WHY THIS ETF TRADE SHOULD BE CELEBRATED

Anita Rausch — Head of Capital Markets
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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. On September 28, 2016, more than $139 million of an approximate $157 million Fund was sold in one execution. The next day, a redemption order was placed and the WisdomTree Australia & New Zealand Debt Fund (AUNZ) lost about 88% of its assets without any adverse effects. What I want to highlight is the seamless nature of the transaction and the ETF structure's ability to be unaffected by it. This sale of shares should be celebrated and used as an example to further educate the industry on the benefits of the ETF structure itself. **Average Daily Volume Doesn't Equal Liquidity** The average daily volume (ADV) of AUNZ for the prior six months, as of September 27, 2016, was about 9,000 shares. Many investors might judge this ETF on that ADV and think that trading AUNZ might be difficult. However, as you see below, 7,422,215 shares were sold at $18.76, which was inside the bid of $18.71.

AUNZ US Equity | 1) Actions | 97) Settings | Page 12 Trade/Quote Recap
Range 09/28/16 04:00:00 - 09/28/16 20:30:00
2) Trade Recap | 3) Quote Recap
Cond Code Definitions
High 18.79 Low 18.7399

Time	BMMKR	E	Bid/Trd/Ask	E	Size (x100)	AMMKR	Cond
					<min size>		
13:55:10		D	18.79		.01		T,OL
13:47:58		P	18.73 / 18.79	P	4 x 6		
13:47:56		P	18.73 / 18.79	P	1 x 6		
13:47:24		P	18.73 / 18.79	P	4 x 6		
13:47:18		P	18.73 / 18.79	P	1 x 6		
13:46:49		P	18.73 / 18.79	P	4 x 6		
13:46:49		P	18.73 / 18.79	P	1 x 6		
13:46:49		T	18.72 / 18.79	P	3 x 6		
13:39:04		P	18.71 / 18.79	P	5 x 6		
13:39:03		Z	18.71 / 18.79	P	4 x 6		
13:34:20		P	18.71 / 18.79	P	4 x 6		
13:33:12		Z	18.71 / 18.79	P	4 x 6		
13:31:43		D	↑ 18.76		74.22K		T
13:31:07		P	18.71 / 18.79	P	4 x 16		
13:28:00		P	18.71 / 18.79	P	1 x 16		
13:27:52		P	18.71 / 18.79	P	4 x 16		
13:26:50		P	18.71 / 18.79	P	1 x 16		
13:26:11		T	18.70 / 18.79	P	3 x 16		
13:26:09		Z	18.71 / 18.79	P	1 x 16		

Source: Bloomberg, 9/28/16.

This trade was possible because the liquidity capacity of an ETF is defined not by how many people buy and sell that ETF on a daily basis but by how much liquidity can be transferred to the ETF from other sources such as the underlying basket of securities and other correlated trading vehicles. In this example, the underlying basket of securities is comprised of local bonds in Australia and New Zealand. The estimated daily turnover of those bonds in the Fund is about $5 billion. **So while $139 million seems like a lot when comparing it to the ADV of the ETF, it is a fraction of what the underlying securities trade and, therefore, what the ETF is capable of trading.** This execution was possible because of liquidity that can be transferred to the ETF by the ETF market makers. **Liquidity Equality** This execution is not only a great example of liquidity potential but also the fact that the same liquidity is available on the way in and on the way out. Between the ETF issuer and the ETF investor lies the ETF market maker. The ETF investor will never send a check directly to the ETF issuer; instead, the money will always flow through market makers. The ETF market maker is issuer-agnostic and doesn't really care whether an investor is buying or selling; it cares about the liquidity and cost of its hedge. One should never judge an ETF by the ADV alone and understand that there is no liquidity bias to the direction of the trade. **Assets Under Management (AUM) Don't Equal Investment Capacity** It's a common misconception that AUM levels are indicative of risk to the fund investors. In this instance, a large holder was able to exit the ETF with no discernible harmful effects to other investors. The redemption of 88% of the ETF assets barely had an effect on its value. As measured by the

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net asset value (NAV) of the Fund, the value of the underlying bonds actually went up 19 basis point (bps) the day of the redemption. The outstanding size of the bond issues in AUNZ is $420 **billion**. Again, $139 million is a fraction of that, and the underlying market absorbed it without impact. It is the notional value of assets that are tied to the investment strategy of the ETF that will dictate its investment capacity. Regardless of the number and size of shareholders in an ETF, the liquidity and capacity for investment typically remain the same. **The ETF Structure Can Help Protect Each Investor** AUNZ's creation and redemption practices are generally done in-kind through an authorized participant (AP). This means that, in a redemption like this, the Fund itself doesn't sell the bonds. Instead, the ETF delivers the underlying securities to the AP, which then trades those bonds in the open marketplace. This in-kind mechanism has a number of benefits to the other ETF holders. First, the transaction costs for every creation/redemption are borne by the AP and ultimately the one investor initiating the transaction. In the world of mutual funds, the portfolio managers buy and sell all the securities, and all of those transaction costs erode the NAV of the mutual fund every time any investor enters and exits. Second, the in-kind nature of the transaction allows the ETF to be more tax efficient and, via in-kind redemptions, capital gains in the ETF can be pushed out, minimizing the tax burden for the remaining investors. In this instance, one large investor was able to exit the Fund without causing undue costs or tax burdens to remaining investors. Third, in a traditional mutual fund expense structure, "other expenses" are paid by the fund to third parties for custody, accounting, administration and printing. The relative size of those other expenses increase as the asset size of the mutual fund decreases. However, for nearly all ETFs, including AUNZ, the investment advisor (WisdomTree, in this case) pays these "other expenses" out of its advisory fee. Hence, there is no additional risk of increasing expenses to ETF investors. The ETF structure is one of transparency and equality. This trade is a perfect example of how investors are protected in the structure and how there is more to an ETF than its AUM and ADV.

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DEFINITIONS

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.

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.

Average daily volume : Average dollar amount traded over the course of a single trading day.

Underlying basket : Securities held by a fund to replicate an investment strategy or index.

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

Basis point : 1/100th of 1 percent.

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

Capital gains : Positive difference between the sale price of an asset and the original purchase price.