

ETF TRADING

ETFs are generally traded in one of two ways: open market participation or principal bids from market makers. How do you know which path is best for you? [The answer requires an understanding of the potential trading costs and possible trading strategies.](#)

POTENTIAL TRADING COSTS

SPREAD COSTS

Difference between the bid and ask. Spread costs are directly related to the ease of creation. The harder it is to create, the higher the spread costs.

RISK PREMIUM

Quoted discount or premium charged by market makers to buy or sell a position. The liquidity and volatility of the underlying securities drive risk bids.

OPPORTUNITY COST

Performance impact related to market exposure imbalances. For rebalancing events, opportunity costs can easily be greater than spread and risk premium combined.

BEST TRADING STRATEGY

OPEN MARKET PARTICIPATION

Highly liquid ETFs are usually best traded in the open market. In fact, a good trading strategy can result in an execution price inside the spread.

PRINCIPAL BIDS/OFFERS

Putting at least three market makers in competition is usually the best strategy for illiquid ETFs. You will generally pay spread cost plus a risk premium to get it done.

COMBINATION STRATEGY

Rebalancing programs lend themselves to a more complex trading strategy. By combining open market participation with principal bids, you can remain dollar neutral and reduce opportunity cost risk. The sample post-trade shown at right illustrates total program trading costs versus Interval VWAP and Arrival Price.

POST-TRADE BENCHMARKS

Client: XYZ Bank
 Trade Date: 11-May-20XX
 Description: ETF Rebal

Entered Timestamp: 11-May-20XX 11:27:41
 Last Executed Timestamp: 11-May-20XX 12:48:56

			Interval VWAP		Arrival Price	
Symbol	Shares	Principal	Gross P/L	BPS	Gross P/L	BPS
OVERALL	2,342,462	155,665,105	(6,321.87)	(0.41)	18,575.33	1.19
Buy Orders						
B AGG	69,902	6,985,563	(123.24)	(0.18)	1,141.57	1.63
B ANGL	5,488	150,454	25.21	1.68	27.44	1.82
B BGRN	5,768	272,707	(24.35)	(0.89)	3.80	0.14
B EAGG	11,503	554,089	134.06	2.42	10.72	0.19
B ESGD	2,271	166,800	(33.82)	(2.03)	(17.29)	(1.04)
B ICLN	9,023	166,392	(107.51)	(6.46)	(97.72)	(5.87)
B KRBN	1,782	68,972	(47.39)	(6.87)	26.93	3.90
B NULG	9,396	516,938	(55.62)	(1.08)	(533.92)	(10.33)
B USFR	179,586	9,053,828	86.41	0.10	897.93	0.99
B VEA	343,221	15,819,048	(5,907.67)	(3.73)	(13,720.90)	(8.67)
B VOE	2,286	299,363	(291.73)	(9.75)	(468.63)	(15.65)
B VOT	1,024	193,228	(31.83)	(1.65)	(214.56)	(11.10)
B VTV	47,089	6,440,436	356.05	0.55	(11,845.91)	(18.39)
B VUG	62,707	15,938,463	(1.06)	(0.00)	2,283.58	1.43
B XBIL	441,856	22,132,221	(21.92)	(0.01)	346.00	0.16
	1,192,902	78,758,502	(6,044.41)	(0.77)	(22,160.97)	(2.81)
Sell Orders						
S AGG	1,490	148,918	1.55	0.10	7.45	0.50
S ANGL	6,346	173,971	(4.21)	(0.24)	27.44	1.58
S ESGU	3,556	322,010	(152.32)	(4.73)	370.28	11.50
S ICLN	2,942	54,206	12.83	2.37	14.71	2.71
S IJH	6,193	1,499,270	233.80	1.56	2,731.41	18.22
S IVV	24,935	10,310,617	49.01	0.05	6,726.88	6.52
S USFR	2,719	137,078	(0.37)	(0.03)	13.60	0.99
S VB	2,212	406,188	178.95	4.41	1,237.59	30.47
S VBR	33,616	5,121,806	(436.87)	(0.85)	12,845.87	25.08
S VEU	300,895	16,288,492	(203.68)	(0.13)	7,063.90	4.34
S VGSB	323,138	18,948,807	(585.26)	(0.31)	(4.88)	(0.00)
S VMBS	151,620	7,101,660	(548.82)	(0.77)	1,295.78	1.82
S VOE	18,426	2,414,963	802.98	3.33	6,315.81	26.15
S VTV	3,247	443,832	200.04	4.51	584.46	13.17
S VUSB	264,357	13,009,009	(53.43)	(0.04)	1.00	0.00
S VXF	3,868	525,774	228.34	4.34	1,505.00	28.62
	1,149,560	76,906,603	(277.46)	(0.04)	40,736.29	5.30

ETF TRADING

Do ETFs trade more like stocks or bonds? In small size, most ETFs trade like stocks. Bids and offers are readily available, and transactions can be executed in seconds. However, when positions become sizeable, it may be beneficial to put multiple firms in competition, similar to trading corporate bonds.

CONSIDER A RECENT TRADE IN AN ISHARES COMMODITY ETF

BUY: 680,000 CMDY
BID ASK: \$50.66 / \$50.75 (9 CENT SPREAD)
10-DAY ADV: 46,160

The client wanted to move quickly, but the market was showing 100 shares on the offer. We needed 14 times the average daily volume.

WHAT IS THE BEST STRATEGY FOR THIS ETF?

Given the lack of volume in the open market and the need to act quickly, this ETF trade called for an RFQ, or bond-like, approach.

In this real-life example, the advisor asked CAPIS to run point. We requested a two-sided quote from multiple market makers.

MARKET MAKER #1: -2 CPS / +3 CPS
MARKET MAKER #2: PASSED MARKET
MARKET MAKER #3: -6 CPS / +5 CPS

The market traded off slightly, and we were able to print all 680,000 shares at \$50.75 with Market Maker #1.

MORAL OF THE STORY

When buying or selling ETF shares in size, it is important to use a broker that will request two-sided quotes from multiple market makers. No single market maker will always offer the best price.

ETF TERMINOLOGY

AUTHORIZED PARTICIPANT (AP)

APs are broker dealers that can create and redeem shares by interacting directly with the underlying fund trust.

MARKET MAKERS

Given their ability to hedge an ETF with its underlying securities, market makers often provide very competitive two-sided quotes.

RFQ

A Request-for-Quote is a process designed to gather multiple two-sided quotes in a competitive situation. Most APs are market makers.

CREATION UNITS

This is the block size necessary to create shares. For example, SPY shares are created in 50,000 share blocks.

LIQUIDITY CHARACTERISTICS

For large blocks, liquidity is based on the ease of creation rather than the average daily volume.

MARKET TRENDS

Given the ease of trading, many advisors are using ETFs, rather than mutual funds, for their asset allocation strategies.