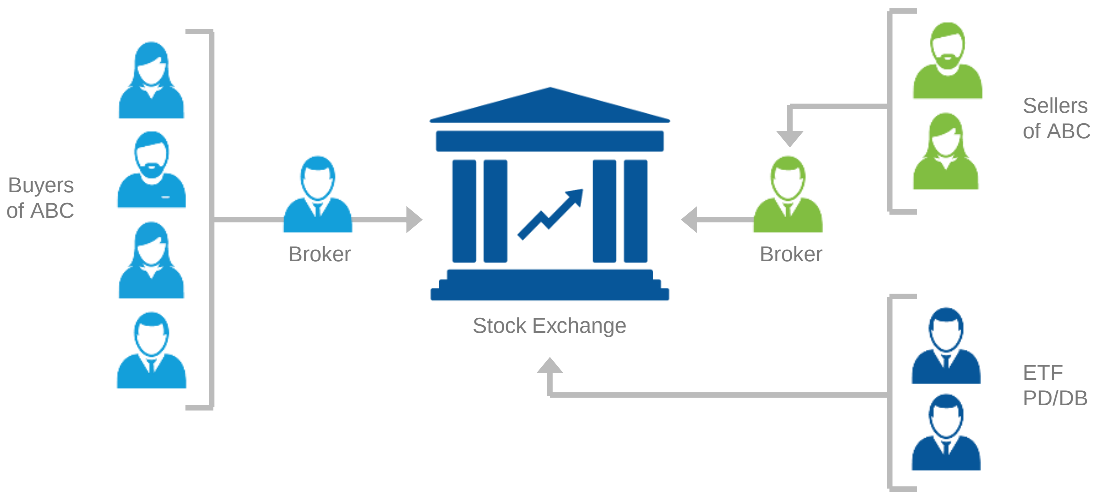
The Basics of an ETF Trade

Buying or selling an ETF is done in the same manner as buying or selling a stock, and the price of the ETF is generally in line with the price of the underlying basket of securities.

Behind the scenes, Participating Dealers (PDs) and Designated Brokers (DBs) can use the creation/redemption process to manage their inventory if there is an imbalance between natural buyers and sellers. If there is an influx of buyers, they will meet that demand by selling ETF securities, buying the underlying basket of securities and delivering it to the sponsor as part of a creation.

Similarly, when there is an influx of sellers, the PDs will buy ETF securities, deliver them to the sponsor in exchange for the basket of securities, which they will sell in the market. For established products with high volumes, buyers can transact with sellers on the exchange, often without triggering any trading in the underlying basket of securities.

The ETF Ecosystem



When new investors enter the market to purchase securities of an ETF, demand can often be met by existing securityholders who are looking to sell their securities.

When there's an imbalance between buyers and sellers, Participating Dealers and Designated Brokers step in to make additional supply available through the creation/redemption mechanism.

This process helps keep an ETF's price in line with the net asset value of its underlying securities.

The Special Case of the New ETF

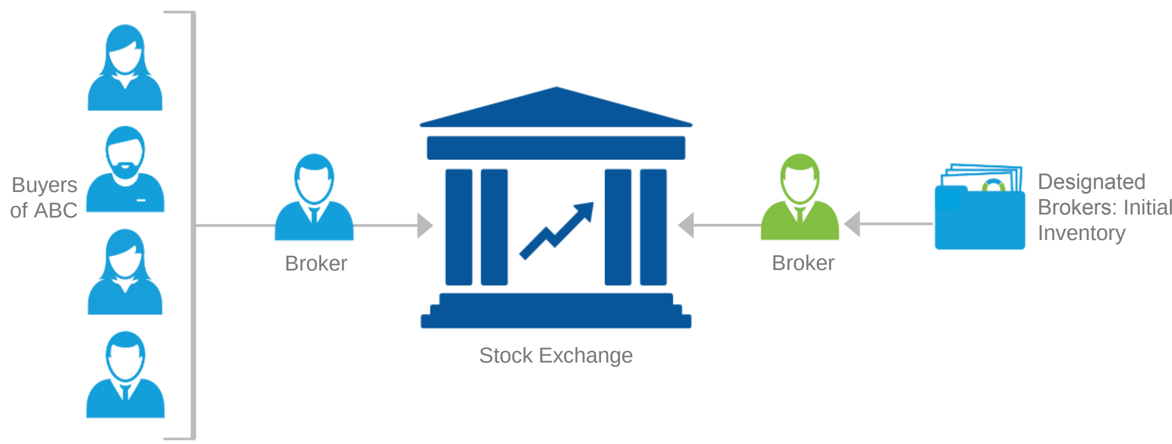
A new ETF's price will also generally remain in line with the price of the underlying basket of securities. Yet unlike a more established product with a significant number of existing securityholders, there may be only one—or very few—securityholders available to sell shares.

