Direxion
ETFs | Funds

The Basics of ETF Liquidity

What you get is not necessarily what you see.

In the investing world, the term liquidity refers to the degree to which an asset or security can be bought or sold without impacting that asset's fair market price. Liquidity for individual securities is typically characterized by a high level of trading activity. Since exchange traded funds (ETFs) are essentially a "wrapper" for other securities, liquidity is determined mainly by the trading volume of those underlying securities.

When the market volume of an ETF is low, liquidity still exists in the underlying securities. That liquidity is accessed to facilitate order execution for the ETF. To understand this, it is important to be familiar with the role of the market maker.

Making a market.

A market maker is a bank or brokerage firm that stands ready every second of the trading day with a firm bid[*] and ask[**] price. This is good for investors, because when an order is placed to sell your shares of an ETF, the market maker will actually purchase the ETF at that price, even if he doesn't have a seller lined up. In doing so, the firm is literally "making a market" for the ETF. Because market makers are not interested in exposing themselves to undue market risk, their willingness to fill those buy and sell orders at or near the market price is based on their ability to hedge their position.

Hypothetical Example:

- A trader buys $5 million dollars of a XYZ ETF
- The market maker fills that order without the existence of a corresponding seller. He is now short[+] the XYZ ETF.
- To offset this short position, the market maker buys an equal amount of exposure to the underlying securities that the ETF is tracking, to hedge the position.

The easier it is for a market maker to access these underlying securities, the easier it will be for them to hedge their short position, and the easier it will be for them to facilitate liquidity in the secondary market.

The bottom line is that even if the trading volume of the ETF is relatively low, an ETF may still be liquid, as long as the underlying securities in the ETF can be easily accessed as a hedge.

Here's an example:

Underlying Liquidity Case Study: ZMLP

The Direxion Zacks MLP High Income ETF (ZMLP) seeks investment results, before fees and expenses, which track the price and yield performance of the Zacks MLP Index.

ZMLP is a good example of a product that has underlying liquidity but does not trade significant volumes intraday, because it's most frequently used as a long-term investment vehicle.

The underlying securities of ZMLP are liquid as it invests in 25 MLPs that are traded on major U.S. exchanges with a trading value of approximately $450 million.

On March 20, 2014, ZMLP traded 60,418 shares of which 52,486 shares (87% of the day's volume) was executed in only two separate trades:

Trade One (11:31 a.m.)

- Spread – Bid: $39.92 – Ask: $39.96
- Trade execution - 24,711 shares filled at an average price of $39.94

Trade Two (1:00 p.m.)

- Spread – Bid: $39.98 – Ask: $40.05
- Trade execution - 27,775 shares filled at an average price of $40.05

The average price of the two trades was $39.995 while the volume-weighted average price for the day was $40.003. Although the trades constituted a majority of the daily volume, the bid-ask spreads for each trade were narrow and the executed price for each trade was within the spread.

You have another option for large trades.

Authorized participants (APs) are large institutional investors that have the ability to create or redeem shares of an ETF directly with the fund manager at its net asset value (NAV). This is often referred to as the primary market. APs create or redeem shares in large blocks (tens of thousands of shares) called creation units. Authorized participants may access the primary market either for clients wishing to enter or exit large positions at NAV, or to provide liquidity in the open market as a market maker. In their capacity as a market maker, AP's will create or redeem shares to match the supply and demand in the secondary market (shares trading on the exchange), and ensure that an ETF's intraday market price approximates the net asset value of the underlying assets.

The ETF Creation and Redemption process provides another alternative to create shares of an ETF, without impacting open market pricing. For investors that trade ETFs in large blocks, accessing the primary market through an AP may be an option.

Potential Advantages of the creation/redemption process include the ability to:

1. Enter into or exit out of sizable positions without affecting the secondary market ETF share price, regardless of the secondary market volume of the ETF.
2. Buy or sell at the fund's fair value/NAV and avoid premiums/discounts created by changes in the value of the underlying Index, and supply/demand for the ETF.

Below is an example of liquidity statistics for the underlying index for the Direxion S&P 500 Volatility Response Shares (VSPY)

VSPY, the Direxion S&P 500 Volatility Response Shares, seeks investment results, before fees and expenses, that track the S&P 500® Dynamic Rebalancing Risk Control Index. The fund allocates exposure between equities in the S&P 500® Index++ and U.S. Treasury Bills (T-Bills). As of April 17, 2014 some key 20 day average liquidity statistics for the S&P 500 Indexes are as follows:

- S&P 500® Index
- 2,395,088,854 shares
- Notional value traded of $130,209,931,447
- $0.03 bid/ask spreads^
- 0.03% bid/ask spread
- 1,800 share bid size
- 1,800 share ask size

T-Bills trade in volumes upwards of $100 Billion daily.

