TRANSPARENCY INTERRUPTED: AN ETF REFLECTION ON AUGUST 24

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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 Happened** On Monday, August 24, 2015, we awoke to extremely volatile global markets. U.S. futures hit limit down pre-open, and sell orders started building for the market open. Listed securities then opened over the course of the first half hour. Some listed securities had so many sellers that prices fell precipitously, which triggered individual limit up-limit down (LULD) halts and a pause in trading for five minutes. More than 1,200 halts occurred that morning across all listed securities, and they were triggered when the prices fell, as well as when they recovered. These trading halts are meant to take panic out of the market and give the marketplace time to replenish liquidity. However, the sheer number and frequency of the halts on that Monday actually took pricing clarity and transparency out of the market and caused confusion and a delay to a return of less volatile markets. After about an hour, most of the trading halts rolled off, the listed securities that had gone into free fall rebounded and normalized spreads for the current environment returned. ETFs went on to have one of their biggest volume days that Monday. ETFs are normally about 25% of notionally traded volume, but on August 24, they accounted for 37% of the notionally traded volume. WisdomTree ETFs traded over 2.5x their notional average for the first 21 days of August.[1] **How Did the ETF Structure Hold Up?** Some have tried to tarnish and blame the ETF structure for that day's events. But in reality, this volatility event that led to a very brief liquidity event highlighted how dependent ETFs are on transparency. The LULD halts took clarity of value out of the marketplace. Traders couldn't make reasonable assumptions on the value of baskets with such trading disruptions. That lack of clarity was reflected in wider bid/ask spreads of some ETFs. Remember, an ETF is a transparent and tax-efficient wrapper for a larger set of securities. ETFs are meant to reflect the value of their underlying components. The ETF structure is not meant to circumvent what is going on in those underlying securities. Let me explain the difference between the August 24 events and a normal ETF trading with closed or stale-priced underlying securities. ETFs are a great vehicle for price discovery for baskets of securities that are closed but that still have clarity of value. DXJ, the WisdomTree Japan Hedged Equity Fund, is an ETF that trades during U.S. hours, but its basket contains Japanese stocks with a currency hedge. Those Japanese stocks are closed during the time that DXJ trades, so the real-time value of the basket is not real time, it's stale. However, there is clarity in the closing prices of those stocks, and traders can then make assessments on where the current value of the basket is. DXJ then becomes a price discovery vehicle and trades in anticipation of where the marketplace thinks those stocks will open next. DXJ traded orderly on August 24. However, the value of some ETFs with U.S.-listed underlying securities was called into question when numerous and repeated LULD halts caused delays in the ability of the marketplace to come to a collective decision on where the value of those stocks was. The LULD halts took liquidity out of the marketplace. Transparency and clarity were taken out of the ETF dynamic, and traders priced in that uncertainty. ETFs functioned properly under extraordinary market circumstances, and their bid/ask spreads reflected the uncertainty of their basket holdings. **Trading Advice** There are two parts to ETF investing:

1. **Asset Allocation—**Deciding which ETF to use
2. **Implementation—**Deciding when to execute your chosen ETF

Both parts have an effect on your total return. The sales force of ETF providers help you decide which ETF to use, and the capital markets groups of ETF providers help you understand how to best implement your ETF allocations. We speak to clients all the time and educate them on best trading practices. Some of the most important things we always say are: • Do not trade in the first and last 15 minutes of the trading day. This is because that is when the traders know the least, and that is reflected in wider markets. The first hour of August 24 was when the traders knew the least. Their markets reflected that. • Place limit orders in reasonable ranges of fair value; do not use market orders. In a time of volatility like that of August 24, we advise not to use market orders, even those connected to stop-loss orders. Remember, stop-loss orders turn into "market" orders when triggered. • When in doubt, if you don't know how to best implement your ETF, or if the bid/ask spread or marketplace is causing you concern, use the resources you have to make a more informed decision. Get to know the capital markets desks; we can help you navigate your trading process. You can read more about our tips for best trading practices here. There was not a time more relevant to heed this advice than on that Monday. **What Happens Now?** There isn't one target to blame for the extreme volatility experienced on the morning of August 24, but what will happen is a review of market structure and continuing education that market orders, even stop-loss market orders orders, can be dangerous. We are working with all levels of market participants — regulators, exchanges, industry groups and market makers — to analyze what happened and decide on any proposals to help ensure that the next volatility event is more orderly. The markets experienced something new and remarkable on Monday, August 24, 2015. The LULD rule was approved in 2012 and had never been triggered on a marketwide basis. The marketplace didn't know how to react to this new event, but within the hour it learned, recovered and returned to orderly markets. ETFs are not to blame, nor are they immune to volatile events in the broader marketplace. Their trading efficiency hinges on transparency, and that wasn't more apparent than on that Monday morning. We believe ETFs remain a great tool for investors to access and express views, and they went on to have one of their biggest trading days ever.

[1]Sources: Goldman Sachs and WisdomTree.

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DEFINITIONS

Limit Orders : An order placed with a brokerage to buy or sell a set number of shares at a specified price or better.

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.

Limit up-limit down rule (LULD) : FINRA mechanism to prevent trades in NMS stocks from occurring outside of specified price bands, coupled with trading pauses to accommodate more fundamental price moves.

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.

Free fall : rapid and steep decline in market price.

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.

Notional : The dollar value of the derivative contract.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Baskets : The composition of an ETF in terms one creation/redemption unit.

Stale-priced : price that does not reflect real-time value.

Price Discovery : The process of the market finding a fair price for an asset through the process of bringing together buyers and sellers.

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

Stop-loss market orders : an order whereby the investor instructs the broker to automatically sell the stock if it drops to a certain price.