Best practices for effective ETF trading

When you buy or sell an exchange-traded fund (ETF), you want to execute your trade as effectively as possible. You're more likely to do so, even when markets are volatile, by being aware of a few best trading practices.

Remember a few basics

Use limit orders. A limit order lets you set the price at which you buy or sell an ETF. If you use a market order instead, you may pay more or receive less than you would have liked. With a limit order, however, units may not be available at your specified price and not all of your trade may be executed.

Consider market volatility. Market conditions can affect bid-ask spreads, or the difference between the price at which an investor can sell a security and the higher price required to buy the same security. During volatile periods, fewer units may be listed at best-bid and best-ask prices, increasing the importance of using the appropriate order type and monitoring your trades.

Keep abreast of the news. ETFs can briefly trade at a premium or a discount to the net asset value of their underlying holdings. Such swings can result from the release of economic indicators or statements from central banks, as well as earnings and other news from companies that are large constituents of an ETF and its benchmark.

Understand liquidity. Contrary to popular belief, an ETF's liquidity isn't best determined by average daily volume. Because ETF units can be created or redeemed at any time, the liquidity of the underlying securities in the creation/redemption basket is what matters most. When the underlying securities are difficult to trade, the market maker's costs may increase, resulting in wider bid-ask spreads than usual or compared with ETFs in other asset classes. Liquidity of the underlying securities is known as primary market liquidity, while an ETF's average daily volume is known as secondary market liquidity.

Heed the clock and the calendar

Spreads can widen at certain times each day or on certain days of the year.

At the market's open. Some of an ETF's underlying securities may not begin trading at the open, perhaps because of material news about a security. In such situations, the market maker can't price the ETF with certainty.

When the bond market is closed but the stock market is open. ETFs trade like stocks, even when they seek to track bond indexes. So fixed income ETFs trade whenever the stock market is open—even if the bond market is closed and, as a result, the market maker doesn't have a pricing source. (For example, the bond market is closed and the stock market is open on Remembrance Day, which is typically 11 November; and from 1 to 4 p.m., Eastern time, the day before other bond market holidays.)

When U.S. markets are closed. Some ETFs in Canada invest primarily in U.S. ETFs. Spreads can widen when the stock market is open in Canada but closed in the United States. These days are Martin Luther King Day (the third Monday in January), Memorial Day (the last Monday in May), Independence Day (4 July) and Thanksgiving Day (the fourth Thursday in November).

At the market's close. Fewer firms may make markets in an ETF at the market's close, so fewer units may be listed for purchase and sale than at other times of the day.

Use a block desk

A block desk, if one is available to you, can use its trading tools and network of relationships to help you when you place a large order. Your block desk may be able to:

- Review the depth of interest in an ETF before placing a trade. You may be able to determine from your trading screen only how many units are available at best-bid and best-ask prices. Your block desk can evaluate additional availability of units.
- Trade in increments to manage any effect that large trades could have on prices.
- Create and redeem ETF units directly with the ETF issuer.
- Obtain a quote to execute the entire trade.

Some common order types

Market order	You buy or sell immediately at the best available current price. When you place a market order, your priority is making the trade quickly, not securing a particular price.
Stop order	You set a price—the stop price—at which you automatically buy or sell. When the market hits the stop price, *your stop order becomes a market order*. The price you then get is the best available current price. That price may have changed, for better or worse, in the moments after your stop price triggered your market order. When you place a stop order, your priority is trying to limit a loss or protect a profit.
Limit order	You set a price and execute your trade only if units are available at that price or better. Limit orders protect you from executing a trade at an undesirable price. When you place a limit order, your priority is securing a certain price, not speed of execution.
Stop-limit order	Similar to a stop order, but in addition to setting the stop price, you also set a limit price. When the market hits the stop price your stop order becomes a limit order, at the limit price you specified. When you place a stop-limit order, your priority is trying to limit a loss or protect a profit without the unpredictability of a market order.

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