

ETF MARKET STRUCTURE

ETF Liquidity Cheat Sheet

Clear explanations of ETF market structure for investment professionals. By Will Lee, CFA, CAIA, FRM

1 ETFs trade in two markets

ETF MARKET STRUCTURE

ETFs trade in two connected markets



This is how ETF supply adjusts to trading demand. Liquidity ultimately comes from the underlying securities.

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2 Where ETF liquidity comes from

WHY ETF LIQUIDITY ≠ AUM

How ETF liquidity flows

ETF liquidity is not stored inside the ETF. It is accessed through a market structure that links ETF shares to their underlying assets.



ETF liquidity ultimately comes from the liquidity of the underlying securities, not from the number of ETF shares already outstanding.

AUM describes how much capital is invested. Liquidity describes how efficiently additional capital can move.

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WHY ETF LIQUIDITY ≠ AUM

Common assumption vs. reality

AUM measures scale, not capacity. Volume describes how often an ETF trades, not how much it can trade.

	COMMON ASSUMPTION	REALITY
Fund size (AUM)	A higher-AUM ETF is automatically more liquid than a smaller ETF.	AUM reflects accumulated investor capital. A small ETF holding highly liquid large-cap equities may absorb very large trades with minimal market impact.
Large funds, less liquid assets	A large ETF in a less liquid asset class is safe because of its size.	Size does not remove constraints. A large ETF holding high-yield bonds or thinly traded international equities may face tighter liquidity constraints.
On-screen volume	Low trading volume means low liquidity.	Low volume may reflect a buy-and-hold investor base or episodic demand. If the underlying securities are liquid, APs can create or redeem shares as needed.
Spreads under stress	Wider bid-ask spreads mean ETF liquidity has failed.	ETFs transmit conditions, not create them: higher volatility, tighter balance sheets, and more uncertain underlying liquidity.

A more accurate assessment focuses on:

- Liquidity of the underlying securities
- Structure of the ETF basket
- Primary market functionality
- Execution strategy, not headline metrics

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3 AUM and volume are not liquidity

AUM measures scale, not capacity.

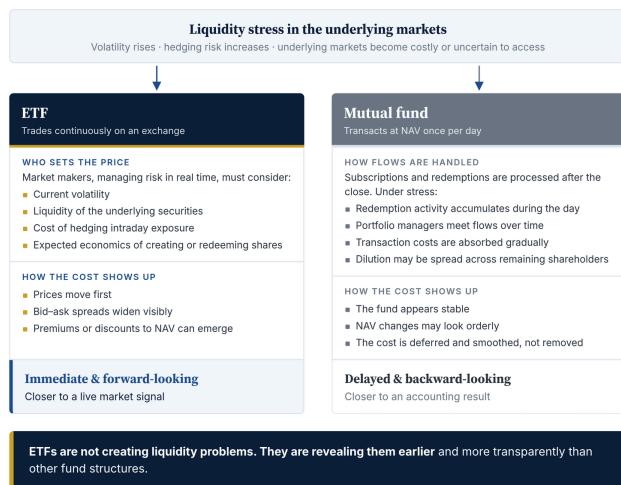
Secondary market volume describes how often an ETF trades—not how much it can trade.

AUM describes how much capital is invested. Liquidity describes how efficiently additional capital can move.

WHY ETFS SURFACE LIQUIDITY CONSTRAINTS FASTER THAN MUTUAL FUNDS

Same stress, different visibility

Mutual funds do not avoid liquidity stress. ETFs show it in real time; mutual funds defer and smooth it.



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4 Same stress, different visibility

ETFs do not fail under stress—they reflect it.

ETFs are compressing price discovery into the present. Mutual funds are distributing it across time.

Mutual fund NAVs, by contrast, are backward-looking. They reflect executed trades, not the marginal cost of the next one.

Go deeper

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Why ETF Liquidity ≠ AUM
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Why ETFs Surface Liquidity Constraints Faster Than Mutual Funds
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