

THE TRUE LIQUIDITY OF iSHARES ETFS

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With iShares ETFs,
there's more at work than just trading volume.

The true liquidity of iShares ETFs.

- ETFs are as liquid as their underlying holdings.
- With ETFs, the market depth is not limited to what is visible on-screen.
- It is possible to purchase more than the existing market capitalisation of an ETF.

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Like all open ended ETFs, iShares offer multiple sources of liquidity (an open ended ETF is one in which the pool of assets can change and there is no prescribed date for the fund to end):

- They offer liquidity in the secondary market, measured by their trading volume in Australia.
- They offer secondary market liquidity through exchanges in the US.
- The unique issuance/cancellation process in Australia which occurs via the US exchange provides liquidity.
- They also have underlying liquidity stemming from the US primary market creation/redemption process, which reflects the liquidity of the individual positions within the iShares fund.

That is why the multiple sources of liquidity means the true liquidity of an iShares fund can far exceed that which its traded volume or market capitalisation might suggest.

iShares funds offer all the liquidity of their underlying positions

Each iShares fund holds exposure in an underlying basket of securities that reflects a specific market index. In effect, trading an iShares fund is equivalent to trading all of the underlying stocks of that index. That is why the true liquidity of an iShares fund is only partly reflected in its trading volume. It is also a function of the liquidity of the positions that make up the fund.

The unique creation/redemption process is the key to true liquidity

Shares and closed-end funds have a finite number of shares outstanding for sale or purchase. A limited supply of outstanding shares can make large institutional trades difficult, if not impossible, to execute without causing a significant impact on the market trading and price of that share.

For example, a Listed Investment Company (LIC) has a fixed supply of units on offer. The price of a LIC can trade at a premium or a discount to Net Asset Value (NAV). So an investor might trade a LIC at a discount or premium to its NAV.

The number of issued shares for each iShares fund, on the other hand, can be increased or decreased on a daily basis according to investor demand, thereby keeping the market price closely in line with NAV.

Lower trading volume, higher liquidity? With iShares, it's possible.

For iShares listed on the ASX, the creation/redemption process occurs in the US

Large blocks of iShares (called creation units) can be created or redeemed by the delivery of shares from Authorised Participants (APs) in the US to the fund, or vice versa.

Every US business day, a portfolio composition file (PCF) is published. A PCF describes the composition of the stock basket that can be delivered to the fund in order to create new shares of a given iShares fund. The AP can purchase these securities via the capital markets and deliver them to the fund in predetermined proportions, along with any cash that may be required to complete the order.

The fund in return issues creation units at that day's NAV. The redemption process works in reverse. So when evaluating iShares funds that may experience low turnover from time to time, it is just as important to examine the liquidity of underlying stocks.

The APs manage the number of iShares on issue in the market. This ensures the liquidity of iShares ETFs is tied to the liquidity of the fund's component holdings rather than just the trading volume. Furthermore, this mechanism balances supply/demand through arbitrage of price discrepancies between the underlying securities and the iShares fund. So investors benefit from the continual re-pricing of iShares ETFs throughout the day to closely reflect NAV.

TRADING EXAMPLE ONE

Liquidity that surpasses market depth

In May 2002, a US investor purchased more than double the existing market capitalisation of the iShares MSCI EAFE (NYSE code: EFA). With the creation/redemption process, a collection of APs were able to create additional EFA shares – and tap into the liquidity of the underlying stocks – to execute the trade.

- The EFA fund had a total market capitalisation of approximately US\$1 billion.
- At the close of the day, an investor bought US\$2.25 billion of the fund.
- An AP created the necessary shares by purchasing and depositing the underlying stocks.
- This activity resulted in an increase to EFA's market capitalisation due to in-kind delivery of that day's fund underlying holdings, rather than the significant buying pressure and accompanying market impact that could be expected on the ETF's underlying stocks in executing such a large order.

It would have been impossible to execute this trade if EFA had been a traditional stock with limited market depth. Even if enough shares had been available to fill the order, the market impact would have been immense.

However, the shares of EFA were created off the exchange floor by a series of APs acquiring the securities to deliver through a series of channels. The channels available for use include direct purchases on the secondary market, existing trading inventories and borrowing. This creation process ensured the market impact on EFA was minimised versus a long purchase of US\$2.25 billion of EFA holdings.

iShares offer access to the liquidity benefits of local currency in local time by trading on the ASX

iShares are cross-listed funds that are domiciled in the US. The iShares traded on the ASX are settled using CHESSE Depository Interests (CDIs). The process that facilitates supply of iShares locally is the issuance/cancellation of CDIs.

