

Congratulations, You Are Now "Head of Trading"

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Zach Hascoe

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The asset management industry has been evolving over the past decade, with investors flocking to transparent, liquid, low-cost ways of investing. Historically, large percentages of investors held more traditional investments in their portfolios. After the investment decision had been made, the execution process was simple: Press a button (or make a phone call), and your cash was delivered to the investment company; in return you received a net asset value (NAV) for your shares. There was no thought needed for the execution. It was all done for you. You typically would receive end-of-day net asset value (NAV) the day of your investment. With the arrival of exchange-traded funds (ETFs) to the investment landscape, every investor, advisor, analyst or chief investment officer has now become "Head of Trading". The execution should factor into the projected total return analytics of the investment. What is the ETF's [bid/ask spread](#)? What is the cost to execute beyond the commission? ETFs can provide many benefits to investors; however, those benefits come with added responsibility. The fact that ETFs are "exchange"-traded means that they trade on the secondary market (NYSE, NASDAQ, Better Alternative Trading System (BATS), etc.). Increased liquidity adds a level of complexity. Now you, the investor, and not the fund's portfolio manager, are in control of the execution process. This is critically important. ETF investors should take the time to understand the nuances of the execution process. No matter how big your investment allocation is going to be, the execution process should be taken seriously. There are a variety of different components at work when one is looking at a potential investment in an ETF and how that ETF may interact on the secondary market. Are the underlying stocks domestic, international or emerging markets? Are the stocks trading at the same time as the ETF? These simple questions factor into the understanding of what is happening when the U.S. market opens and the ETF starts trading on the secondary market. In addition, it is important for investors to realize that ETFs have a bid/ask spread, a net asset value (NAV), an indicative value (IV), a fair value and a last price. You wouldn't buy a house and accept whatever price the seller was selling it for, would you? You would look at what the house last sold for and what the market has done in the interim, determine where you felt the "fair value" of the house was now, and evaluate all that based upon the offered price. Evaluating ETFs should follow a similar thought process. Investors need to take ETF execution due diligence seriously. In an upcoming blog, we will explain the differences of all the values mentioned in more detail. As investors continue to utilize ETFs in their portfolios, it is imperative that they take the time to understand the mechanics at work when buying and selling ETFs. Poor execution can significantly hamper returns. As an investor, do your due diligence. Call the ETF sponsor's capital markets desk. Speak with the traders that are going to be executing on your behalf. Take the time to build the proper

relationships. Investors need to embrace this new responsibility and educate themselves on the market dynamics at work when investing in ETFs. "With great power comes great responsibility." - Voltaire

Important Risks Related to this Article

The contents of this post are relevant to institutional investors interested in trading ETFs in significant size. Individual investors do not always have access to liquidity providers to trade ETFs as referenced above. ETFs typically issue and redeem shares at NAV only in large blocks of shares ("Creation Units"), which only institutions or large investors may purchase or redeem. Currently, Creation Units generally consist of 100,000 shares, though this may change from time to time. Creation Units are not expected to consist of less than 50,000 shares. ETFs generally issue and redeem Creation Units in exchange for a portfolio of securities closely approximating the holdings of the ETF and/or a designated amount of U.S. cash.