SPDR UNIVERSITY

ETF Fact or Fiction: Should Large ETF Creations and Redemptions Cause Concern for Investors?

Despite the growth of the exchange traded fund (ETF) industry, ETF trading is still not thoroughly understood by all investors. With the introduction of ETFs came greater cost-efficient access to previously inaccessible segments of the market for individual investors that were historically only available to large institutions. While this accessibility has been a great benefit for individual investors, questions have been raised as to the potential risk posed to the individual investor when large trades are made in or out of a fund.

Institutions were the first to adopt ETFs in the early 1990s, using the funds as cash equitization vehicles. While much has changed in the industry over the past two decades, institutions have consistently remained among the largest ETF investors. Given their scale, institutions tend to make ETF trades that are larger than the average buy or sell order. Consequently, these institutional trades have allowed for increased liquidity, visibility and growth within the ETF marketplace. And due to the unique creation/redemption process by which ETFs are bought and sold, these large trades have minimal impact on other shareholders in the fund.

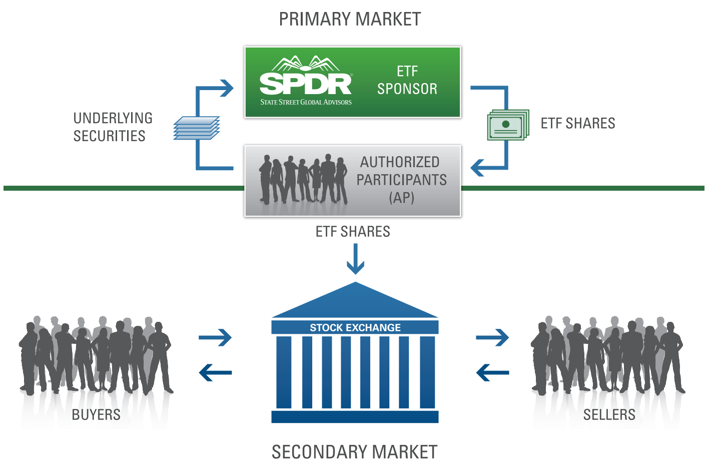
THE CREATION/REDEMPTION PROCESS

The creation/redemption process takes place in the primary market between the fund and authorized participants (APs). APs are US registered, self-clearing broker dealers who meet certain criteria and sign a participant agreement with a particular ETF sponsor or distributor to become APs of the fund. APs are highly scrutinized for their integrity and operational competence; as such they are the only parties who transact directly with the fund.

In order for APs to create fund shares in large increments, known as creation units, they start by assembling the underlying securities of the fund in their appropriate weightings to reach creation unit size (typically 50,000 fund shares) and then delivering those securities to the fund in-kind. In return, the AP receives fund shares which are then introduced to the secondary market—where they are traded between buyers and sellers through the exchange—or sold directly to institutional investors.

APs also have the ability to redeem fund shares through the same process in reverse. Large increments of fund shares—known as redemption units—are acquired in the secondary market or directly from institutional investors and then delivered to the fund in-kind in exchange for the underlying securities in the appropriate weighting equaling that redemption unit (again, typically 50,000 shares).

FIGURE 1: ETF CREATION/REDEMPTION



As a result of the creation/redemption process, the ETF's portfolio manager typically does not need to buy or sell securities except for rebalancing purposes. This means that a portfolio manager does not incur cash drag by allocating a portion of their portfolio to cash and potentially underperforming the index they are benchmarked against or the transaction costs of executing buys and sells. Thus, despite frequent inflows and outflows into an ETF, there should not be a significant impact on performance because securities do not need to be bought or sold on the margin.

Turnover of individual stocks will have either short term or capital gains tax consequences only for the individual shareholder making the trade. Similarly, holders of ETFs will not typically be affected by other shareholder redemptions. Therefore, large redemptions to a fund will have minimal impact on individual investors. In fact, each ETF investor decides when to sell his or her ETF shares and much like a stock transaction the individual controls the timing of any taxes on any resulting capital gain/loss.

LARGE ETF TRADES

Despite the efficiencies of the secondary market, some investors may face situations where their trades simply outsize the available liquidity in the secondary market. Given their size and scale, institutional investors tend to make ETF trades that are larger than the average buy or sell order placed by individual investors. In these circumstances, it may make sense to execute trades through a liquidity provider. Liquidity providers for ETFs are most often APs as they are generally able to seamlessly create or redeem shares of the ETF. Liquidity providers who are not APs do tend to have relationships with clearing firms that are APs and can create or redeem on their behalf.

Because these large trades are occurring in the primary market and are executed through APs using the creation/redemption mechanism they do not affect the individual investor who is making ETF trades in the secondary market. The process also seeks to provide an added layer of liquidity that balances the supply and demand of ETFs, which can help to keep bid-ask spreads tight.

CONCLUSION

Unique to ETFs, the "in kind" transaction in the creation/redemption process, in which shares are traded instead of cash, provides institutions with the ability to gain fast, cost efficient exposure to an ETF's underlying securities without any negative implications or added fees for existing shareholders in the fund. In fact, the ability to create and redeem shares to meet market demand helps keep ETF share prices in line with their net asset values (NAVs). Because investors are not affected by other shareholder redemptions, the creation/redemption process may also improve overall tax efficiency. By increasing ETF market volume, trading activity and institutional expertise, large trades among funds actually helps all investors in the fund and the overall market, by creating liquidity, visibility and growth.

For more information on ETFs, visit www.spdrs.com or www.etffactorfiction.com.

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