Editorial

ETFs Prove Their Worth in Turbulent Times

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If a casual observer were to look at the latest figures for exchange traded funds (ETFs), s/he would not guess that a pandemic and a war hit the global economy hard in the last two years and, at least in the meantime, also the capital markets, because the growth of ETFs is unbroken.

Since their introduction in the 90s, ETFs have become one of the most popular product innovations in the asset and wealth management industry. Demand from private investors, especially for ETF savings plans, is also on the rise. Last year, assets under management in Deutsche Börse's ETF segment exceeded EUR 1 trillion for the first time, 39% higher than in the previous year. A new all-time high.

Market observers even assume that assets under management can continue to achieve double-digit growth rates in the coming years. In a study, PwC estimates that global ETF assets could grow by an average of 17% per year until 2026.

Their formula for success: ETFs provide investors with an efficient financial instrument for the cost-effective implementation of investment and trading strategies. In addition, ETFs may even improve liquidity conditions in comparatively less liquid asset classes during quiet market phases due to their instant accessibility. But what about a prolonged period of increased market volatility: Are ETFs more liquid than their underlying components?

To investigate this, the bid-ask spread can be applied as a simple measure of market liquidity (the analysis was based on Xetra order book data). This metric is used to assess whether ETFs are more liquid than their underlying basket of securities.

Xetra is the leading trading venue for DAX shares and ETFs in Europe. Let's, therefore, look for the first four months of the year at the spread development of the most liquid DAX ETF (the spread calculation for the DAX ETF was based on the bid-ask spreads for a simulated order size of EUR 100,000), tradable on Xetra as well as that of the basket of 40 individual DAX stocks considering their index weighting ("DAX basket"; the spread calculation for the DAX basket was based on the best bid-ask spreads of the index stocks according to their index weighting). During this period, the DAX ETF had an average spread of 3.39 basis points (bp), while the DAX basket showed an average spread of 3.71 bp. Accordingly, the average daily spread difference during this period was 0.32 bp or 8.6% in favor of the ETF.

We also examined the impact of the expansion of the DAX index from 30 to 40 individual securities implemented on September 20th, 2021, on the respective spreads in a period of 50 trading days before and after the index expansion. Despite the expansion by less liquid stocks on average, no negative effect on the spread of the most liquid DAX ETF could be determined. In fact, there was even a slight decrease in the average daily spread of the DAX ETF from 2.91 to 2.89 bp, or by 0.5%. In contrast, the average spread of the DAX basket increased from 3.12 to 3.27 bp, or by 5.1%, in the comparison period.

These results impressively underline the high liquidity of ETFs on Europe's leading trading venue Xetra – even in periods of increased market volatility.