TRADING ETFS DURING VOLATILE TIMES: WHAT YOU SHOULD KNOW

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The doubters of the ETF structure always warn about a situation, a crisis, just like this, when ETFs would blow up. With the confluence of many storms—the coronavirus, OPEC's in-fighting and general uncertainty about being quarantined in our homes—the markets are experiencing extreme volatility.

How is the ETF structure holding up, and how should you interact with these markets?

These past two weeks have been another feather in the ETF's cap. We are watching in real time how ETFs work as a liquidity release valve to compensate for less liquidity in underlying asset class. Let us look at high yield, since that's what everyone uses as the canary in the coal mine. High yield had one of its worst days of performance on Monday, March 9, 2020, with prices down 6% at one point. Liquidity dried up in the bond markets, but some high-yield ETFs went on to trade three to four times their average volume, as all types of users were using them to hedge or gain exposure. Spreads widened by 1% in the bond market but only by 6 basis points (bps) in some cases in the high-yield ETF world. Some high-yield ETFs actually took in assets on the Monday.

This tells us that in times of stress

a) ETFs add liquidity to the system,

b) Market makers are supporting ETFs and not backing away, and

c) ETFs continue to provide the possible benefit of trading at lower cost than the cost of the underlying basket.

Overall, the broader suite of ETFs experienced similar situations. ETFs are usually about 25% of the average daily volume, but recently they have been averaging about 40%. During the week of March 2, 2020, ETFs traded $1.8 trillion, with only about $24 billion in redemptions. That means that a little over 1% of those shares that traded on an exchange, resulted in trading within the fund or in the underlying securities. Of the ETF shares that were traded, 99% were either exchanged between buyers and sellers or held by a market maker and their balance sheet.

ETFs are becoming a crisis management tool

The ETF structure is still providing the benefits of:

1) Tax efficiency,

2) Enhanced liquidity, and

3) The ability to trade cheaper than the cost of a similar mutual fund

The market-wide circuit breaker was triggered twice last week, after not being used for almost 12 years. Spreads are wider during times like these, as it takes market makers time to adapt to the radically changing volatility. The cost of trading in volatile times can be high, but sometimes trading is necessary, and downright economical. Review some tips before you trade.

What to do before you trade

1) Do not use market orders

Market orders are time-sensitive, rather than price-sensitive and will rip through the quotes until the order is fully executed, regardless of price. They do not give market makers time to respond to the request for liquidity.

2) Mind your stop loss orders

Stop loss orders turn into market orders at the most volatile times. After the market hits a circuit breaker and pauses for 15 minutes and your stop loss order gets triggered, it will be released at the reopen as a market order while the liquidity providers are getting their bearings. That's when you see large gap downs in the prices of securities, and the potential to hit a limit down state in which the name would take a 15 minute pause.

3) Use limit orders or stop loss limit orders

In these cases you can control your worst-case price. The downside to these execution strategies is that if you pick the wrong limit, you may end up chasing the market.

4) Use not held orders, which go to your platform trading desks

Sending an order as not held gives the professional trading desk of your custodian, wirehouse or trusted liquidity counterparty discretion to find the best price. This may be the best option in times of stress as market makers are being contacted directly to control the execution.

5) Use your resources, capital markets teams and trading desks

Most of these resources are free to use by professional and experienced traders. The Capital Markets team at WisdomTree is staffed by ex-ETF traders with a combined 45 years of trading experience (not sure what that says other than that we are older…). We can help you pick that limit price or safely reach your trading professionals.

At the end of the day, there is a lot of uncertainty out there. We are certain that the ETF structure is, again, proving itself to be a durable, reliable and additive structure to the industry and an almost imperative part of any investor's tool box. Trade well, take care and know that we are here for you when you need us.

For more investing insights, check out our Economic & Market Outlook

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DEFINITIONS

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

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.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

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.

Basis point : 1/100th of 1 percent.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

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.

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

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