Demystifying Liquidity and Taxes in ETFs

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ETFs have several benefits that many shareholders do not understand fully. Two of the most misunderstood and important features of ETFs that benefit shareholders are liquidity and tax efficiency. These aspects derive from the unique market ecosystem of ETFs, so to understand why these benefits exist, you must understand how ETFs trade.

ETF Trading Ecosystem

ETFs trade on the same exchanges as stocks so it is not surprising that many investors view an ETF in a similar fashion as they do stocks. However, stocks and ETFs are fundamentally different.

- Stocks have a finite number of shares issued on the market. If you want to buy a stock, someone must be willing to sell it to you. Stocks trade on basic economic supply/demand with the price of a stock determined by the level at which supply and demand balance out in the market.
- ETFs are "open ended" meaning that the ETF issuer can add or subtract shares from the market based on investor supply and demand. These processes are known as Creation and Redemption and they allow virtually unlimited liquidity for ETFs to keep the ETF price very close to the Net Asset Value of the Fund.

Note the important difference there. In a stock, the price is determined by the supply and demand in the market. In an ETF, the price is determined by the Net Asset Value.

The ETF creation/redemption of shares is the crucial feature in this ecosystem to understand. Put in the simplest terms, there are two markets for ETFs. The Secondary Market is the exchange where public investors can buy and sell shares of an ETF just as they would shares of Apple or Disney. This is simple, straightforward, and very much like a stock. The market is managed by Market Makers whose job it is to provide liquidity in the form of a Bid/Ask that facilitates an orderly market.

The Primary Market for an ETF is between the issuer of the ETF and a specialized group of investors called Authorized Participants or APs. APs are some of the biggest financial institutions in the world, like Goldman Sachs, J.P. Morgan, or Credit Suisse. These APs create and redeem shares of the ETF at the request of the Market Makers, facilitating the process with the ETF Issuer at the Net Asset Value of the fund. As Market Maker provides liquidity in the Secondary Market, they build up a long or short position in the ETF on their balance sheet. When the Market Maker has a certain number of shares, typically 25,000, they ask the AP to create or redeem shares to clear their books. This creation/redemption process is why the ETF is considered "Open Ended". New shares are issued or old shares are redeemed maintaining ETF liquidity while keeping the ETF price near the Net Asset Value of the fund.

ETF Liquidity

For stocks, Market Capitalization and Daily Volume are accepted indicators of liquidity. With a stock, there are a fixed number of shares that have been issued by the company, so these are generally considered good metrics to rely on. If you buy a stock, someone must sell it to you. For Apple, this is almost irrelevant as there are over 100 million shares traded every day and sometimes several times that volume. For a microcap stock, liquidity can be a huge issue to enter or exit a position. A $50 million market cap stock with only a few thousand shares traded each day can be an enormous challenge for an investor to enter or exit. Liquidity is a risk that must be assessed for thinly traded stocks.

This manner of evaluating liquidity risk does not apply to the ETF world. As we have described above, ETFs trade in a fundamentally different way that means that an ETFs Assets Under Management and Daily Volume do not represent liquidity. Liquidity is provided by the Market Makers and they seek to keep the price near the Net Asset Value of the Fund.

What determines the amount of liquidity a Market Maker will provide for an ETF? It goes back to the creation/redemption process. In that process, shares are being exchanged based on the underlying positions in the fund. The liquidity of the underlying position is what matters to the process. If an authorized participant like Goldman Sachs is asked to create a batch of 25,000 shares of an ETF, they have to go the market and buy the underlying positions to deliver them to the ETF Issuer in exchange for the shares of the ETF. That is where the liquidity is determined. In a direct way, the liquidity of an ETF is determined by the liquidity of the underlying positions in the Fund. An ETF that invests in S&P 500 large cap stocks should have a liquidity profile that reflects the large cap stocks that it holds.

The amount of liquidity a Market Maker will be willing to provide in the Secondary Market for investors is determined by how easily traded the underlying positions are for the AP. As a result, an ETF holding S&P 500 stocks with $5 million in AUM and virtually no daily volume has a high level of liquidity available to investors.

ETF Tax Efficiency

The structure of an ETF gives the issuer the ability to manage the taxes generated in the fund much more efficiently than a traditional open-end mutual fund by using the same Creation/Redemption process we described above. This is best described by walking through an example. Imagine you have an ETF with 2 positions in it. Stock ABC and Stock XYZ. Each position started at the same level and over the course of 6 months, ABC stock has gone up 100% and XYZ stock has gone down -50%.

Starting ETF Positions

Stock	Shares	Cost Basis/ Share	Cost Basis	Current Price	Value	Total Gain/ Loss
ABC Lot 1	1,000	$100	$100,000	$200	$200,000	$100,000
XYZ Lot 1	1,000	$100	$100,000	$50	$50,000	-$50,000

You can see the situation in the table above. At this point, the portfolio manager decides to sell these positions. If you were dealing with a traditional mutual fund, the fund would have a short-term net gain of $50,000 which would have to be distributed to shareholders as a short-term capital gain distribution.

ETFs have a work around to avoid this short-term gain. For the position in ABC, the manager asks the Market Maker to create a special batch of ETF shares that only represent the position in ABC, effectively doubling the position in ABC overnight with new shares that have a cost basis in ABC of the current price at $200.

ETF Positions After Special Creation

Stock	Shares	Cost Basis/ Share	Cost Basis	Current Price	Value	Total Gain/ Loss
ABC Lot 1	1,000	$100	$100,000	$200	$200,000	$100,000
ABC Lot 2	1,000	$200	$200,000	$200	$200,000	$0
XYZ Lot 1	1,000	$100	$100,000	$50	$50,000	-$50,000

The Market Maker then redeems that special batch of shares the next day, but when the redemption order comes through the portfolio manager sends the ABC lot with shares at a cost basis of $100. As no ABC shares were sold, there is no capital gain realized. At the end of the process the shares of ABC in the fund have a cost basis of $200, the same as the current price of ABC as you can see in the chart below.

ETF Positions Post Create/Redeem

Stock	Shares	Cost Basis/ Share	Cost Basis	Current Price	Value	Total Gain/ Loss
ABC Lot 1	1,000	$200	$200,000	$200	$200,000	$0
XYZ Lot 1	1,000	$100	$100,000	$50	$50,000	-$50,000

The fund manager is now free to sell the position in ABC without generating capital gains. The manager also sells the position in XYZ and realizes a 50% loss of -$50,000. Overall, the positions are sold for a net loss of -$50,000 and no short-term gains. Since no net gains were generated, no capital gains are distributed to the shareholders.

From the shareholders perspective, they buy the ETF positions at a particular price and eventually sell that position when they want to. The long- or short-term tax basis of their capital gain will be determined by their holding period. In the interim period of ownership, there should be no or only minimal need for the ETF to distribute significant gains from the ETF to shareholders.

Conclusion

ETFs offer investors a powerful tool to gain exposure to the market. Given that they are relatively new choice compared to equities and mutual funds, it is not surprising that there are misunderstandings concerning how ETFs operate and some of the more nuanced benefits of the structure. Liquidity and tax efficiency are two of the most important features ETF offer to shareholders.

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