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"Information and Liquidity Linkages in ETFs and Underlying Markets"

Abstract. We show that exchange-traded funds (ETFs) establish strong information links with the underlying equities but weak ones with the underlying corporate debt securities. This has several distinct effects on each asset class. First, ETFs propagate illiquidity to equities but not to debt securities. Second, ETF share price returns exhibit comovement with the underlying securities' returns but to a much larger magnitude with equities than with debt securities. Third, higher ETF ownership increases equities' volatility but decreases debt securities' volatility. The results are consistent with the view that the higher accessibility of equities facilitates the formation of close information links with ETFs through arbitrage, which makes equities' prices sensitive to ETF demand shocks and creates the potential for illiquidity contagion when this link is disrupted. In contrast, the hard-to access nature of corporate debt securities results in weak information