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Plenty of Players Provide Liquidity for ETFs

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A recent article in the *Financial Times*' *FT Alphaville* blog ("Lies, Damned Lies, and Liquidity Expectations") focused on a paper published by the Committee on the Global Financial System, an organization that monitors developments in global financial markets for central bank governors. The paper warns that "the liquidity of ETF bond funds…builds on the willingness and capacity of authorized participants—typically the same dealers that provide immediacy services in bond markets—to make markets for ETF shares."

Unfortunately, the statement demonstrates a fundamental misunderstanding of the structure of exchange-traded funds (ETFs) and the role of authorized participants (APs), which are financial institutions that deal directly with ETFs in the process used to create and redeem ETF shares. Here are a few common misconceptions embedded in this statement that need to be cleared up.

Do investors have to interact with an AP to buy or sell ETF shares, including bond ETF shares?

No. Investors can buy and sell ETF shares on stock exchanges, dark pools, and other trading venues by trading with other investors through market makers or liquidity providers. Although APs do make markets for ETF shares in the secondary market, they are not the only market makers. There are many other market makers and liquidity providers that stand ready to buy or sell ETF shares in the secondary market on a continuous basis at publicly quoted prices. These entities are not APs, nor are they required to be APs to deal in ETF shares.

Is most of the trading activity in bond ETF shares conducted through an AP via the creation/redemption channel?

No. ICI's recent primer, "Understanding Exchange-Traded Funds: How ETFs Work," shows that, on average, only about one-fifth of total activity in bond ETFs is transacted in the primary market (i.e., through creations and redemptions with APs). The vast majority of the trading activity in bond ETFs occurs in the secondary market—and these trades can be accomplished without any intermediation by APs. Most of these secondary market transactions do not create transactions in the underlying bonds, because only the ETF shares are changing hands.

Will secondary market liquidity in bond ETFs evaporate in the aftermath of a shock?

Experience suggests that the answer is no. In the summer of 2013, bond prices moved sharply downward in response to indications that the Federal Reserve might begin to curtail its massive bond-buying program known as QE3. Over three months, from May to July 2013, the nominal interest rate on the 10-year Treasury bond rose 90 basis points. In a ranking of interest rate shocks to the financial system, this was a good-sized hit to the bond market—the largest since the three-month period ending August 2003, during which the interest rate on the 10-year Treasury rose 108 basis points. Here are two other points to consider about recent events.

- Did secondary market liquidity in bond ETFs disappear in the 2013 episode?

  No. In fact, by one measure (dollar-value traded), there was more liquidity demanded (presumably by sellers) and more liquidity supplied (presumably by buyers). As shown in the table below, volume in the secondary market for all bond ETFs averaged close to $5 billion per day during the May to July period, up from a daily average of nearly $3.8 billion during the preceding four-month period. Even narrower bond-ETF asset classes, such as domestic high-yield and emerging markets, had ample liquidity in secondary market trading during the summer of 2013.
- Did primary market activity in bond ETFs increase proportionately more than secondary market trading?

  No. Though investors did make more use of the creation/redemption channel to access liquidity in bond ETFs, secondary market trading rose just as quickly. In fact, for all bond ETFs, the ratio didn't budge: creations and redemptions amounted to 18 percent of total activity in the primary and secondary markets on a daily basis both preceding and during the summer of 2013. For domestic high-yield bond ETFs, creations and redemptions were 16 percent of total activity, slightly below their average earlier in the year. For emerging markets bond ETFs, they were 20 percent, just above their average.

Trading Activity in Bond ETFs, January–April 2013 and May–July 2013

All bond ETFs	Primary Market[1] *Millions of dollars*	Secondary Market[2] *Millions of dollars*	Primary Market Share of Total Trading[3] *Percent*
January–April 2013	$825	$3,772	18%
May–July 2013	1,068	4,990	18
Domestic high-yield bond ETFs			
January–April 2013	133	628	17
May–July 2013	196	1,020	16
Emerging markets bond ETFs			
January–April 2013	49	210	19
May–July 2013	54	221	20

[1]Represented by average daily ETF share creations and redemptions, which are computed by averaging the sum of creations and the absolute value of redemptions across all ETFs in each investment objective each day.

[2]Average daily value traded of ETF shares on exchanges, in dark pools, and on other venues across all ETFs in each investment objective.

[3]Primary market activity in ETF shares as a percentage of total ETF share activity in both the primary market and secondary market, calculated as: primary/(primary+secondary).

Source: Investment Company Institute and Bloomberg

Even in times of stress, recent experience demonstrates that most of the trading activity in ETF shares remains in the secondary market, where APs are just a subset of the many market makers available to help match sellers of ETF shares with willing buyers. During the summer of 2013, when prices of bonds and bond ETF shares were declining sharply, buyers for bond ETF shares stepped up and secondary market liquidity in bond ETF shares did not depend on the willingness and capacity of APs.

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