

# iSHARES INVESTIGATES: THE ETF ECOSYSTEM

## Part 3 | ETF Primary Market Liquidity

Exchange-traded funds (ETFs) are unique; they provide exposure to a diversified collection of assets, like a mutual fund, but trade on an exchange, like a stock. This structure makes the liquidity of ETFs unique, too.<sup>1</sup>

ETFs have two “layers” of liquidity. The first is primary market liquidity, which is provided by the ETFs’ underlying securities. The second is secondary market liquidity, which comes from the ability to trade ETFs on an exchange.

This paper examines the true extent of ETF primary market liquidity and analyzes the impact that primary market activity has on underlying securities.

### Transparency into primary market activity

To comply with the U.S. Securities and Exchange Commission’s (SEC) Form N-CEN disclosure requirements, ETF issuers must identify, on a fund-by-fund basis, the authorized participants (APs) that engage with their ETFs.<sup>2</sup> These APs are the financial institutions that transact with ETF issuers to create and redeem ETF shares in the primary market.

*To learn more about the role of APs and the creation/redemption process see [Part 1](#) and [Part 2](#).*

Issuers must also disclose information on funds’ primary market activity—the creation and redemption of ETF shares—as part of their Form N-CEN filings.

Unlike the daily fund flow figures that are made publicly available by Bloomberg and other data providers (which provide **net** primary market activity), Form N-CEN filings identify **gross** primary market activity, or the total volume of creations and redemptions in U.S.-listed ETFs.

This gross volume data was not publicly available prior to the initiation of these filings (which began in June 2018).

### What gross flows tell us

Unsurprisingly, we find that the gross volumes of primary market activity reported in Form N-CEN disclosures are much larger than the net volumes reported over the same period (**Figure 1**).

Prior to the availability of this data, total ETF creation and redemption activity over a period could be obtained only by adding together (“grossing up”) the daily flows of each ETF. The weakness in this approach is that those daily flows are obscured by intraday netting.

This means that if Fund A had \$200M of creations (positive flow) and \$100M of redemptions (negative flow) on the same day, only \$100M of net flows would be reported.

The true gross primary market volumes—those reported in Form N-CEN—are **not** obscured by daily netting. Using the same example, Fund A would report \$300M of gross activity.

This means that the primary market liquidity of ETFs is greater than previously believed.

**1** Liquidity refers to the ease of buying or selling a security or other instrument. **2** The SEC requires fund companies to disclose specific fund information through Form N-CEN annually. For more information on Form N-CEN see <https://www.sec.gov/rules/final/2016/33-10231.pdf>

**Figure 1: Gross and net flows by ETF issuer (\$USD)**

Fixed Income ETFs				Equity ETFs			
Issuer	AUM (\$B) <sup>3</sup>	Total net flows (\$B) <sup>4</sup>	Gross flows (\$B) <sup>5</sup>	Issuer	AUM (\$B) <sup>3</sup>	Total net flows (\$B) <sup>4</sup>	Gross flows (\$B) <sup>5</sup>
BlackRock	291	286	351	BlackRock	1,081	631	757
Vanguard	175	89	97	Vanguard	806	275	318
State Street	61	87	130	State Street	530	814	1,687
Invesco	30	26	36	Invesco	167	190	316
Charles Schwab	23	16	18	Charles Schwab	110	37	39
All other issuers	61	57	67	All other issuers	264	285	332

Annual flows between February 1, 2018 and December 31, 2019. Reporting period varies on a fund-by-fund basis. Total net flows are the sum of absolute daily net flows over the period.

## ETF flows have minimal impact on stocks

Flow data can also be used to better understand the influence of ETF primary market activity on underlying securities.

