FinStart

Why is there a bid / ask spread?

The bid / ask spread is the difference between the price the buyer pays and the seller receives if they transact at the same time.

How does this work?

- You, an investor, buy at the ask price. Another investor who is selling the same security, will sell at the bid price.
- The broker buys from you at the bid price and sells at the ask price. The bid price is lower than the ask price – the broker keeps the spread.

As a result,

- For investors, the spread is the cost of transacting.
- For the broker through whom they transact it's a way to cover some of their costs / make profit.

The bid / ask spread measures how easy / difficult it is to buy or sell a security. This is called 'liquidity' – liquid means easy to buy / sell, illiquid means difficult to buy / sell. The easier it is to buy / sell, the smaller (tigher) the bid / ask spread.

For ETFs, liquidity, measured by the bid / ask spread) depends on 3 things:

1. The ETF's liquidity – its daily trading volume and the proportion of buyers to sellers at any given moment.
2. Liquidity of the securities the ETFs holds (called 'underlying securities'). It affects the cost of transactions within the ETF. ETFs that hold less liquid securities have a wider bid/ask spread (for example, US equities are very liquid, international bonds are not).
3. Broad market liquidity – bid/ask spreads are wider when markets are volatile. 'Volatile' means changing quickly and unpredictably.