These sellers are institutional investors (called "Designated Brokers") who hold the initial inventory in an ETF. These Designated Brokers are eager for a product to succeed, as they would prefer not to keep the inventory on their books.

Furthermore, since Designated Brokers are motivated to sell securities to new investors, the ETF tends to trade in line with the price of the underlying basket of securities, just as with more established products.

The diagram below provides an overview of trading a new ETF. The best practices outlined on the following page are designed to help ensure that ETF prices are in line with the value of their underlying securities.

The Ecosystem for Newly Introduced ETFs



> **"Designated Brokers are motivated to sell securities into the marketplace at prices that generally reflect the costs associated with assembling the underlying securities."**

Best Practices for Trading Newly Listed ETFs

A **Allow Time for Designated Brokers to Set Initial Quotes.** Often a single firm actively quotes new ETFs, so it is prudent to provide an opportunity for them to digest any market news as they set their initial markets, especially when some of the underlying securities may not have opened for trading. Investors should have an understanding of the normal spread for a newly listed ETF and then avoid trading that product until it is reached.

B **Buy Using a Limit Order.** A limit order specifies the maximum price a buyer is willing to pay per security. In the case of a new ETF, this approach can be useful because Designated Brokers are often willing to sell more securities than they're offering on screen given the inventory they may have on their books.

Notably for investors, it is important to understand the dynamics of "market orders" which seek liquidity at any price as well as "stop limit orders"[1] which may be executed if there is a sudden lack of market liquidity.

C **Call on Capital Markets for Larger Trades.** A firm's capital markets desk works with market participants to foster healthy ETF trading. This can help both financial advisors and institutional clients have a positive experience when trading newer ETFs. For example, the capital markets desk can help connect investors with the Designated Brokers, who are often the best source of liquidity.

D **Don't Forget What Is Happening in the Markets.** Many investors have turned to ETFs during recent periods of volatility such as the Taper Tantrum and Brexit. Yet it's best to keep in mind that volatile markets can also spell uncertainty for ETF pricing as prices of the underlying securities move sharply—leading to wider bid/ask spreads. It's always best to understand what's happening in the broader markets when entering any ETF order.

E **Enjoy the Optionality of Trading throughout the Day.** Above, we suggested avoiding the market open to give the liquidity providers time to set their initial markets. Once that has happened, ETFs tend to trade efficiently throughout the rest of the day. Clients should be comfortable trading at any time during the trading day regardless whether the underlying markets of the stocks held by an ETF are open or closed.

For example, European stock trading overlaps with Canadian stock trading by only two hours, yet the Canadian market is generally proficient at estimating the price of international securities that are closed. Often called the price discovery mechanism, it is the market's attempt to price in the expectation of a security's next-day price based on current market conditions in Canada.

The Bottom Line

Innovation in the ETF marketplace has made a wide variety of new strategies available to investors—many of them designed to meet a growing range of needs that could serve as attractive additions to a portfolio. The simple steps outlined above are designed to give investors greater confidence in placing a trade in these newly introduced ETFs.

[1] A stop-limit order combines the features of a stop order with those of a limit order. A stop-limit order will be executed at a specified price, or better, after a given stop price has been reached. Once the stop price is reached, the stop-limit order becomes a limit order to buy or sell at the limit price or better.

When you're ready to trade, your financial advisor can reach out to our capital markets experts, particularly for larger trades. These professionals have up-to-the-minute intelligence on market trends, communicate regularly with Designated Brokers and PDs, can connect you with liquidity providers and provide guidance on limit orders—all to help you achieve the best possible executions.

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ABOUT THE AUTHOR

The Capital Markets team works with both investors and financial advisors to help ensure Franklin LibertyShares ETFs trade as they were designed. Mr. Mann's responsibilities include working with liquidity providers to foster healthy creation and redemption processes and on-screen markets as well as partnering with Franklin Templeton sales specialists to discuss ETF trading and structure with clients.

IMPORTANT LEGAL INFORMATION

All investments involve risks, including possible loss of principal.

ETF units may be bought or sold throughout the day at their market price on the exchange on which they are listed. However, there can be no guarantee that an active trading market for ETF units will develop or be maintained, or that their listing will continue or remain unchanged. While the units of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

The trading prices of an ETF units in the secondary market generally differ from the ETF's daily NAV and are affected by market forces such as supply and demand, economic conditions and other factors.

ETFs trade like stocks, fluctuate in market value and may trade at prices above or below the ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

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