Guidelines for Trading ETFs

Investor Education

Introduction

While ETFs offer intraday trading and potential tax efficiency, investors should follow sound trading practices when buying and selling ETFs.

Regardless of experience level, investors can potentially benefit from a few guidelines that may help them trade ETFs more effectively.



3 Key Takeaways

1. **Consider your order type**, and why investors often select limit orders.
2. **Understand the risks** of trading near market open or market close, as well as the risks of trading during market volatility.
3. Know that ETF liquidity is about **more than just the average daily volume**. Investors should consider an ETF's distinct characteristics, especially before large trades.

1. Order Type Selection

It's important to understand the risks associated with the different order types listed below.

A **market order** is an order to buy or sell immediately at the best available price. Using this order type could lead to a sub-optimal execution price.

A **limit order** is an order with a set maximum buy price, or minimum sell price, but it does not guarantee execution of the full order. Many investors use limit orders to help control the price they pay or receive, but these orders may not be executed if the market moves away from the limit price.

2. Order Timing

Bid/ask spreads — the difference between the bid price (the highest price a buyer is willing to pay) and ask price (the lowest price a seller is willing to accept) — may be wider at market open and close. This means entering a trade at these times may result in paying more when buying, or receiving less when selling, than at other times of the day.

Here are a couple of hypothetical examples:

- Early in the day, some of the underlying stocks may not be open for trading yet, making it more difficult for market makers to price the ETF.
- As the market close approaches, market makers can potentially manage their inventory risk by widening quotes and displaying less size.

3. ETF Liquidity

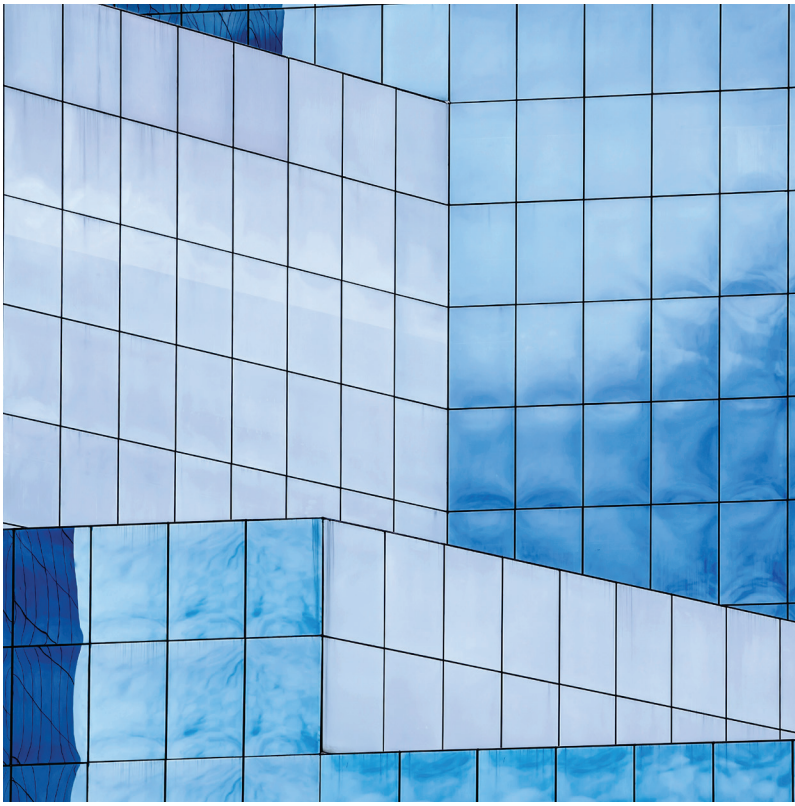
An ETF's liquidity depends on more than its average daily volume, which measures the average number of shares traded on the secondary market over a specific period. The bid/ask spread and the liquidity and trading hours of the underlying securities are both factors in overall liquidity. Investors should consider these factors together with the average daily volume when trading an ETF.

4. Volatile Market Environments

The net asset value (NAV) represents the ETF's actual per-share value. When the market is volatile, ETF pricing may fluctuate rapidly either above or below the NAV (at a premium or discount), leading to an unpredictable cost. Investors should also take note of any significant events like press releases, earnings reports, and various governmental announcements, as they may affect bid/ask spreads in real time.

5. Large Trade Execution

With larger orders, it's important to consider the liquidity characteristics of specific ETFs prior to any trade execution. ETFs trade differently depending on their underlying asset classes. US equity, international equity, and fixed-income ETFs each have distinct characteristics that affect pricing and liquidity. Investors planning large ETF trades should contact a broker representative before placing the order.



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