

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

Michael Barrer — Director of Capital Markets
01/06/2015

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 | Actions | Settings | Feedback | Page 1 | Trade/Quote Recap

Time	BMMKR	E	Bid/Trd/Ask	E	+Size	AMMKR	Cond
16:17:52		P	17.80/18.38		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 5212 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.

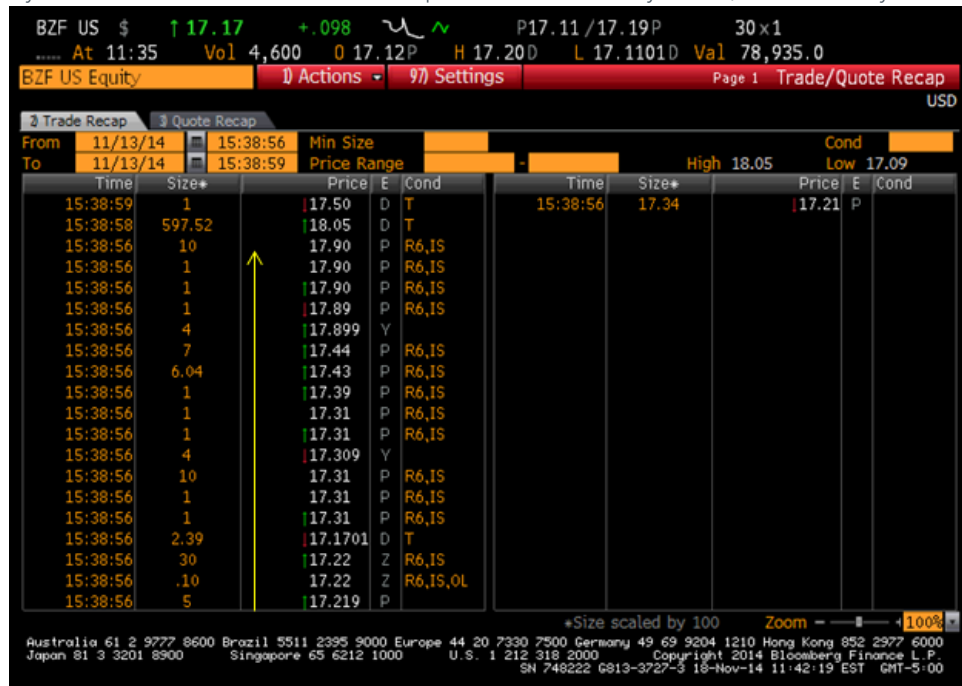
The client who initiated that trade was able to work with an ETF [liquidity provider](#) who had the ability to access the [underlying basket](#) in the [primary market](#) on behalf of the client. It is important to remember that an ETF is at least as [liquid](#) as its underlying securities, regardless 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

Past performance is not indicative of future results.

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.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. This Fund focuses its investments in Brazil, thereby increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in emerging or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. Unlike typical exchange-traded Funds, there are no indexes that the Fund attempts to track or replicate. Thus, the ability of the Fund to achieve its objectives will depend on the effectiveness of the portfolio manager. Due to the investment strategy of this Fund it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

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.