Explaining ETF premiums and discounts

A recurring question from advisors: “Why is ETF A trading at a premium?” or “Why is ETF B selling at a discount?” A closer look into the costs of ETF transactions can help answer these questions.

**NAV versus market price**

Many of the costs of trading ETFs are the same costs a portfolio manager incurs when buying and selling securities in a mutual fund. The biggest difference is that a mutual fund captures most of these costs in a single measure, its daily net asset value (NAV), whereas an ETF has two values: the NAV, which is used as a reference point, and the ETF’s actual price, an intraday market price that carries a premium or discount to its NAV. The size of the premium or discount at any given time depends on the cost of trading the securities that make up the index the ETF seeks to track. These trading costs are implicit in a mutual fund’s NAV but are explicit in an ETF’s market price.

**NAV:** For bond ETFs, the NAV is based on the bid prices of the underlying bonds in the portfolio. For an equity ETF, the NAV is based on the last traded prices of the underlying securities. The NAV is calculated at the close of the prior trading day.

**Market price:** For both equity and bond ETFs, the market price is based on the last traded price of the ETF (ETF sponsors use a different measure of market price—the midpoint of the bid-ask spread on the ETF at market close—but trading platforms use last traded price throughout the trading day). In most cases, that price will fall within the bid-ask spread of the underlying basket of securities for a stock ETF, while bond ETFs are more likely to trade at a premium because the NAV is set at the lower bid price.

**Trading costs**

Figure 1 (on the next page) may help to explain some of the costs of trading ETFs. Keep in mind that the basket of stocks underlying the ETF and the ETF itself have three prices:

**Ask:** The lowest price at which a seller is willing to sell (the price an investor pays when buying).

**Bid:** The highest price at which a buyer will buy (the price at which an investor sells).

**Last traded price:** The actual price at which a security last traded.
The tan bar represents the bid-ask spread for the underlying securities. The size of the bid-ask spread of the underlying basket and of the ETF itself is tied to market liquidity, or the proportion of buyers to sellers at any given moment. Bid-ask spreads are very small for ETFs tracking broad-market indexes, large-capitalization stocks or government bonds. They can be much wider in markets that are less heavily traded, where market makers’ trading costs also rise.

**Premiums and discounts**

An equity ETF’s market price will generally trade within the bid-ask spread of the basket. That is the case when supply of and demand for the ETF are more or less in balance and trading occurs in the secondary market. Heavy buying or selling of the ETF can temporarily push its market price outside the bounds of the underlying basket. If the ETF trades at a significant premium or discount, traders can seize an opportunity to profit from the difference between the ETF’s market price and the prices of the underlying securities.

When that happens, the market maker can go to the primary market to transact with the ETF sponsor—creating new units in the ETF when demand is high and redeeming ETF units when supply exceeds demand. The primary market helps bring the ETF market price back in line with the NAV. However, the creation/redemption process triggers the costs represented by the blue bars, meaning the ETF will usually trade at an increased premium or discount to reflect those costs until two-way order flow in the ETF returns.

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**Figure 1. How spreads and trading costs affect ETF premiums and discounts**

Market maker costs include:

- Creation/redemption fee, which captures the custody bank’s fees for delivering securities into the portfolio. This fee can range from $0 to $30,000 or more per transaction.
- Stamp taxes owed when buying or selling stocks in certain countries.
- Operational costs to the market maker, such as commissions, hedging costs, trading fees.

The creation/redemption fee, stamp taxes, and operational costs are represented by the blue bars. The ETF market price and NAV are represented by the ETF Market price and ETF NAV, respectively.
Managing expectations

Your expectations for premiums and discounts should be based on the asset class that you’re trading. The wider the spread on the basket of underlying stocks and the larger the costs associated with trading them, the larger the premium or discount relative to the ETF’s NAV. For a large-cap ETF, the spread costs for the underlying basket may be only 5 basis points (bps) and the market maker’s costs may be no more than 1 bp. By contrast, the basket for a global ETF could have a spread of 15 to 30 bps, with market maker costs ranging from 10 to 40 bps (Figure 2).

Figure 3 shows a basket with a large bid-ask spread that has low trading costs, which is common in some bond sectors. Keep in mind that the size of the premium or discount is the difference between the market price and NAV, so it’s important to understand how the NAV is calculated. As mentioned earlier, the NAV for fixed income products is based on the bid price for the underlying bonds. This makes the premium or discount seem continuously skewed. During times of heavy bond buying, the ETF will appear to trade at a steep premium because the entire spread to buy the bonds is reflected in the market price.

Built for speed—and the long run

ETFs offer pricing transparency, allowing you to obtain the intraday price in any asset class. The challenge is that the costs of that trade are explicit—they aren’t rolled into one figure at the end of the trading day, as with mutual funds. It’s important to be mindful of trading costs, particularly in less liquid parts of the market, and to avoid following the herd, which can result in buying at a premium and selling at a discount. Despite the “built for speed” nature of ETFs, they remain most effective for investors seeking long-term exposure to distinct asset classes.

Figure 2. Stock ETF

- Market maker costs: 40 bps
- Basket spread: 20 bps
- $100.40 (40¢ premium)
- $100
- $99.70 (30¢ discount)

Figure 3. Bond ETF

- Market maker costs: 5 bps
- Basket spread: 100 bps
- $50.52 (52¢ premium)
- $50.15 (15¢ premium)
- $50
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