Talking Points

Ten Tips For More Effective ETF Investing

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Investors want more information and education to help them effectively use ETFs. That's what polling data suggested at the May 2019 Morningstar Investment Conference. In the conference's listed investments session 62% of respondents wanted more information and education materials. Only one third of respondents believed there is adequate information to make investment decisions and trade listed funds effectively.

That raises an eyebrow, because ETFs sometimes trade with wider than normal bid/ask spreads, or deviate substantially from their net asset value (NAV), which can jack up the cost to investors. Reasons can range from market volatility, illiquid or closed underlying markets, thin market-making activity, or operational errors. We've seen extreme spreads and discounts in US-listed ETFs at times, and to a lesser extent, but still substantial, in Australia too. Yet by being aware of a few simple rules, investors can avoid most of these issues.

It's worthwhile revisiting the 10 rules of thumb for ETF transactions that we published in 2015. Every rule remains just as relevant in 2019, and we wouldn't be surprised if these rules remain relevant for years to come.

1. "No Limit" is a Poker Game, Not an Investment Strategy. Consider Using Limit Orders, Not Market Orders
Market orders can be useful when time is of the essence and price is of secondary importance, or when there is plenty of liquidity. Investors using market orders want to execute their entire order as soon as possible.

For large, very liquid ETFs that trade contemporaneously with their underlying securities, market orders will likely result in fast execution at a good price. But there are smaller or less liquid ETFs, and there are also ETFs that trade out of sync with their constituent securities (such as U.S. equity ETFs where there's no overlap between Australian and U.S. trading hours). Limit orders help ensure favourable execution from a price perspective. A buy limit order will fetch the buyer a price less than or equal to the limit price, while a sell limit order will transact at a price greater than or equal to the limit price.

2.Avoid Trading at Open, Close, or in the Auction Period
For ASX-listed ETFs, this means at the very least, avoid trading earlier than 10.15am or later than 3.45pm. At these times, market-makers may not be watching the market as closely, and some underlying stocks may not be trading, making it more difficult for the market-maker to calculate an accurate price.

3. Check the Bid/Ask Spread
If the bid/ask spread is wide, it may indicate that something is amiss, and it might pay to delay your trade or dig further. It is also worth observing the bid/ask spread to see if it is unstable i.e. narrowing and expanding frequently. If so, it's a sign that market makers are adjusting for risk and caution may be required.

4. Be Wary When Transacting While Underlying Securities Are Not Open for Trading
ETF trading volumes should be substantially higher and bid/ask spreads will typically be lower when the underlying stocks are also trading and have transparent pricing. For example, trade Asian ETFs in the afternoon, once the Hong Kong, Singapore, and Shanghai exchanges are open. In fact, for any ETFs, spreads could well be tighter in the afternoon, due to the better price discovery available once Asian markets open.

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5. Use the Available Tools

ETF providers offer tools such as the intraday NAV, or iNAV, which can help gauge whether an ETF is trading near its NAV. Although there’s no guarantee the iNAV will be an exact representation of the NAV, it’s a useful indicator. If there is one, check the iNAV before trading.

6. Check Trading Volumes and ETF Size

An ETF’s on-screen trading volume doesn’t tell the whole story. The liquidity of the underlying assets is arguably more important, because the market-maker can create or redeem ETF shares to balance supply and demand, as long as the underlying market is liquid. However, the size of an ETF and on-screen volume are worth monitoring, particularly for ETFs where the underlying assets trade outside Australian hours. For example for global equity ETFs, the on screen volume may be important (but it isn’t the whole story). As a general rule the larger the ETF size, the less likely investors are to have problems trading it.

7. It’s Hard to Do a Bad Trade If You Don’t Trade

Ask yourself: is there anything unusual here? Is the ETF price substantially different from the previous day, or even from a few minutes ago? Is the ETF price stable while underlying markets are rising or falling? Are markets going through extraordinary volatility, has there been a distribution on the day but the price hasn’t reduced accordingly? If so, further research or patience may be required before placing a trade. That said, sometimes it’s best to trade regardless of the transaction costs, if you’ve realised that your thesis was wrong. Apply a common sense check to make your decisions, avoid emotions and rely on your intellect, and good advice.

8. Stop-Loss Strategies May Not Stop Your Losses

Stop-loss strategies can lose more money than they save, especially during market turmoil. For example in the 2015 volatility in the U.S., the market gapped downward because of a momentary lack of liquidity, which triggered stop-loss orders. Because some of these stop-losses were market orders, they were filled at any price available, and with limited liquidity at the time, may have caused an even bigger drop in prices. Investors with stop-loss orders may have sold out at the bottom. We advise caution using stop-loss strategies, especially if they’re triggered automatically or use market orders. Price alerts can be used instead.

9. If In Doubt, Give a Shout. Contact the ETF Provider or Market-Maker If Anything Looks Odd or You’re Not Sure

The ETF provider (or for large investors, the market-maker) can answer questions about trading an ETF and explain anomalies. If in doubt, contact the ETF provider or market-maker before trading.

10. Remember – It’s All About Your Investment Strategy

Long-term investors will likely have fewer worries when transacting ETFs. If a volatile market causes bid/ask spreads to widen, a long-term investor can ride it out. Should trading be necessary then they can wait to execute their trade when volatility has subsided. In contrast a short-term trader may be forced to exit a trade quickly, no matter what the cost. It can be a very high cost to do a panic trade when spreads are widened, and investors will need to carefully weigh up whether it is more important to trade and incur the cost, or if they can afford to wait.

If an ETF doesn’t help you achieve your investment goals and strategy, or fit with your tolerance for risk and investment time horizon, then it’s unlikely to be the best fit for you, no matter how attractive an investment proposition it seems. K