Global Asset Management

RBC Exchange Traded Funds

Understanding ETF bid-ask spreads

At any given time there are two prices for an ETF – the price someone is willing to purchase the ETF (known as the bid) and the price that someone is willing to sell the ETF (known as the ask). When trading ETFs, it is useful to measure the difference between these two prices, which is called the bid-ask spread.

Stock exchanges can be considered 'meeting points' for investors, where each investor considering a transaction is trying to maximize their value. Buyers of ETFs want to pay a reasonable price and would prefer to receive a discount on the value of the underlying securities in the ETF if possible, and sellers want the maximum price for their units when they sell on the exchange.

The reason spreads exist is because in an open market, buyers and sellers are trying to negotiate the best price possible. Once buyers and sellers agree on a price, a transaction takes place and ETF units change hands.

An ETF's bid and ask prices will closely approximate the value of the underlying securities held by the ETF, but bid-ask spreads can differ depending on many factors, including:

1 Spreads on the underlying securities

As an ETF is really a basket of securities, the spread on the ETF will be a product of the spread on the underlying securities. Another way to say this is that liquidity of the ETF is a product of liquidity of the underlying asset class. As such, if the underlying securities themselves are very liquid, it stands to reason that the ETF should also be very liquid, and therefore have a small spread. An example of this would be large-cap U.S. stocks, which generally have high trading volumes and very narrow spreads.

On the other hand, asset classes that are not as liquid as large-cap U.S. stocks, such as small-cap Canadian stocks, will have wider spreads. This will also be reflected in the spreads on ETF units that represent that asset class.

2 Cost of assembling and trading

The cost of assembling and trading the basket of securities inside an ETF may impact the spread. For instance, if the ETF invests in foreign securities, there will be additional costs to convert Canadian dollars to the underlying currencies. An ETF that buys European dividend stocks first needs to buy Pounds Sterling, Euros, Swiss Francs, and so on.

Another example would be regulatory costs and taxes. In the United Kingdom for example, there is a 0.5% fee every time an investor buys a stock on a stock exchange, called a Stamp Duty. This cost would be reflected in the spread on any ETF associated with U.K. securities.

3 Trading Volumes

When an investor is making a very large purchase of an ETF, for more than the amount of inventory the market maker has for sale, the market maker may need to create more ETF units by buying substantial amounts of the underlying securities. This may involve having to pay higher asking prices to fill the orders – often referred to as 'market impact costs.'

4 Market risks

Bid-ask spreads can also widen during times of heightened market risk or increased market volatility. If market makers are required to take extra steps to facilitate their trades during periods of volatility, spreads of the underlying securities may be wider, which will mean wider spreads on the ETF.

Trading risk arises during times when foreign markets are closed and Canadian markets are open. During American Thanksgiving for instance, U.S. equity ETFs continue to trade in Canada on the Toronto Stock Exchange, even though U.S. stock markets are closed for the holiday. Investors can still purchase a U.S. equity ETF, but market makers cannot buy more U.S. stocks in order to create units, nor can they monitor the underlying prices of those securities directly. As a result, spreads on U.S. equity ETFs may be wider on American Thanksgiving to compensate for that risk.

About RBC Global Asset Management

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116394 (10/2017)

016GAM176_116394 (10-2017)_ARTICLE_ETF_BIDASK_EN_V1 03/07/2017