THE ETF TRADER INTERVIEW SERIES: CHRIS HEMPSTEAD, KCG

Zach Hascoe — Capital Markets
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In 1988, the book *Market Wizards* by Jack Schwager was published. It introduced investors to a group of traders, many of whom would become household names in the financial markets and still are to this day. Exchange-Traded Funds (ETFs) are still reasonably young investment products, but they are changing the nature of trading in the markets. When investors utilize ETFs in their portfolios, they are interacting either directly or indirectly with an ETF trader. At WisdomTree, we believe that helping our investors understand the markets and the ways to trade ETFs efficiently is paramount to the customer experience. We work extensively with the ETF trading community to ensure a good experience when investing in our products. Today we want to introduce you to the ***new market wizards***. Over the next several weeks, we'll bring you a series of interviews with people who have many years of experience trading and educating clients on ETFs. They have seen the industry grow and evolve and are considered experts in their field. They trade for all manner of client types and trading strategies and have valuable insight into best trading practices. You'll learn what they think works and what they wish customers would do differently, which tools they have and wish they had, and how they think ETF trading will evolve in the future. This is the beginning of a deeper dive into ETF trading and mechanics. As always, we welcome your questions and feedback. In this first edition of the series, Zach Hascoe, Director, Capital Markets – WisdomTree Europe Ltd, speaks with Chris Hempstead of KCG. Chris is the Head of ETF Sales for KCG and leads the company's team serving institutions and issuers with their ETF trading, liquidity and market intelligence needs. Prior to joining KCG in 2013, Chris served as a key member of the WallachBeth Capital ETF cash desk, guiding clients in the design and implementation of ETF trading strategies. ***Zach Hascoe: Tell us a little about yourself and your business. Let's start off by explaining your firm.*** **Chris Hempstead:** KCG is a leading independent securities firm offering investors a range of services designed to address trading needs across most asset classes and product types. The firm combines advanced technology with exceptional client service across market making and agency execution. KCG has multiple access points to trade global equities, fixed income, currencies and commodities via voice or automated execution. ***ZH: What services do you provide?*** **CH:** Our ETF trading team offers clients agency and pricipal facilitation across all ETF sponsors, in all ETFs, in the Americas and Europe. We also offer creation/redemption in the primary market, which allows institutional investors an alternative path to ETF exposure. We're lead market maker in well over 650 ETFs, which gives us considerable insight into their valuation and how they trade. ***ZH: Describe your client base and your experience.*** **CH:** We serve a wide range of professional investment firms that may require ETF trading, liquidity and expertise, from mutual funds, pension funds and hedge funds, to broker-dealers and Registered Investment Advisors (RIAs). I started trading ETFs on the floor of the exchange as a specialist whose primary role was to ensure fair and orderly markets. Over the years, as trading technology and market making evolved, I too evolved into a client-facing execution specialist whose primary role is to—again—ensure fair and orderly executions for our clients. ***ZH: Give an example of a trading/execution strategy you have developed with a client.*** **CH:** Many clients still have a tendency to trade in the markets by simply asking for an offer and reacting through "market orders." But execution strategy is important, so I help clients understand the market conditions that would make a "working order," or an order worked in the market by an algorithm, the better way to lower trading costs and market impact. There are many ways to enhance the execution experience, including agency creation and redemption, portfolio netting and intraday net asset value, or INAV, trading. **ZH: What do you wish you had available as an ETF trader that would help you and your clients? CH:** Other than a crystal ball, we are always looking for ways to improve our trading platform so that we can offer more competitive execution to the clients. KCG has an incredible team of quantitative analysts and technologists who work with the traders to build and enhance the systems as market structure and market conditions change. If there is something on my wish list, I can assure you that someone at KCG is working on building it for us. ***ZH: What do you wish clients would do better?*** **CH:** Our clients get the most value out of our team by asking questions before they need to trade. Having thoughtful discussions about products and trade ideas in advance of actually trading them helps all the parties involved get a better sense of the costs involved in trading. That level of collaboration and shared insight is invaluable. ***ZH: What do you think the future of ETF trading will look like?*** **CH:** It is hard to imagine a more efficient marketplace than the one that exists today. That said, I think there will be more competition going forward, which could lead to even tighter spreads. As ETF volumes and breadth of ownership continue to increase, I believe that more ETFs will trade with very narrow spreads due to the presence of "natural" buyers and sellers. Market makers step in when there is an absence of buyers or sellers or when markets are inefficient. ***ZH: The ETF managed portfolio segment is one of the fastest growing segments of the ETF market. Is there anything in particular that group should be focused on when transitioning its portfolio holdings?*** **CH:** When transitioning holdings, it is important that portfolio managers understand the big picture of the entire trade. Netting risk and knowing how to leverage buy and sell orders so that trade costs can be reduced is a critical part of adding value and outperforming your peers. ***ZH: What is the best way to assess the potential liquidity of a fixed income ETF?*** **CH:** It helps to have a relationship with a desk that understands not only the ETF construct but also the nuances of trading bonds. Understanding liquidity and wider spreads of underlying bonds helps traders remain competitive when making bids and offers to clients. Asking traders where they are seeing bids and offers in the bond market also is the best way to assess where deep liquidity lies in the ETF. ***ZH: Do you think the bid/ask spread, the difference between the best price you can buy and sell an ETF electronically, really matters when judging an ETF for investment candidacy? What do you think is the best way an investor should judge liquidity and execution cost of an ETF?*** **CH:** The bid/ask spread (the NBBO, or National Best Bid and Offer) is one of many useful tools in determining an ETF's liquidity. It is important, however, to use other metrics too, such as volume, premium and discount, number of trades, etc. It is helpful if you have an idea of what the ETF is worth, what you are willing to pay for it and how long it will take you to implement your investment. Only then should you make a judgment as to the quality of your execution. ***ZH: Explain the significance of a creation unit. Do investors need to be aware of how many shares equal a creation unit for an ETF?*** **CH:** It is useful to know how many shares equal a creation unit if you are trading a small portion or nearly all of one creation unit. Sometimes smaller sizes have bigger costs associated with them due to the inability of the market maker to create and redeem smaller sizes. That said, most ETFs that I track show quoting characteristics in line with those of one full creation unit. ***ZH: Thank you very much for participating in this series.***

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DEFINITIONS

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 asset.

Market maker : Someone who quotes a buy and a sell price in a financial instrument.

Agency execution : An execution whereby the broker executes the trade in the market at agreed upon instruction and passes on the exact execution to the client.

Principal facilitation : An execution whereby the broker takes on the risk of the execution. In most cases, the client trades at an agreed upon price and the broker then goes out and hedges themselves afterwards.

Portfolio netting : The practice where, in a rebalance situation, the client or broker will look at the underlying exposure of buys and sells and net off any overlap. The net result is trading less in the market place.

Net Asset Value (NAV) : The calculated assets minus liabilities divided by shares outstanding. NAV is the straightforward account of the actual assets in the fun.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Creation Unit (CU) : A specified number of shares issued by an exchange-traded fund (ETF) in large blocks, generally between 25,000 and 200,000 shares. The authorized participants that buy creation units either keep the ETF shares that make up the creation unit or sell all or part of them on a stock exchange.