

The Risks of Not Using a Liquidity Provider – A Case Study

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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. What if I told you that a large \$500 million order and a smaller \$1.2 million order traded in the same ETF, but one executed around the [bid/ask spread](#) and the other drove up the ETF price 84 cents, or almost 5%. Could you guess which trade was responsible for each outcome? The answer may surprise you. The \$500 million notional block traded in-line, and a small order of \$1.2 million notional block pushed the [WisdomTree Brazilian Real Fund \(BZF\)](#) price 5% away from its underlying value. The trades were done on different days and times, but the price of the ETF and its trading characteristics were similar. So what was the difference between the two trades? On October 9, 2013, a 27-million-share block order worth approximately \$500 million executed inside the bid/ask spread of BZF. You can see the trade in the highlighted area in figure 1. **Figure 1***

BZF US \$		↑ 17.04	+.18	Z17.09/17.18P	15x27
At 11:25		Vol 15,350	O 16.87P	H 17.0941D L 16.87P	Val 261,450
BZF US Equity		1) Actions	9) Settings	9) Feedback	Page 1 Trade/Quote Recap
		USD			
Trade Recap		Quote Recap			
From	10/09/13	02:00:00	Min Vol		Cond
To	10/09/13	16:30:00	Price Range		Low 18.28
Time	BMMKR	E	Bid/Trd/Ask	E	+Size
16:17:52		P	17.80/18.38	P	6x3
16:15:04		Z	18.36		
16:15:04		Y	18.37		
16:15:04		O	18.35		
16:15:04		T	18.36		
16:15:04		P	17.70/18.38	P	x
16:15:04		P	18.33		
16:15:04		K	18.36		
16:15:04		J	18.36		
16:15:04		D	18.33		
16:15:04		B	18.37		
16:15:04		D	18.33		
16:15:00		P	17.70/18.38	P	6x3
16:14:41		P	18.09/18.38	P	1x3
16:14:41		P	18.12/18.38	P	6x3
16:06:27		D	18.3594		272.74K
16:03:07		P	18.13/18.38	P	5x3
16:02:46		P	18.13/18.48	P	5x3
16:02:46		P	18.13/18.50	P	5x4
16:02:46		P	18.13/18.47	P	5x3

Price White: Best qt Amber: MM qt Gray: Prev qt +Size scaled by 100 Zoom 100%

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
 Japan 81 3 3201 0900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2014 Bloomberg Finance L.P.
 SN 279533 EST GMT-5:00 G453-1427-1 04-Feb-2014 11:56:20

Source: Bloomberg, 2/4/14.

Past performance is not indicative of future results.

