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Diving into New ETFs: Three Simple Steps

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New or less-liquid exchange-traded funds (ETFs) carry some special considerations traders and investors need to be cognizant of.

I've spent a fair amount of time talking about ETF trading best practices and some of the misconceptions about trading new or less-liquid ETFs. While it's true that trading less-liquid ETFs shouldn't raise much concern because an investor can leverage the liquidity in the underlying basket of securities, one must not get too complacent.

There are numerous examples of large trades in less liquid ETFs—often at multiples of the average daily volume—that occur inside of the bid/ask spread. Remember, the bid/ask spread represents the difference between the highest price a buyer is willing to pay for an asset and the lowest price a seller is willing to take.

However, I often worry that the takeaway from that statement is: "Trading newer or less-liquid products is just as easy as trading more established, highly liquid products." This is not true. More care does need to be taken when trading products with lower average volumes, but knowing this is half the battle.

There are three steps I generally consider when diving into new or less liquid ETFs.

Step 1: I learn what the "normal" spread of the ETF is—and understand what is unusual.

The ETF issuer's capital markets team has many jobs. One is to monitor the ETF's bid/ask spread. When the spread appears wider than usual, an ETF issuer's capital markets team can work with the designated broker to better manage the spread, ensuring that the on-exchange markets of the ETF are in line with the underlying basket of securities. ETF Participating Dealers and Designated Brokers provide liquidity when there is an imbalance between buyers and sellers.

Once we have established that the ETF is at its usual spread and that the market is in line with the value of the underlying basket of securities, making a transaction should feel more comfortable.

Ensuring the ETF is at its usual spread also means that one is avoiding using market-on-open and market-on-close orders, leading us to the next step.

So, what is a typical spread? Unfortunately, there isn't a one-size-fits-all answer for *all* ETFs, given their different underlying securities and different net-asset value (NAV) prices. However, if you want to draw a line somewhere, I think anything over $0.10 or 50 basis points (bps)[1] should generally be considered atypical.

Step 2: I consider placing a limit order to buy on the "ask" price or to sell on the "bid" price of the market (avoid a "market" order, which prioritizes speed and execution of the transaction over price).

Often the market makers are willing to trade more shares than they are showing on exchange because of their risk parameters. So it is usually not an issue to place a limit order at a size greater than that in the current market.

Using a limit order avoids the dreaded "market" order that seeks liquidity at any price. This is usually the cause of ETFs trading at disconnected prices as compared to the value of the underlying basket of securities, like we saw during the 2015 U.S. Flash Crash.

Step 3: If I am unsure, I do not hesitate to ask for help.

Executing brokers and retail trading desks have well-established processes for finding the best sources of liquidity in ETFs across the entire average volume spectrum. Furthermore, an ETF issuer's capital markets desk can also answer any trading-related questions, whether specific to a particular trade in a particular name or a broader ETF ecosystem question.

Trading new or less-liquid ETFs should not necessarily be difficult. Every day there are numerous examples of investors seamlessly investing in these products. The steps listed above will help ensure that is the case and, more importantly, not trading on a rare instance when the bid/ask spread widens.

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1. One basis point is equal to 1/100th of a percent, or 0.0001 in decimal terms.

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 Participating Dealers, 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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The Capital Markets team works with both investors and broker-dealers 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.

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