THE ETF TRADER INTERVIEW SERIES: AARON KEHOE, CANTOR FITZGERALD

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Welcome to the third installment of the ETF Trader Interview Series. This 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. In this edition, Anita Rausch, Director of Capital Markets, speaks with Aaron Kehoe, Managing Director and Head of Fixed Income ETF trading at Cantor Fitzgerald. Aaron joined Cantor in September 2013 and focuses primarily on managing and trading the firm's book of fixed income ETFs. In addition, Aaron was instrumental in the product launches of many new fixed income ETFs and all senior loan ETFs. In 1999, he began his career trading ETFs for Spear, Leeds & Kellogg Index Specialists (now a subsidiary of Goldman Sachs). ***Anita Rausch: Tell us a little about yourself and your business. Explain your firm, what services you provide, your client base and your experience.*** **Aaron Kehoe:** Cantor Fitzgerald is a capital markets investment bank. We are recognized for strengths in the equity and fixed income capital markets. With a global distribution footprint, we are an independent middle-market investment bank providing investment banking services, prime brokerage and commercial real estate financing. We have a diverse client base with representation that spans across all institutional client segments globally. ***AR: Give an example of a trading/execution strategy you have developed with a client.*** **AK:** Within our Equities division, our ETF unit provides liquidity and execution in all North American-listed ETFs from New York and all European-listed ETFs from London. Without limitation to execution paths, we seek efficiencies to deliver the client to best price. Our clients have a transparent view in our execution process with flexibility to optimize secondary market liquidity, creations/redemption mode and principal facilitation at the arbitrage zone. ***AR: What mistakes do you see clients making in their execution process?*** **AK:** The biggest mistake we see is clients make their intentions known to too many counterparties while looking for the cheapest price. This often leads to information leakage in the marketplace and performance impact on the execution. Clients should pick two counterparties that they trust. Working with trusted partners allows the client to obtain their best price due diligence without telegraphing to the market their intentions. ***AR: What do you wish you had available as an ETF trader that would help you and your clients?*** **AK:** Transparency in the fixed income markets is the next market innovation. Market depth of fixed income constituents in ETFs would offer a measurement of transaction cost for the end client. With the over-the-counter (OTC) nature of the fixed income market, liquidity is often very difficult to gauge. ***AR: What do you wish clients would do better?*** **AK:** Impact of trade or the historical cost versus NAV is the largest misunderstood component of trading. Clients with an understanding of the ETF asset class characteristics tend to deploy best practices in the approach of trade execution. ***AR: How do you think ETF issuers could help the process of client execution and education?*** **AK:** ETF issuers are usually the first contact with a prospective investor. ETF sponsor strengths are the construction of ETF and potential use of their ETF. Execution of the trade once the allocation has been decided on is the strength of the authorized participant (AP)/liquidity provider. Very often the issuer does not bring in the AP until the very end of the conversation with the client. The client would benefit in talking to both the AP and issuer early in the investment decision in order to understand all aspects of the investment. ***AR: What do you think the future of ETF trading will look like?*** **AK:** Trading and execution of ETFs will mirror future innovation or regulatory changes to the equity capital markets structure. ***AR: 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?*** **AK:** Trade rotation across platforms when adjusting assets should be the chief operational focus. Impact of successive trades at times can materially harm performance. Impact mitigation should be one focus, which can be achieved by having a discussion with your trading partners. ***AR: Discuss the growth of the Fixed Income ETF segment and what you believe its effect on the bond market could be for individual bonds.*** **AK:** The fixed income market has started to take notice of the ETF market. Even with record bond issuance, bond supply and inventory is at historical lows. The ETF has become a liquid and efficient alternative to individual bond investing. Traditional bond traders have begun to track ETF-specific bonds to try to anticipate supply or demand of the bonds needed to create or redeem ETFs. The real-time transparency of ETFs allows bond dealers to see exactly what bonds are in ETFs. As ETF-authorized participants try to buy and sell these bonds, the dealers for the bonds already know what bonds the AP is looking to trade. This is especially the case in the high-yield market. ***AR: What is the best way to assess the potential liquidity of a fixed income ETF?*** **AK:** Assessing the liquidity of any ETF should start with the underlying market. An ETF's liquidity is at a minimum as liquid as the asset it represents. The secondary trading of the ETF can add a layer of liquidity as the ETF grows in size and volume. In fixed income ETFs, it is difficult to measure the liquidity of bonds. They are mostly traded OTC, and many have no reported volume. The best way to measure liquidity is to look at deal size of the bonds in the ETFs. This will allow investors to understand what the bond's capacity is for the ETF to own. This is unfortunately not foolproof. Many bonds that are bought at issuance are owned to maturity. This means that even though the deal size can be large, it does not guarantee an active secondary trading market. ***AR: What should clients be thinking about/asking when getting ready to execute an ETF block trade in a lower-volume ETF?*** **AK:** The depth of liquidity in the underlying basket is the main determining factor for trade outcome. ***AR: What are the most typical concerns you hear from clients regarding the ETF market?*** **AK:** Can the ETF create/redeem process break? How will ETFs perform in high-stress markets? ***AR: 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?*** **AK:** When trading with a trusted liquidity partner, the bid/ask spread should not matter. The investor should look at the ETF for its benchmark, how its create/redeem process works, management costs and spread and liquidity of the underlying asset. If the ETF has low average daily volume (ADV) or small fund size, it can still be used as an investment option if it suits. The investor can work with an AP trade to create liquidity for the ETF from the underlying basket. This can often be done well inside wide bid/ask spreads that are not representative of the underlying basket liquidity. ***AR: Explain the significance of a creation unit. Do investors need to be aware of how many shares equal a creation unit for an ETF?*** **AK:** Creation unit sizes are crucial for market makers to efficiently manage their inventories. The larger the unit size, the less likely an AP will create an ETF to buy or sell a smaller-than-unit-size order. In the case of a client order to buy, if an AP is not long the shares of a smaller than create size order, this will leave them long the extra shares after the client order is executed. If the AP doesn't create, this will leave them short and can expose them to buy-in risk. There are many more reasons for keeping creation units as small as possible. ***AR: 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.

Execution process : The process of getting in and out of an investment.

Over-the-Counter (OTC) : A security traded in some context other than on a formal exchange such as the NYSE, TSX, AMEX, etc.

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.

Authorized Participant (AP) : An entity, usually an institutional investor, that submits orders to the ETF for the creation and redemption of ETF creation units.

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.

Average Daily Trading Volumes : The average amount of individual securities traded in a day or over a specified amount of time. Trading activity relates to the liquidity of a security; therefore, when average daily trading volume is high, the stock can be easily traded and has high liquidity. As a result, average daily trading volume can have an effect on the price of the security. If trading volume isn't very high, the security will tend to be less expensive because people are not as willing to buy it.

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.