Six trading best practices to improve your ETF execution

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New investors are using ETFs more and more every day. As a result, we're increasingly asked about ETF execution and implementation. This blog aims to answer some of those most commonly-asked questions. While it's important to note that there are several ways to implement an ETF trade and therefore there isn't one right or best way to execute, there are, however, some simple guidelines we believe will help investors better understand the nature of ETF execution and could help investors achieve better execution.

As one of the most common ways investors execute small to moderate sized orders, this blog focuses on on-exchange execution.

1) Focus on spreads, not volume

Unlike single stocks, the volume of an ETF isn't the best gauge of its liquidity. Whilst it is true that ETFs with high turnover can offer improvements in trade-ability, the vast majority of liquidity available in a given ETF is sourced from the underlying market. A better indication is often the spread of the products as this will be reflected in the Authorised Participants' cost of accessing the underlying market and creating or redeeming ETF shares.

2)Use Marketable Limit Orders over Market Orders

It is better practice is to use Marketable Limit Orders with the aim of placing an order with a high probability of execution whilst providing protection against sweeping through the order book. Generally, a market maker is happy to price in sizes bigger than they typically quote in, whilst prices behind the market maker quotes will be from speculative investors waiting for the price to move before they are willing to trade. If the size you wish to execute is larger than the market maker's quoted size, the market maker would need to refresh their quotes in order for you to be filled at the prevailing market price. By placing a limit order with the limit set at the current quoted price the market maker is given a chance to do just that, whilst a Market Order runs the risk of blindly sweeping through the order book.

Table 01: Definition of terms referred to above

Market order

An order to buy or sell a security immediately at the prevailing market price.

Limit order

An order to execute a stock market transaction at a specific price (the limit price), or better. A minimum price is set in the case of a sell order, and a maximum price for a buy order.

Marketable Limit order

A marketable limit order is a buy order with a price at or above the lowest offer in the market or a sell order with a price at or below the highest bid in the market.

3)Tread carefully around the opening and closing auctions

It's best practice to avoid executing too close to an opening or closing auction. Just after open, market makers are often dealing with a period of volatility and thinner liquidity in the underlying markets as prices stabilise at start of a new session. Similarly, just prior to close, market makers are under pressure to manage their risk, as this is the time they begin to place hedging trades. Both these situations can lead to wider bid-offer spreads and a reduced number of market makers quoting any given product.

4)Watch out for volatility

Similar to the periods around auctions, volatility in the underlying markets can lead to uncertainty and market makers will often widen their quotes as a result. One of the most common situations where we see this is around big data announcements (for example, non-farm payrolls and BOE rate decisions.) However, increased market volatility can happen for any number of reasons. Every market situation is different but it can become difficult to execute during times of volatility and you have an increased risk of achieving a poor execution. If you do not have to trade at or by a specific time, it may be best to avoid executing during periods of volatility. If, however, you must trade, utilising good risk management procedures (such as limit orders) becomes imperative.

5)Trade when the underlying securities' markets are open

Many ETFs offer access to markets that trade during hours outside those that the ETF itself trades in. What we typically see is that an ETF will trade tighter when an underlying market is open and wider once it shuts due to less information being available as to the true value of the underlying securities. Where possible, it's best to execute whilst the underlying markets are open. For those trading on European exchanges, this is during the morning for Asian underlyings and in the afternoon for products with exposure to the Americas.

6) If you're unsure, ask for help

Most ETF issuers have a dedicated Capital Markets team who are available to help with any investor queries. While we hope the above has given you some insight into ETF execution best practice, if you're ever in doubt you should not hesitate to get in contact with your broker or IFA. ETFs are a nuanced product and you need to ensure that you have the best possible experience and achieve the best possible price on every trade.

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