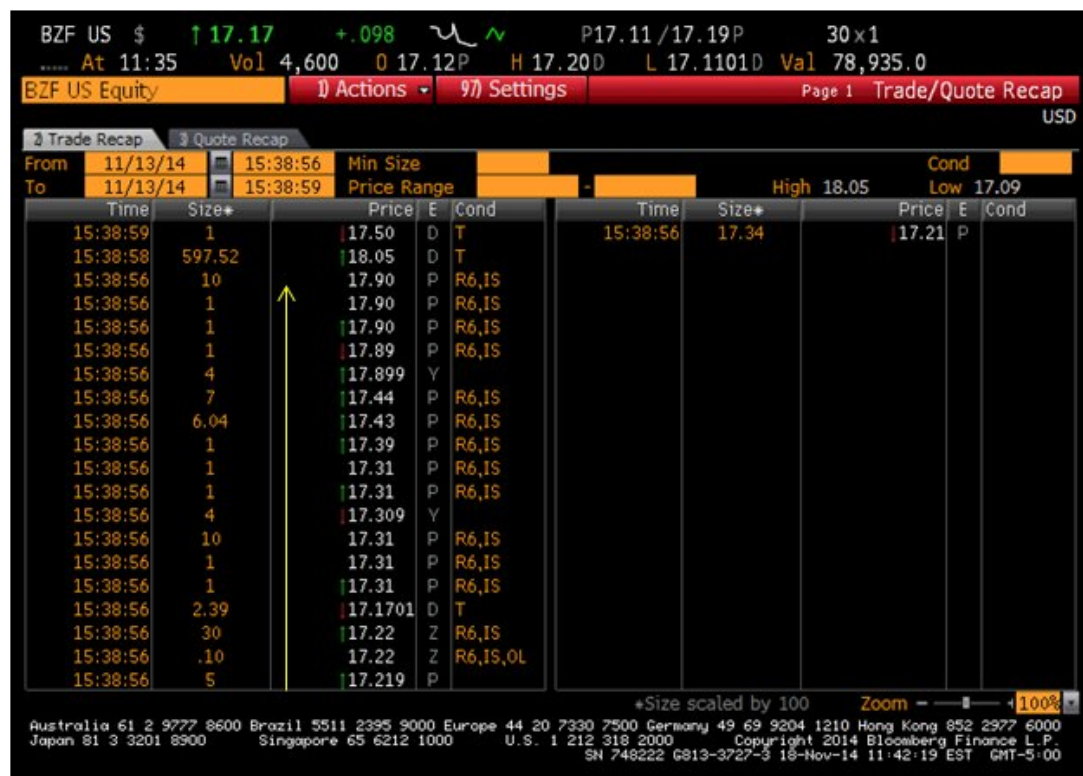
The client who initiated that trade was able to work with an ETF liquidity provider who had the ability to access the underlying basket in the primary market on behalf of the client. It is important to remember that an ETF is at least as liquid as its underlying securities, regardless of the average daily volume. That demonstrates the beauty of the open-ended ETF structure and its ability to create new shares and redeem shares daily. This trade was successful from an execution standpoint because the client worked together with their trading partners on a best execution strategy. On the other side of the execution spectrum, another investor entered a 70,000-share (\$1.2 million notional value) *market order* in BZF on November 13, 2014, just before 3:39 p.m. ET. This resulted in a quick spike up in the price of the ETF, as you can see in figure 2. **Figure 2**



Source: Bloomberg, 11/18/14

Past performance is not indicative of future results.

In this second example, the order book, or depth of the bids and offers of the ETF trading on the exchange, handled a market order of this size in an inefficient manner. The depth of bids and offers in an ETF order book is not always reflective of the liquidity of the underlying asset. While there is a lot of liquidity in Brazilian Real forwards, there are not a lot of resting orders in the BZF order book. By definition, a “market order” is designed to buy or sell an investment *immediately* at the best available price on the secondary market and will not stop until completed. For this reason, the order for 70,000 shares swept up all available shares for sale until it was completed, which resulted in the price increasing by almost 5%. This was followed by the price of the ETF correcting back in line with the “indicative value” of the underlying basket. Figure 3, and the yellow arrow, illustrate how quickly the order was filled and how far the price moved to satisfy the 70,000- share buy order in the order book. **Figure 3**



Source: Bloomberg, 11/18/14

Past performance is not indicative of future results.

You may be wondering, “Isn’t there a market maker who is supposed to be providing liquidity so this doesn’t happen?” The answer is yes. A market maker provides a few thousand shares that he or she would be willing to buy or sell on either side of the quote. But a market order typically moves so fast that it may not provide enough time for the market maker to reload their bid or offer before the order has driven up the price significantly. In summary, these two examples are something that all ETF investors can learn from. On the Capital Markets Team at WisdomTree, we try to be proactive in consulting with our clients on best-execution strategies. For larger orders, always look to work with a liquidity provider who can access the underlying basket on the clients’ behalf and provide execution close to the “fair value” of the ETF. Lastly, we encourage all investors to be sure to have a full grasp of the depth of the order book before implementing any market order. We hope this information helps investors in future ETF trades.

Important Risks Related to this Article

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