

THE RISKS OF NOT USING A LIQUIDITY PROVIDER – A CASE STUDY

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This blog post is relevant to institutional investors interested in trading exchange-traded funds (ETFs) in significant volume. Individual investors do not always have access to liquidity providers to trade ETFs as referenced below. What if I told you that a large \$500 million order and a smaller \$1.2 million order traded in the same ETF, but one executed around the [bid/ask spread](#) and the other drove up the ETF price 84 cents, or almost 5%. Could you guess which trade was responsible for each outcome? The answer may surprise you. The \$500 million [notional block](#) traded [in-line](#), and a small order of \$1.2 million notional block pushed the [WisdomTree Brazilian Real Fund \(BZF\)](#) price 5% away from its [underlying value](#). The trades were done on different days and times, but the price of the ETF and its trading characteristics were similar. So what was the difference between the two trades? On October 9, 2013, a 27-million-share [block order](#) worth approximately \$500 million executed inside the bid/ask spread of BZF. You can see the trade in the highlighted area in figure 1.

Figure 1

BZF US \$ ↑ 17.04 +.18 Z17.09/17.18P 15x27
At 11:25 Vol 15,350 O 16.87P H 17.0941D L 16.87P Val 261,450

BZF US Equity 1) Actions 9) Settings 9) Feedback Page 1 Trade/Quote Recap USD

Trade Recap		Quote Recap		Min Vol		Price Range		High 18.43		Cond Low 18.28	
From	10/09/13	02:00:00									
To	10/09/13	16:30:00									
Time	BMMKR	E	Bid/Trd/Ask	E	+Size	AMMKR	Cond				
16:17:52		P	17.80/18.38	P	6x3						
16:15:04		Z	18.36				OC				
16:15:04		Y	18.37				OC				
16:15:04		O	18.35				OC				
16:15:04		T	18.36				OC				
16:15:04		P	17.70/18.38	P	x		LQ/LQ				
16:15:04		P	18.33				OC				
16:15:04		K	18.36				OC				
16:15:04		J	18.36				OC				
16:15:04		D	18.33				OC				
16:15:04		B	18.37				OC				
16:15:04		D	18.33				CC				
16:15:00		P	17.70/18.38	P	6x3						
16:14:41		P	18.09/18.38	P	1x3						
16:14:41		P	18.12/18.38	P	6x3						
16:06:27		D	18.3594		272.74K		FT,T				
16:03:07		P	18.13/18.38	P	5x3						
16:02:46		P	18.13/18.48	P	5x3						
16:02:46		P	18.13/18.50	P	5x4						
16:02:46		P	18.13/18.47	P	5x3						

Price White: Best qt Amber: MM qt Gray: Prev qt +Size scaled by 100 Zoom 100%

Australia 61 2 9777 8600 Brazil 5511 3040 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2014 Bloomberg Finance L.P.
SN 279533 EST GMT-5:00 G453-1427-1 04-Feb-2014 11:56:20

Source: Bloomberg, 2/4/14.

Past performance is not indicative of future results.

The client who initiated that trade was able to work with an ETF [liquidity provider](#) who had the ability to access the [underlying basket](#) in the [primary market](#) on behalf of the client. It is important to remember that an ETF is at least as [liquid](#) as its underlying securities, regardless of the [average daily volume](#). That demonstrates the beauty of the open-ended ETF structure and its ability to [create](#) new shares and redeem shares daily. This trade was successful from an execution standpoint because the client worked together with their trading partners on a best execution strategy. On the other side of the execution spectrum, another investor entered a 70,000-share (\$1.2 million notional value) [market order](#) in BZF on November 13, 2014, just before 3:39 p.m. ET. This resulted in a quick spike up in the price of the ETF, as you can see in figure 2. **Figure 2**



Source: Bloomberg, 11/18/14

Past performance is not indicative of future results.

In this second example, the [order book](#), or depth of the [bids](#) and [offers](#) of the ETF trading on the exchange, handled a market order of this size in an inefficient manner. The depth of bids and offers in an ETF order book is not always reflective of the liquidity of the underlying asset. While there is a lot of liquidity in Brazilian Real forwards, there are not a lot of [resting orders](#) in the BZF order book. By definition, a “market order” is designed to buy or sell an investment *immediately* at the best available price on the [secondary market](#) and will not stop until completed. For this reason, the order for 70,000 shares swept up all available shares for sale until it was completed, which resulted in the price increasing by almost 5%. This was followed by the price of the ETF correcting back in line with the “indicative value” of the underlying basket. Figure 3, and the yellow arrow, illustrate how quickly the order was filled and how far the price moved to satisfy the 70,000- share buy order in the



Source: Bloomberg, 11/18/14

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order book. **Figure 3**

may be wondering, “Isn’t there a market maker who is supposed to be providing liquidity so this doesn’t happen?” The

You

answer is yes. A market maker provides a few thousand shares that he or she would be willing to buy or sell on either side of the quote. But a market order typically moves so fast that it may not provide enough time for the market maker to reload their bid or offer before the order has driven up the price significantly. In summary, these two examples are something that all ETF investors can learn from. On the Capital Markets Team at WisdomTree, we try to be proactive in consulting with our clients on best- execution strategies. For larger orders, always look to work with a liquidity provider who can access the underlying basket on the clients' behalf and provide execution close to the "fair value" of the ETF. Lastly, we encourage all investors to be sure to have a full grasp of the depth of the order book before implementing any market order. We hope this information helps investors in future ETF trades.

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DEFINITIONS

Notional : The dollar value of the derivative contract.

In-line : When trade execution of a fund occurs close to the published quote or to the value of underlying basket.

Underlying value : Another term for indicative value.

Block order : Typically, a 10,000 share order (excluding penny stocks) or \$200,000 worth of fixed-income securities would constitute a block order.

Liquidity providers : Traders that facilitate the trading of ETF shares by conducting the transference of liquidity between the underlying basket shares and the ETF.

Underlying basket : Securities held by a fund to replicate an investment strategy or index.

Primary Market : The primary market is the market where shares of an ETF are created or redeemed.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

Average daily volume : Average dollar amount traded over the course of a single trading day.

Creation and Redemption Process : The process whereby an ETF issuer takes in and disburses baskets of assets in exchange for the issuance or removal of new ETF shares.

Market Orders : An order that an investor makes through a broker or brokerage service to buy or sell an investment immediately at the best available current price.

Order flow : The collective orders to either buy or sell specific securities.

Bids : What investors are willing to pay.

Offer : The price at which investors are willing to sell.

Resting orders : A limit order to buy at a price below or to sell at a price above the prevailing market that is being held by a floor broker.

Secondary market : A market where investors purchase or sell securities or assets from or to other investors, rather than from issuing companies themselves—exchanges such as the New York Stock Exchange and the NASDAQ—are secondary markets.