Debunking the Myths of ETFs

Exchange Traded Funds have become the foundation of clients' investment portfolios, and while many benefits are understood there are misconceptions that have entered into client conversations. ETFs are an important innovation in financial markets, and allow more investors to access different asset classes, and deliver better trade execution on more diversified portfolios. With the rise of ETF popularity, like any new product, there are several myths and misconceptions. It is important for clients to understand how ETFs function so they can be confident and informed when using them as investment tools.

Myth: ETFs are just like stocks.

Fact: ETFs trade on an exchange like a stock, but stocks have a finite number of shares available. An ETF is an open-ended fund that can create new units based on demand. Market makers will continually offer new shares, and will create new units when needed.

Myth: Stocks and funds outperform ETFs.

Fact: Active management can deliver meaningful outperformance; the challenge is to do so consistently over time. ETFs can outperform when the entire market lifts off, or when higher fees and adverse stock selection impacts active managers.

Myth: ETFs aren't liquid.

Fact: ETFs have access to the liquidity of their underlying portfolios. Therefore a large trade on a small ETF will not move the ETF's market price. Also, ETF quotes are constantly refreshed, which works like a stock. Market Makers **may** have offsetting trades on ETF transactions, which neutralizes the market impact on the underlying securities.

Myth: ETFs cause market crashes.

Fact: Just like a stock, an ETF is subject to the integrity of the markets. If there is a market event or large moves in investor sentiment we should expect ETFs to move with the market. ETFs are priced based on their underlying portfolios, not the other way around, the assumption that ETFs impacted market stability as they became prominent then doesn't make sense.

The True Liquidity of an ETF

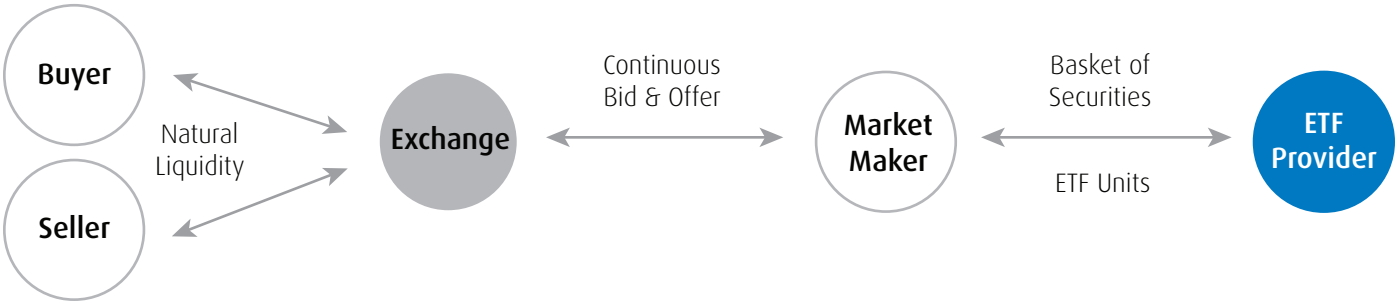
How does the ETF liquidity mechanism work?

First level of liquidity – On the exchange
The interaction between buyers and sellers creates the first level of liquidity for an ETF. This natural liquidity is established when a sell order from an existing unit holder is matched with a buy order from a purchaser on the exchange. Popular and established ETFs with high transaction volumes can develop even greater liquidity than their underlying holdings.

Second level of liquidity – Market maker activity
Market makers are responsible for posting bid and ask offers on the exchange. This enhances liquidity and allows a buyer or seller to transact with minimal trading costs. Market Makers continually post units at a price which reflects the spread of the underlying portfolio.

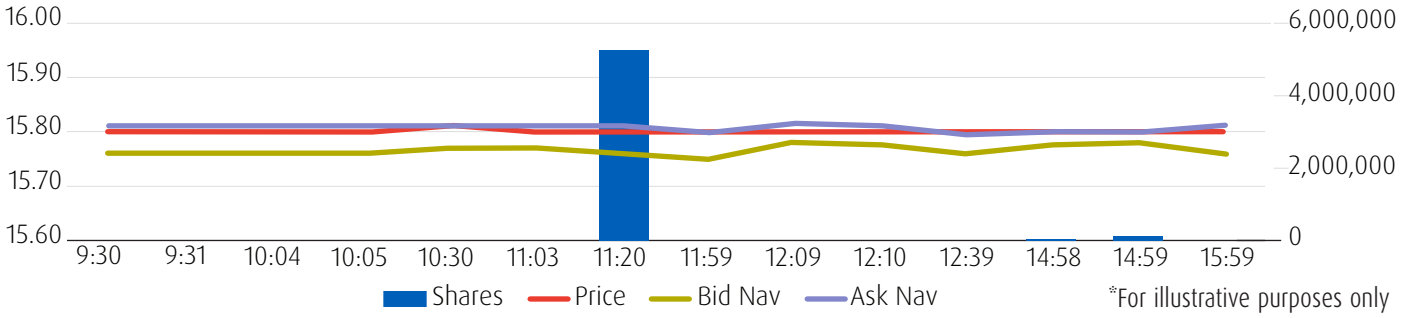
Third level of liquidity – Unit creation based on underlying securities
Market makers can offset an increase in demand by creating more units. On the other hand, when the demand for the units decreases, the market maker redeems units to tighten supply. When a large buy order occurs, the market maker will buy the basket of securities and initiate a creation order with the ETF provider.

When evaluating ETFs, the underlying liquidity is what matters. The true liquidity of an ETF is best measured by the liquidity of its underlying securities and can be enhanced with mature ETFs.



The chart below illustrates a large trade placed on BMO Aggregate Bond Index ETF (ZAG). An $80 million dollar trade had no impact on the trade's execution price. The true liquidity an ETF is best measured by the liquidity of its underlying securities and allows for significant trade orders without having an impact on the price of the ETF itself.

Large Trade on ZAG



BMO Exchange Traded Funds

Risk is defined as the uncertainty of a return and the potential for capital loss in your investment.