What is the 'spread' on an ETF?

As investors increase their awareness and use of Exchange Traded Funds (ETFs) in their investment accounts, there are a few elements to consider that will ultimately improve the experience and resulting outcome. Afterall, ETFs can be created and used to meet a range of needs beyond the most prevalent understanding: that buying an ETF enables exposure, via a single purchase, to multiple underlying securities without having to buy each individual stock.

In fact, ETFs are also being used to diversify by sector, country, management type (active vs. passive), and asset class (equities vs. fixed income). They can be a one-ticket-solution for buying a managed basket of all of the above, if desired, or they can be used to purchase securities in a market that may otherwise be challenging to reach for individual investors directly - like futures, commodities, or other unique mandates. This is just the tip of the iceberg as asset managers continue to explore how they tackle investment management challenges leveraging the ETF vehicle.

As a result, no two ETFs are the same and it is important to do your homework to ensure a clear understanding of the costs – both those clearly disclosed in a prospectus and those inherent in the way ETFs are bought and sold – before proceeding.

First and foremost, ETFs are exchange listed. This means that they exhibit similar trading characteristics and provide data points we typically see when investing in publicly traded companies – information like:

- Bid / bid size
- Offer / offer size
- Volume traded
- AUM (in place of Market Cap)
- Daily / yearly statistics like open / high / low / close

When comparing two ETFs, just like when research analysts compare two public companies, a deeper look into the fundamentals and investment strategy, among other details, creates a second set of data points for consideration. Ultimately, these details are critical to better understand the investor experience when buying and eventually selling an ETF unit – the actual security an investor is purchasing as a proxy for the basket of underlying securities, not the underlying security itself.

Evaluating Top of Book: the best bid & offer for a new buyer:

Let's assume you've confirmed your investment thesis, evaluated performance benchmarks and criteria, and are now set on buying one particular ETF for your portfolio. In that review, you would have seen some information which may further inform the size of the spread you can expect to see when looking at the top of book bid / ask. Information like fees, investment strategy, liquidity of underlying holdings, asset class, geography, risk, among others, are factored into the spread that shows up in the form of a quote from a market maker on an exchange (either NEO or the TSX in Canada) for you to see and trade with.

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Understanding the spread – calculated simply by taking the best offer and subtracting the best bid – is the first way an investor assesses an ETF to purchase units. A smaller spread, where there's reasonable size (in Canada, that's a standardized metric shared on all "ETF Fact Sheets", for reference), is better but it's important to understand what you're getting in order to ensure you're comfortable with the risk and exposure you may receive (e.g. index based vs. actively managed, highly liquid underlying securities vs. less liquid with perhaps a great risk / reward payoff, etc.).

When buying an ETF, your first interaction before placing an order is to understand the best offer price available in the market. This price will set your entry point into the ETF's investment mandate.

You also interact with the spread should you choose to sell the ETF you currently own - this time, however, on the bid-side. This, alongside management fees, any trading commissions due, and factoring in any distributions, would all accrue into the total cost of owning an ETF and should contribute to the evaluation of which ETF to select.

Lastly, there are a few basic elements to check on before hitting "buy" on an ETF:

- Is your data real-time or delayed? Always ensure you use limit prices and, ideally, a real-time source for indicative quotes so you don't trade at a price you're uncomfortable with
    - Advisors: you already have real-time data for all securities listed on the two Canadian exchanges that list ETFs: NEO & TSX, not consolidated
    - Investors: you likely only have either NEO or TSX data in real-time; it is not consolidated

- Do you need to trade this ETF urgently (e.g. in the opening auction, or at any prevailing market price via a market order)? If not, consider waiting until the Exchanges are open after 9:30AM and underlying securities have had a chance to open, as these market conditions will also be reflected in the spreads at the start and end of day
- Do you need to trade in size, larger than the prevailing quote? Chances are, there's substantial liquidity already available on-screen via one of Canada's twelve market places that you may simply not be seeing – if you're unsure, you can always call your firm's trading desk or the ETF manager directly to verify your ability to trade
    - For the active trading community, it may be worthwhile to source

Many other details factor into the spread presented in your financial tools. Ask questions, do your research, and be sure to understand the differences between products before purchasing.

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