The data above indicates that the underlying securities held in this fund are liquid. If an investor wanted to buy or sell a large number of shares, the market maker would be able to easily hedge out his exposure, and in turn, not fundamentally impact the price of the ETF.

In terms of evaluating secondary market liquidity, the factors most investors and traders point to are spreads, bid/ask size, and secondary market volumes. As of April 17, 2014 the key 20 day average liquidity statistics for VSPY is as follows:

- $0.03 and $0.05 spread
- 0.06% to 0.09% bid/ask spread
- 500 share bid size
- 1,000 share ask size
- 7,000 share 20 day average volume

The data above helps to confirm that this product is liquid, easily tradable, with tight spreads. As the ETF grows over time, the product liquidity profile will not fundamentally change.

Call us! As you seek better outcomes for your portfolios it's important to arm yourself with the trading knowledge to ensure the best ETF order execution. For more information on volume and liquidity for any Direxion Shares ETFs, please call 866-476-7523.

++ The S&P 500 Index is based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The index components and their weightings are determined by S&P Dow Jones Indices.
^ The difference between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

Disclosure:

An investor should consider the investment objectives, risks, charges, and expenses of Direxion Shares carefully before investing. The prospectus and summary prospectus contains this and other information about Direxion Shares. To obtain a prospectus or summary prospectus, please visit www.direxioninvestments.com. The prospectus and summary prospectus should be read carefully before investing.

ZMLP: The Fund's investments are concentrated in the energy sector with an emphasis on securities issued by MLPs, which may increase price fluctuation. The value of commodity-linked investments such as the MLPs in which the Fund invests are subject to risks specific to the industry they serve, such as fluctuations in commodity prices, reduced volumes of available natural gas or other energy commodities, slowdowns in new construction and acquisitions, a sustained reduced demand for crude oil, natural gas and refined petroleum products, depletion of the natural gas reserves or other commodities, changes in the macroeconomic or regulatory environment, environmental hazards, rising interest rates and threats of attack by terrorists on energy assets, each of which could affect the Fund's profitability. MLPs are subject to significant regulation and may be adversely affected by changes in the regulatory environment including the risk that an MLP could lose its tax status as a partnership. If an MLP were to be obligated to pay federal income tax on its income at the corporate tax rate, the amount of cash available for distribution would be reduced and such distributions received by the Fund would be taxed under federal income tax laws applicable to corporate dividends received (as dividend income, return of capital, or capital gain). In addition, investing in MLPs involves additional risks as compared to the risks of investing in common stock, including risks related to cash flow, dilution and voting rights. Such companies may trade less frequently than larger companies due to their smaller capitalizations which may result in erratic price movement or difficulty in buying or selling. Additional management fees and other expenses are associated with investing in MLP funds. The Fund is subject to certain MLP tax risks and risks associated with accounting for its deferred tax liability which could materially reduce the net asset value. An investment in the Fund does not offer the tax benefits of a direct investment in an MLP.

VSPY: An investment in the ETFs involve risk, including the possible loss of principal. The ETFs are non-diversified and include risks associated with concentration risk that results from the Funds' investments in a particular industry, sector, or geography which can increase volatility. The use of derivatives such as futures contracts, forward contracts, options and swaps are subject to market risks that may cause their price to fluctuate over time. The Fund does not attempt to, and should not be expected to, provide returns which are a multiple of the return of the Index for periods other than a single day. For other risks including correlation, leverage, compounding, market volatility and specific risks regarding the funds securities, please read the prospectus.

The Funds are designed to be utilized only by sophisticated investors, such as traders and active investors employing dynamic strategies. Such investors are expected to monitor and manage their portfolios frequently. Investors in the Funds should: (a) understand the consequences of seeking daily investment results, (b) understand the risk of shorting, and (c) intend to actively monitor and manage their investments (c) intend to actively monitor and manage their investments.

Direxion Shares Risks - An investment in the ETFs involve risk, including the possible loss of principal. The ETFs are non-diversified and include risks associated with concentration risk that results from the Funds' investments in a particular industry or sector which can increase volatility. The use of derivatives such as futures contracts, forward contracts, options and swaps are subject to market risks that may cause their price to fluctuate over time. The Fund does not attempt to, and should not be expected to, provide returns which are a multiple of the return of the Index for periods other than a single day. For other risks including leverage, correlation, compounding, market volatility and specific risks regarding each sector, please read the prospectus.

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