CIBC ASSET MANAGEMENT

EXCHANGE TRADED FUNDS

ETF liquidity explained: Clearing up common misconceptions

June 2025

Exchange-traded funds (ETFs) offer a host of attractive features, including intraday trading flexibility, efficient market access, and potentially lower costs. While these benefits are widely recognized, one of the most critical aspects of ETFs—their liquidity—remains misunderstood by many investors. The ability to buy or sell ETFs swiftly and efficiently at reasonable prices is a cornerstone of their structure, benefiting both active and index-tracking strategies.

Myths and realities of ETF liquidity

To fully appreciate ETF liquidity, it is essential to address some of the most common misconceptions surrounding this topic:

Myth #1: ETF liquidity is limited by the liquidity of underlying stocks

Reality: ETFs operate within a unique framework distinct from individual stocks or closed-end funds. Unlike these securities, which have a fixed number of shares, ETFs are open-ended investment vehicles. They can issue or redeem shares in response to investor demand through a process facilitated by market makers and capital markets professionals. This creation and redemption mechanism enables ETFs to provide deeper and more dynamic liquidity than individual stocks. As a result, an ETF's liquidity is primarily influenced by the liquidity of its underlying securities, not its asset size or trading volumes.

Myth #2: Low trading volumes or small fund size indicate liquidity risk

Reality: Contrary to popular belief, ETFs with low daily trading volumes or smaller asset sizes are not inherently illiquid. Thanks to the creation and redemption mechanism, even smaller ETFs can accommodate large buy or sell orders while maintaining prices closely aligned with the net asset value (NAV) of their underlying securities. It's worth noting that many of today's largest ETFs started with minimal assets and trading activity.

Myth #3: Active ETFs have higher costs than passive index ETFs

Reality: While active ETFs may have higher management fees, their overall costs are not necessarily higher than those of passive ETFs. Active ETFs aim to outperform an index, which can result in higher tracking errors, often misinterpreted as additional costs. However, trading costs for active ETFs can be comparable to passive ETFs, with total expenses influenced by factors such as the underlying exposure, investor strategy, and market conditions.

Myth #4: The last price of an ETF represents its current value

Reality: The last recorded price of an ETF reflects the most recent transaction, not its current value. The actual price an investor pays is determined by the value of the underlying securities at the time of purchase. For infrequently traded ETFs, the portfolio value may fluctuate significantly between trades, making the last price an unreliable indicator of fair value. Instead, the real-time value is reflected in the ETF's bid/ask spread.

Five tips for trading ETFs

Time your trades: Avoid trading during the first 10–15 minutes after the market opens and close to the market's closing time. This allows the underlying portfolio to stabilize and reduces the impact of heightened volatility often seen at these times.

Use the right order type: Use limit orders to maintain control over execution price and pace. Limit orders let you specify the number of shares to buy or sell at a set price or better. Be cautious with market orders, as they can result in prices that deviate from expectations.

Trade when the underlying market is open: For international ETFs, aim to trade during the hours when the underlying market is open. This allows market makers to calculate ETF prices more accurately, resulting in narrower bid-ask spreads. Trading when the underlying market is closed often leads to wider spreads, as market makers account for the increased risk of price estimation.

Leverage the expertise of the CIBC ETF team: Collaborate with CIBC's ETF trading and liquidity specialists. Our team works closely with portfolio managers, authorized participants, market makers, and exchanges to assess true ETF liquidity and ensure efficient trade execution.

ETFs have gained popularity in contemporary investment portfolios due to their flexibility and liquidity. The ability to trade ETFs throughout the day in the secondary market, combined with the primary market creation and redemption mechanism, ensures robust liquidity. While trading ETFs can be straightforward, there is no universal approach. Maintaining open communication with ETF distribution and capital markets teams is essential for optimizing liquidity when making large trades.

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