

ETF Liquidity: Why Daily Trading Volume Isn't the Full Story

Understanding the two-layer liquidity model and what it means for evaluating ETFs

KEY TAKEAWAYS

- An ETF's true liquidity is determined by the liquidity of its underlying basket¹ of securities, not by its average daily trading volume ("ADV")².
- The creation³ and redemption⁴ mechanism allows authorized participants ("APs")⁵ to issue or retire shares as needed, meaning ETFs can typically trade in sizes far larger than headline volume suggests.
- For advisors evaluating ETFs, **implied liquidity**⁶ may generally be a more accurate measure than ADV, especially for actively managed and newer funds.

Overview

When evaluating an ETF, many investors start with one number: average daily trading volume (ADV). It's a familiar metric carried over from individual stock analysis, where higher volume generally means easier execution. But ETFs are not stocks, and applying a stock-trader's lens to an ETF can lead to a misleading conclusion: that a low-ADV ETF is illiquid and therefore difficult to own.

That conclusion misses how ETFs actually work. An ETF's liquidity is determined primarily by the tradability of its underlying basket of securities. ADV measures only one layer of activity. For most ETFs, and particularly for actively managed funds, sector-focused strategies, and funds with shorter trading histories, there is a much deeper layer of liquidity that ADV does not capture.

Why It Matters

For an advisor selecting funds for a client portfolio, or an investor researching new allocations, relying on ADV alone can rule out high-quality ETFs that are entirely appropriate vehicles. Two ETFs with identical strategies and equally liquid underlying securities can show very different headline volumes simply because one is older or more widely distributed. Treating ADV as a primary screen risks confusing visibility with capacity.

This may matter when:

- The ETF is actively managed, where the strategy and process, not headline volume, are the point
- The ETF is relatively new and has not yet accumulated broad retail trading flow
- The investor is considering a meaningful allocation, whether a \$250,000 individual position or a multi-million-dollar block trade

In each case, the question isn't "how much did this trade yesterday?" It's "how much can this trade today without moving the underlying securities?"

How It Works

An ETF has two layers of liquidity working in parallel.

Secondary Market

The exchange where ETF shares trade between buyers and sellers throughout the day. Headline ADV reflects activity at this layer alone.

Primary Market

APs create or redeem ETF shares with the issuer, exchanging baskets of underlying securities. Tradable size scales with the underlying market.

Designated firms called authorized participants can create new ETF shares by delivering a basket of the underlying securities to the issuer, or redeem shares by reversing the process. This ties the ETF's tradable size directly to the liquidity of the underlying basket.

An ETF's true tradable capacity, its implied liquidity, is often many multiples of its daily volume. For example, an ETF holding large-cap U.S. equities has capacity that reflects the deep markets in the underlying stocks themselves.

Practical Implications

For advisors and investors evaluating ETFs, three potential takeaways follow.

1 Look past ADV alone.

For a more accurate read on tradability, check the implied liquidity figure. Most major data providers now publish it. For active ETFs, also examine the liquidity of the underlying holdings.

2 Use the issuer's capital markets team for larger trades.

For advisors and institutional investors placing block trades, an ETF issuer can connect you with market makers and authorized participants to execute at fair value with minimal price impact.

3 Use limit orders, particularly at market open and close.

Bid-ask spreads can widen briefly during these windows even on liquid funds. Limit orders⁷ may help control execution price.

At Clough Capital

Clough Capital manages two actively managed ETFs, CBLS and CBSE, both listed on NYSE Arca. Both portfolios are built primarily from exchange-listed equities, which underpins the implied liquidity available to investors at any size. For execution support on larger orders, capital markets contacts are available through Parallel Distributors.

Definitions

- 1. The underlying basket** is the portfolio of securities an ETF holds, and the basket exchanged between the fund and an authorized participant when shares are created or redeemed. Because shares can be created and redeemed against it, the tradability of the underlying basket is a principal factor in how large a trade an ETF can support.
- 2. Average daily trading volume** is the average number of shares of an ETF that are bought and sold on an exchange during a trading day over a specified period (commonly the previous 30, 60, or 90 trading days). ADV reflects historical secondary market trading activity and is one of several factors investors may consider when evaluating an ETF's trading characteristics.
- 3. Creation** is the process by which new ETF shares come into existence. An authorized participant delivers a specified basket of securities, cash, or both to the fund and receives a large block of newly issued ETF shares in return. Creation allows an ETF's share count to grow to meet investor demand.
- 4. Redemption** is the reverse of creation. An authorized participant returns a large block of ETF shares to the fund and receives a basket of the fund's securities, cash, or both. Redemption allows an ETF's share count to shrink when investors sell.
- 5. Authorized Participants (APs)** are large financial institutions authorized to create and redeem ETF shares directly with the fund. To create shares, an AP delivers a basket of the ETF's underlying securities to the fund and receives ETF shares in return; to redeem, the process reverses. This creation/redemption mechanism allows an ETF's share supply to expand or contract with investor demand, and ties the fund's tradable size to the liquidity of its underlying holdings.
- 6. Implied liquidity** is an estimate of how many ETF shares could be traded based on the liquidity of the fund's underlying holdings, rather than on the ETF's own trading history. Many major data providers publish an implied liquidity figure.
- 7. A buy limit order** is an instruction to purchase a security at a specific price or lower, and acts as a price ceiling for a buy trade. A sell limit order is an instruction to sell a security at a specific price or higher, and acts as a price floor for a sell trade. A stop order is an instruction to buy or sell a security once it reaches a specific stop price, and once triggered it instantly becomes a market order and is executed at the best available price. A stop-limit order is an instruction to ensure a broker only buys or sells if the stock hits a specific stop price and then caps the price at a specified limit price, or better.

IMPORTANT DISCLOSURES

Investors should consider the investment objectives, risks, charges, and expenses carefully before investing. This and other information are contained in the prospectus, which may be obtained by visiting www.cloughcapital.com/etfs or by calling 855-393-0559. Please read the prospectus carefully before you invest.

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