If an investor wants to make a large trade on the ASX for which there are not enough iShares on issue, the unique issuance mechanism can be initiated. The issuance process occurs when Australian trading participants request new CDIs be delivered to them in Australia. A US market participant delivers the US iShares to

Computershare Trust Company (CTCNA) in the US. CTCNA holds the US iShares that it receives and within a matter of hours issues CDIs (on 1:1 ratio) for delivery in Australia by the fund's local registrar, Computershare. This facilitates the open-ended supply of iShares listed on the ASX to meet demand in Australia via the ASX.

The cancellation process works in reverse and can address over-supply by cancelling CDIs in Australia and releasing the US iShares held by CTCNA.

Through this issuance/cancellation process Australian investors, when buying and selling, are supported by the liquidity of the secondary market and also the benefits of primary market creation/redemption in the US.

TRADING EXAMPLE TWO

Liquidity that surpasses trading volume – CDI issuance

Take the iShares MSCI Emerging Markets (ASX Code: IEM). At first glance, IEM's daily value traded volume looks too low to accommodate a large trade by an institutional investor. But when the simplicity of the issuance/cancellation process is considered it is possible to see an entirely new picture. If the market maker does not hold sufficient inventory locally, it can easily access the US markets.

Secondary market trading

- Since launching in Australia in October 2007, the value of IEM shares traded has been approximately A\$225,000 per day.
- The daily traded value of the underlying US listed iShares MSCI Emerging Markets (EEM) fund was approximately US\$2.44 billion per day as at December 2007.
- An order of 100,000 shares in that fund would represent 65 times the average daily trading volume of IEM in Australia.
- This order represents only a tiny fraction (less than 0.5%) of the US average daily trading volume.

US Primary market

A trade of A\$100 million to A\$200 million might look dramatic and might be expected to have a large impact on the execution, however, IEM liquidity is ultimately based on its underlying US listed iShares ETF. IEM can trade in much larger blocks than its secondary market trading volume alone suggests since investors also have access to the creation/redemption process in the US, should demand require it.

The commitment to liquidity through market makers in the US

Market makers are liquidity providers who have access to the US market in order to issue iShares in the Australian market through the issuance/cancellation process.

iShares has built relationships across the capital markets and are well positioned now and for the future with liquidity providers.

- iShares maintains liquidity commitment relationships with multiple market makers across different US exchanges.
- iShares continues to educate and attract new liquidity providers to trade ETFs which builds depth and tightens spreads.
- iShares is committed to working with exchanges that provide market structures and quoting incentives to attract liquidity providers.
- Liquidity continues to migrate from floor-based exchanges to more electronic platforms, which affirms the exchange strategy we have been executing over the past two years through partnerships with NYSEArca, and most recently Nasdaq.

The role of market makers and liquidity in Australia

Bid and offer prices are continuously submitted for the iShares listed on the ASX by at least two contracted market makers. This encourages price competition and should result in tighter trading spreads.

Citigroup Global Markets Australia Pty Ltd and Susquehanna Asia Pty Ltd have been appointed by the ASX as dedicated market makers in the iShares listed on ASX. They are required to make two-sided markets within the maximum spread and minimum quantity of iShares as tabled.

Bid Price in \$AUD for Shares	Maximum Spread	Minimum Quantity
\$50<	25c	500
>\$50 – \$100	65c	100
>\$100 – \$150	100c	50
>\$150 – \$250	150c	50
>\$250	200c	50

Source: ASX website, iShares Market Maker Quoting Schedule

Liquidity is available from both dedicated and non-dedicated market makers. Exchange members may contact the market makers from the 'Dealing Contacts' document available on iShares.com.au, to perhaps improve on price for a specific size that might not be reflected on the trading screen.

Conclusion

ETF growth globally has been staggering. With three of the most actively traded stocks in the United States being ETFs, liquidity is far from a concern. The creation/redemption process in the US, together with US secondary market trading, and the CDI issuance/cancellation process in Australia, provide layers of liquidity that surpass what is offered on trading screens. Liquidity is one of the core benefits of iShares.



For more information

Visit our website at iShares.com.au

Call 1300 iShares (1300 474 2737)

Important Information

Before investing in an iShares fund, you should carefully consider the appropriateness of such products to your circumstances, read the applicable Australian prospectus and consult an investment adviser.

This information is general in nature and has been prepared without taking into account your objectives, financial situation or needs.

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International investments such as an iShares fund may have different risk characteristics compared to investments in other securities listed on ASX that do not have international exposure.

Transaction costs are incurred when buying or selling shares on an iShares fund on ASX and brokerage commissions if such trades are done through a broker.

Shares of an iShares fund trade on an exchange at market price (not net asset value ("NAV")). Shares may only be redeemed directly from an iShares fund by persons or entities in the United States called 'Authorised Participants', in very large creation / redemption units.

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