

ETF trading best practices

Exchange traded funds (ETFs) continue to gain popularity among investors of all types. They offer investors diversification, liquidity and flexibility, as well as access to smart beta, active and passive strategies. As ETFs trade on an exchange (like stocks) there are a few simple strategies you can employ to seek the best trade execution for your clients.

1. Use limit orders to seek a balance between timely execution and price

Buy ETFs using limit orders

A client wants to buy X shares of an ETF, but doesn't want to pay any more than Y dollars per share.

Use a limit order to specify a price equal to or greater than the ask price (but not more than what you want to pay). This order increases the likelihood that your trade will be made and avoids the risk of the client paying more than desired.

Sell ETFs using limit orders

A client wants to sell X shares of an ETF, but doesn't want to receive less than Y dollars per share.

Use a limit order to specify a price equal to or less than the bid price (but not less than what you want to receive). This order increases the likelihood that your trade will be made and avoids the risk of the client receiving less than desired.

Key differences between market and limit orders

Market orders:

Buy or sell right away at the best available current price. Priority is fast execution, not securing a certain price.

Considerations:

No upper/lower limit on the price the trade could be made at, meaning you could pay more than you wanted.

Limit orders:

Use to set a target execution price. Priority is securing a certain price, not fast execution.

Considerations:

Your trade may not be executable at the specified price, or only partially executed, requiring an additional trade at a modified price to completely fill the order.



2. Avoid trading within the first and last 15 minutes of the trading day

Avoid market open

Not all of an ETF's underlying securities may have started trading within the first few minutes of the trading session. In such a case, the market maker cannot accurately price the ETF, potentially leading to wider spreads.

Avoid market close

As the market close for the ETF's underlying securities nears, market participants seek to limit their risk. With fewer market participants willing to make markets, spreads can widen.

3. Keep an eye on market volatility

In times of market volatility there is a widening in ETF bid/ask spreads – the difference between what ETF sellers are prepared to accept and what ETF buyers are willing to pay. Premiums or discounts of the ETF's market price relative to the net asset value (value of the underlying securities) may also occur. In these environments, seeking trading assistance and using limit orders may be advisable.

4. Focus on historical spreads and not only recent trading volume

A common misconception is that an ETF's average daily trading volume alone determines its liquidity. In reality, the best measure of an ETF's liquidity is determined by the liquidity of its underlying securities. An ETF's bid-ask spread is a preferred measure of liquidity because it includes the liquidity of its underlying securities and the costs associated with the creation/redemption process.

5. Look at bid/ask prices to gauge the current market price

Current bid and ask prices are a better measure of the fair value of an ETF as they are representative of the basket of securities in the ETF itself. You should note, however, that the market maker bid-ask may not be the highest bid or lowest ask (also known as "top of book" bid-ask). Rather, the market maker bid-ask spread serves as a range to manage the price of the ETF. Using the last traded price can be problematic as the market environment may have changed and the data may be stale.

6. Time can be a factor for international ETFs

ETFs which trade in Canada and the US can be constructed in whole or in part from international securities. International markets in which these securities trade, may be closed when North America is open for trading. When those markets are closed, information continues to flow that may affect the security prices which contribute to the ETF price. It is the responsibility of the market makers to make adjustments to the ETF price during North American trading hours to reflect the new information. The market makers' ability to make these adjustments is aided by proxy securities, but is most accurate if or when the international market is open and trading and overlaps with North American market hours. Therefore it may be preferable to trade the ETF during the trading hours of the underlying securities if possible.



7. Considering the size of the trade

When looking to place large trades of an ETF at a particular time of day, you may not get the best price by executing the transaction online, even by using a limit order. You may also face higher trading costs. In these situations, you can either contact your brokerage platform directly or the ETF provider, for assistance.

8. Consider holidays across US and international markets

Sometimes, Canadian markets remain open while US markets are closed for trading. In such instances, the bid-ask spread may be wider than usual, as capital markets trading desks typically hedge their exposure through US-listed securities or ETFs.

For international ETFs, it is advisable to avoid trading when both European and US markets are closed.

For more information about Mackenzie ETFs, please contact the Mackenzie sales team or visit mackenzieinvestments.com/ETFs.

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