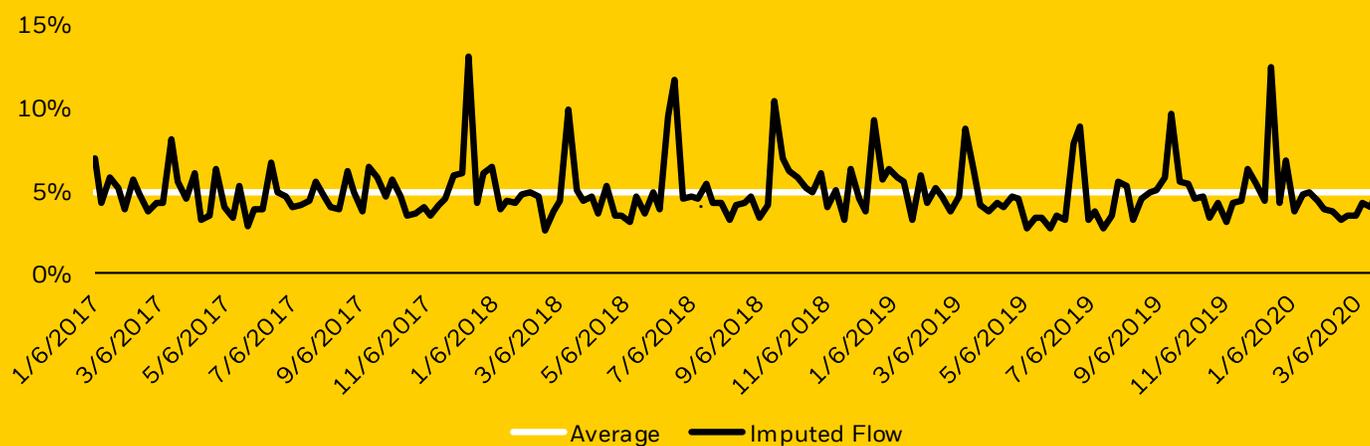
Most ETF activity occurs between buyers and sellers of ETF shares on-exchange. In fact, Form N-CEN data reveal that for every \$5 of ETF trading that takes place in the secondary market, only \$1 results in primary market activity.<sup>6</sup>

To assess the impact of this primary market activity on the prices of underlying stocks, we look to a metric called “imputed flow.” This metric estimates the proportion of all U.S. stock trading that results from ETF creations or redemptions; meaning, imputed flow gives us an approximation for how much stock trading is generated by ETF inflows and outflows.<sup>7</sup>

The impact is modest. On average, just about 5% of trading in individual stocks in the U.S. is attributable to ETF flows (Figure 2).

Even in volatile markets, the influence of ETF trading on underlying stocks is minimal. In fact, during the height of Coronavirus-induced market turmoil in the first quarter of 2020, just under 4% of stock trading on average was attributable to ETF flows.<sup>8</sup>

**Figure 2: Impact of ETF trading on US stocks<sup>9</sup>**



**3** Source: Bloomberg, Markit as of March 31, 2020 **4** Source: Bloomberg, as of March 31, 2020. Period of annual flows corresponds with fund’s N-CEN reporting period and varies on a fund-by-fund basis. **5** Source: BlackRock, Form N-CEN as of March 27, 2020. Flows reported annually in accordance with fund’s fiscal year end; dates vary on a fund-by-fund basis **6** Source: Bloomberg, BlackRock, Form N-CEN, as of March 27, 2020. **7** Imputed flows are the product of the collective weight of flows into all ETFs holding all stocks. **8** Source: Bloomberg, Markit, BlackRock, as of March 27, 2020. Adjustment to imputed flow using gross flows is marginal. **9** Source: Bloomberg, Markit, BlackRock, as of March 27, 2020. Adjustment to imputed flow using gross flows is marginal.

