

ETF Market Structure Diagram Pack

Four diagrams on how ETFs trade, where ETF liquidity comes from, and how liquidity stress shows up. Free to use in training decks, internal notes and client materials with credit.

1. ETFs trade in two connected markets
2. How ETF liquidity flows
3. AUM vs. liquidity: common assumption vs. reality
4. Same stress, different visibility: ETFs vs. mutual funds

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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1 of 4 · ETF market structure: ETFs trade in two connected markets. Investors trade ETF shares on an exchange; market makers and APs connect that secondary market to creation and redemption in the primary market. Liquidity ultimately comes from the underlying securities.

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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2 of 4 · 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.

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 of 4 · 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.

Same stress, different visibility

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

Liquidity stress in the underlying markets

Volatility rises · hedging risk increases · underlying markets become costly or uncertain to access

ETF

Trades continuously on an exchange

WHO SETS THE PRICE

Market makers, managing risk in real time, must consider:

- Current volatility
- Liquidity of the underlying securities
- Cost of hedging intraday exposure
- Expected economics of creating or redeeming shares

HOW THE COST SHOWS UP

- Prices move first
- Bid-ask spreads widen visibly
- Premiums or discounts to NAV can emerge

Immediate & forward-looking

Closer to a live market signal

Mutual fund

Transacts at NAV once per day

HOW FLOWS ARE HANDLED

Subscriptions and redemptions are processed after the close. Under stress:

- Redemption activity accumulates during the day
- Portfolio managers meet flows over time
- Transaction costs are absorbed gradually
- Dilution may be spread across remaining shareholders

HOW THE COST SHOWS UP

- The fund appears stable
- NAV changes may look orderly
- The cost is deferred and smoothed, not removed

Delayed & backward-looking

Closer to an accounting result

ETFs are not creating liquidity problems. They are revealing them earlier and more transparently than other fund structures.

Source: howETFsTrade.com · Free to use with credit

4 of 4 · 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.