ETF myth-busting: Trading volume is not liquidity

Federated Hermes

Exchange-traded funds (ETFs) are a well-established investment vehicle, but there remain common misconceptions.

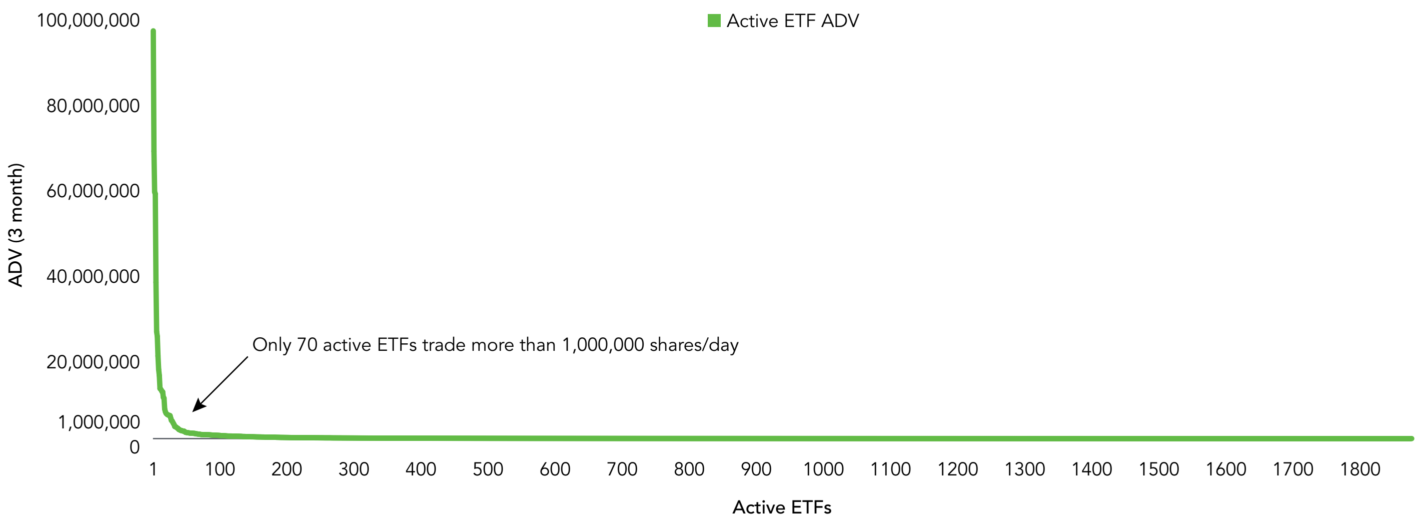
Navigating ETF liquidity

The benefits of ETFs are fairly well understood by many investors. They can offer a route to efficient market access, as well as tax advantages and potentially lower costs.

What's sometimes less well understood is how liquidity in an ETF works. Despite ETFs having been available for more than 30 years, and accounting for more than $10 trillion of investor assets[1], the question of ETF liquidity can still cause confusion.

A particular point of confusion has been trading ETFs with low ADV (average daily trading volume). While high trading volume can indicate greater liquidity, trading an ETF with low ADV typically should not impact the price of an ETF if the transaction is done using a limit order or directly with a block trade desk.

Only 4% of active ETFs have a high ADV of 1,000,000 or more



As of 3/17/25. Source: Morningstar, Inc. Displays the 3-month ADV of every active ETF in Morningstar's database with an ADV value available (1,877 out of 2,007 ETFs). Each active ETF is represented by a number from 1-1,877, ranked from highest ADV (1) to lowest ADV (1,877).

Debunking common myths about ETF liquidity

Myth: Trading volume represents liquidity

Liquidity depends more on the underlying assets. Even low-ADV ETFs have the potential to be highly liquid if they hold highly liquid securities.

Myth: Trading an ETF with low trading volume will move the price

Investors often equate low trading volume with low liquidity, similar to individual stocks. They worry that low volume means they won't be able to buy or sell easily without affecting the price. This misconception arises because they apply stock logic to ETFs, not realizing that ETF liquidity is supported by the creation/redemption process and the securities that the ETF owns. Trading an ETF with low ADV typically should not impact the price if the transaction is done directly with the block trade desk or using a limit order.

ADV can indicate low liquidity in individual securities. However, unlike individual securities, ETFs have multiple layers of liquidity—the liquidity of the ETF vehicle plus the liquidity of the underlying assets, accessible through the ETF share creation/redemption process.[2]

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Myth: Fund size impacts ETF liquidity

Fund size alone typically has minimal impact on ETF liquidity because the vehicle has other methods to generate liquidity such as through its underlying securities. Over time, smaller funds can grow efficiently through the creation/redemption process.

Myth: ETFs trade like mutual funds

ETFs are bought and sold on the secondary market on stock exchanges, like stocks. Unlike mutual funds, which are valued at the end of each trading day, you can buy and sell an ETF in real time throughout the trading day.

Behind the scenes: Key players managing ETF liquidity

Authorized participants (APs) are authorized to transact directly with fund managers in large blocks of ETF shares called creation units. APs perform a very important function, helping to ensure efficient trading and maintaining a balanced supply regardless of trading volume, which can enable new ETFs to grow in assets over time.

Market makers provide investors liquidity for ETFs by buying or selling ETFs on the secondary market based on the cost to create or redeem new ETF shares—which is primarily determined by the cost of the underlying assets. This can help keep ETF prices close to their net asset values. Market makers tend to be specialized firms.

How ETF liquidity really works

For most ETFs, the primary source of liquidity is their underlying securities. For higher ADV ETFs, the ETF itself can also provide another layer of liquidity. During times of market stress, the ETF may provide more liquidity than its underlying securities because it is also a tradeable security.

The liquidity of the underlying securities can offer unique liquidity advantages because of the creation/redemption process, which is central to ETF liquidity. The ability to create and redeem shares means that liquidity should be available to meet demand. Share creation/redemption can also ensure that ETFs trade efficiently and help keep premiums and discounts tight to net asset values.

Harness the full potential of ETF liquidity

Consider using a limit order, or for advisors that have one, your firm's internal block trade desk when trading ETFs. Limit orders ensure that the purchase price occurs at or below an investor-defined price or, when selling, above an investor-defined price. A block trade desk can help provide "best execution" or a fair price for an order and may be able to facilitate the transaction more quickly than a secondary market exchange by directly interacting with market makers.

Ultimately, investors should focus on how an ETF fits into their overall portfolio strategy.

Bottom line

Select an ETF based on its potential to meet the investment need, not its ADV.

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1 Source: Morningstar, Inc. As of 12/31/24.

2 The creation process involves the AP purchasing the securities required to form the ETF shares and delivering them to the ETF sponsor, who then creates the ETF shares. Conversely, the redemption process involves the AP selling the securities that the ETF sponsor needs to redeem ETF shares. This mechanism helps maintain liquidity in the ETF market and keeps ETF prices close to their net asset values (NAVs). The creation/redemption process also allows investors to trade ETFs in large amounts without significantly affecting the ETF's price, regardless of the ETF's size or trading volume.

Definitions:

Block trade desk: A trading desk that is used to execute large trades of securities. They are used by brokerages or investment banks to handle large positions without impacting the market through privately negotiating trades. This process helps minimize price fluctuations during transactions.

Limit order: A direction to purchase or sell a security at a defined price set by the investor to potentially avoid sudden price fluctuations.

Mutual funds and ETFs are subject to risks and fluctuate in value.

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