ETFs: Reflecting on August 24 one year on

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WisdomTree
Contributor

What Happened

On Monday, 24 August 2015, the US market awoke to extremely volatile global markets. US 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, caused confusion and contributed to continued volatility in the markets. After about an hour, most of the trading halts rolled off, the listed securities that had gone into freefall rebounded and normalised 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 24 August, they accounted for 37% of the notionally traded volume. WisdomTree ETFs traded over 3x their notional average for the first 21 days of August.*[1]*

How Did the ETF Structure Hold Up?

Some have tried to blame the ETF structure for that day's events. But in reality, this volatility 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 us look at the difference between the 24 August 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 European and US 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 24 August. However, the value of some ETFs with US -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.

ETF Trading Best Practice

There are two parts to ETF investing:

+ Asset Allocation—Deciding which ETF to use

+ Implementation—Deciding when to execute the chosen ETF

Both parts have an effect on the total return. The sales force of ETF providers helps with the decision of which ETF to use, and the capital markets groups of ETF providers help in understanding how to best implement the ETF allocations. Some important considerations when trading ETFs are:

+ Trades should not take place 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. The markets reflected that.

+ Limit orders should be placed in reasonable ranges of fair value; do not use market orders. In a time of volatility like that of 24 August, market orders should not be used, 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; as they can help you navigate your trading process.

What Happens Now?

There isn’t one target to blame for the extreme volatility experienced on the morning of 24 August, but what then happens after a scenario like this is a review of market structure and continuing education that market orders, even stop-loss market orders, can be dangerous.

The markets experienced something new and remarkable on that Monday. The LULD rule was approved in 2012 and had never been triggered on a market wide 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 was more apparent than ever on that Monday morning. We believe ETFs remain a great tool for investors to access and express views on the market.

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