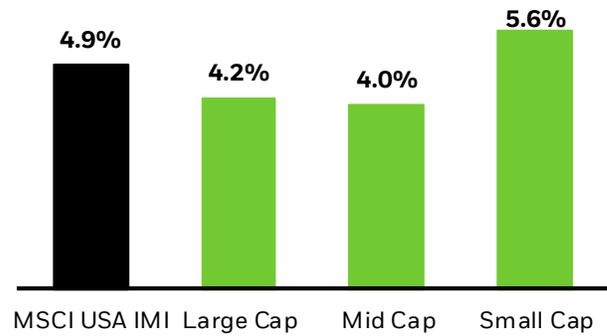
Imputed flow data can also be broken down by market capitalization and sector.

As shown here, ETF trading has the largest impact on small-cap stocks (**Figure 3**) and utilities (**Figure 4**).

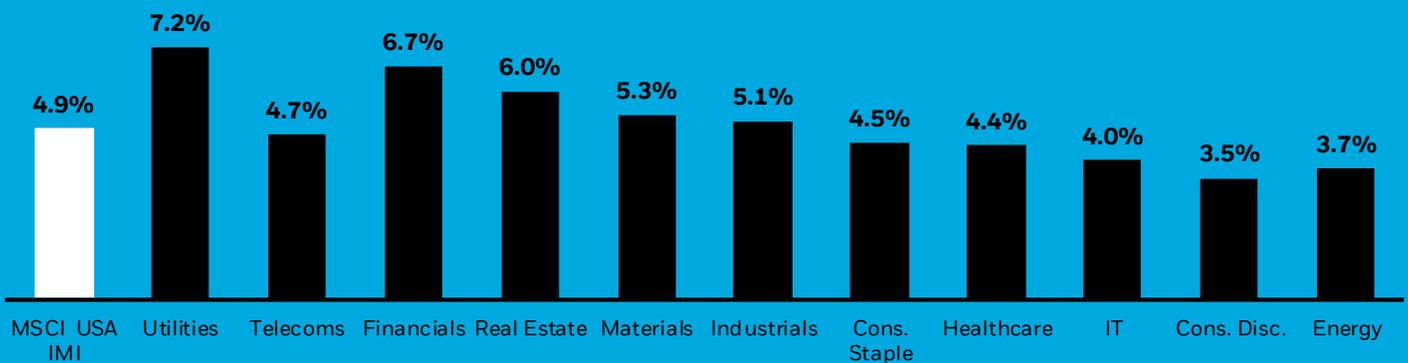
## The bottom line

New data from the SEC shows that primary market activity can be a source of significant liquidity. Importantly, this ETF primary market activity has limited influence on underlying stocks.

**Figure 3: Imputed flow by market capitalization<sup>10</sup>**



**Figure 4: Imputed flow by sector<sup>11</sup>**



<sup>10</sup> Source: Bloomberg, Markit, BlackRock, as of March 27, 2020. Adjustment to imputed flow using gross flows is marginal <sup>11</sup> Source: Bloomberg, Markit, BlackRock, as of March 27, 2020. Adjustment to imputed flow using gross flows is marginal.

## Risks

**Capital at risk.** The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time.

All figures are denominated in U.S. dollars, unless otherwise noted.

### ***Important Information about iShares ETFs***

**For U.S. investors: Carefully consider the Funds' investment objectives, risk factors, and charges and expenses before investing. This and other information can be found in the Funds' prospectuses or, if available, the summary prospectuses which may be obtained by visiting [www.iShares.com](http://www.iShares.com) or [www.blackrock.com](http://www.blackrock.com). Read the prospectus carefully before investing.**

### **Investing involves risk, including possible loss of principal.**

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Shares of iShares ETFs may be bought and sold throughout the day on the exchange through any brokerage account. Shares are not individually redeemable from the ETF, however, shares may be redeemed directly from an ETF by Authorized Participants, in very large creation/redemption units.

Although market makers will generally take advantage of differences between the NAV and the trading price of iShares ETF shares through arbitrage opportunities, there is no guarantee that they will do so.

Buying and selling shares of ETFs may result in brokerage commissions. Diversification may not protect against market risk or loss of principal.

There can be no assurance that an active trading market for shares of an ETF will develop or be maintained.

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