ETF EDUCATION

The Creation/Redemption Process

Understanding the exchange traded fund (ETF) creation/redemption process can help you understand why ETFs are more tax efficient, liquid, and transparent than other investments. Here's how the process works and why it's important to investors:

THE IMPORTANT PARTIES:

Individual Investor

ETF Sponsor/Trust[1]

The ETF company

Authorized Participant (AP)[2]

A large institutional investor, such as a broker-dealer, that enters into a contract with an ETF sponsor to create or redeem shares directly with the fund

KEY TERMS:

Creation/Redemption Unit

A large block of ETF shares, usually 50,000 shares

Primary market

The part of the market that deals with the issuance of new securities

Secondary market

The part of the market where investors purchase securities/ETFs from other investors

REASONS TO CREATE:

Fill orders / Create inventory / Take advantage of arbitrage opportunities

Step 1
The Investor places an order to buy ETF shares on the secondary market:

- If there are enough shares in the market to satisfy the order, the order is filled.
- If there are not enough shares, the creation process is kicked off in the primary market.

Step 2
The AP acquires the securities that make up the ETF and delivers them to the ETF sponsor.

Step 3
The ETF sponsor creates the ETF shares and delivers them back to the AP as a creation unit.

Step 4
The AP delivers the creation unit/ETF shares to the secondary market.

REASONS TO REDEEM:

Fill orders / Reduce inventory / Take advantage of arbitrage opportunities

Step 1
The Investor decides to sell their ETF shares on the secondary market:

- If there is market demand, the shares are sold on the market.
- If there is low demand, the AP gathers up enough shares to create a redemption unit.

Step 2
The AP puts together a redemption unit and delivers it to the ETF sponsor in the primary market.

Step 3
The ETF sponsor redeems the ETF shares for the individual securities that make up the shares and delivers them back to the AP.

Step 4
The AP can sell the individual securities in the secondary market for cash.

(1)Also refered to as a Portfolio Manager (2)Also refered to as a Liquidity Provider

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THE SIGNIFICANCE

Liquidity

- ETFs are traded throughout the day on exchanges. When supply and demand get out of balance, the creation/redemption process allows the authorized participant to create and redeem fund shares.

Fair pricing

- The price of an ETF is based on its IIV (Intraday Indicative Value)/IOPV (Indicative Optimized Portfolio Value), in other words the value of the underlying securities. However, ETFs are bought and sold at market price like stocks and the price can fluctuate based on supply and demand. When the market price gets too far away from the IIV/IOPV, a large institutional investor, like the AP, will take advantage of the price discrepancy by buying or selling the ETF shares/underlying securities (arbitrage).

Tax efficiency

- In-kind transfer of securities – When an AP creates or redeems shares with the ETF sponsor they trade the ETF shares for the underlying securities or vice versa. Essentially, this is a trade of equivalent items and is not a taxable event for the fund or the ETF shareholder.

- Offset capital gains/losses – There are many opportunities for the fund manager to offset capital gains and losses during the creation/redemption process or when the fund is rebalanced.

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