

Institutional ETF trading

Evolving workflows and execution strategies

Risk.net Q4 2019



3rd annual global institutional ETF trading survey report

Risk.net



COMMISSIONED BY

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Street**

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Introduction

This report presents the findings from *Risk.net's* third annual global exchange-traded fund (ETF) trading survey, commissioned by Jane Street.

It includes responses from 304 institutional investors, as well as qualitative interviews from 13 buy-side firms.

Executive summary

The 2019 survey shows that buy-side ETF traders are becoming more sophisticated in gauging ETF liquidity, optimising execution strategy and selecting effective counterparties. In the current environment of fee pressure and increased regulation, prioritising competitive pricing has emerged as a theme that transcends both region and institution type. ETF trading desks are also becoming more complex, with traders applying new technology and carefully considering with whom, how and where they execute trades.

- **Competitive pricing**

Across regions and institution types, traders value competitive pricing above all else when choosing a counterparty. Globally, 58% of survey respondents said this was the most important criterion when choosing a liquidity provider. Respondents also revealed that they are taking a more systematic approach to measuring the competitiveness of their brokers.

- **Trading desks**

A significant percentage of institutions – 29% – have dedicated trading desks or dedicated traders for handling ETF orders. The same proportion use separate brokers for their equities and ETF orders. These statistics indicate that institutions increasingly value those who understand the nuances of ETF trading methods.

- **Request-for-quote platforms**

Buy-side traders are making use of request-for-quote (RFQ) platforms to place multiple counterparties in competition with one another. 41% of respondents say they use RFQ platforms most frequently to trade, the highest share in the three-year history of the survey.

- **Benchmarking**

Comparing the trade price to the best bid/offer at the time of the trade continues to be the most common means by which institutions gauge execution quality, with 36% of respondents citing this as their primary benchmark. Four other benchmarks were each cited by more than 10% of respondents, suggesting a wide variety of benchmark preferences.

Liquidity decision-making

In previous surveys, traders were asked to identify their most important criterion when gauging the liquidity of an ETF. This year, in recognition of the fact that traders rarely evaluate an ETF on one singular metric, they were asked to label several different liquidity criteria as being “very important”, “important” or “not important”.

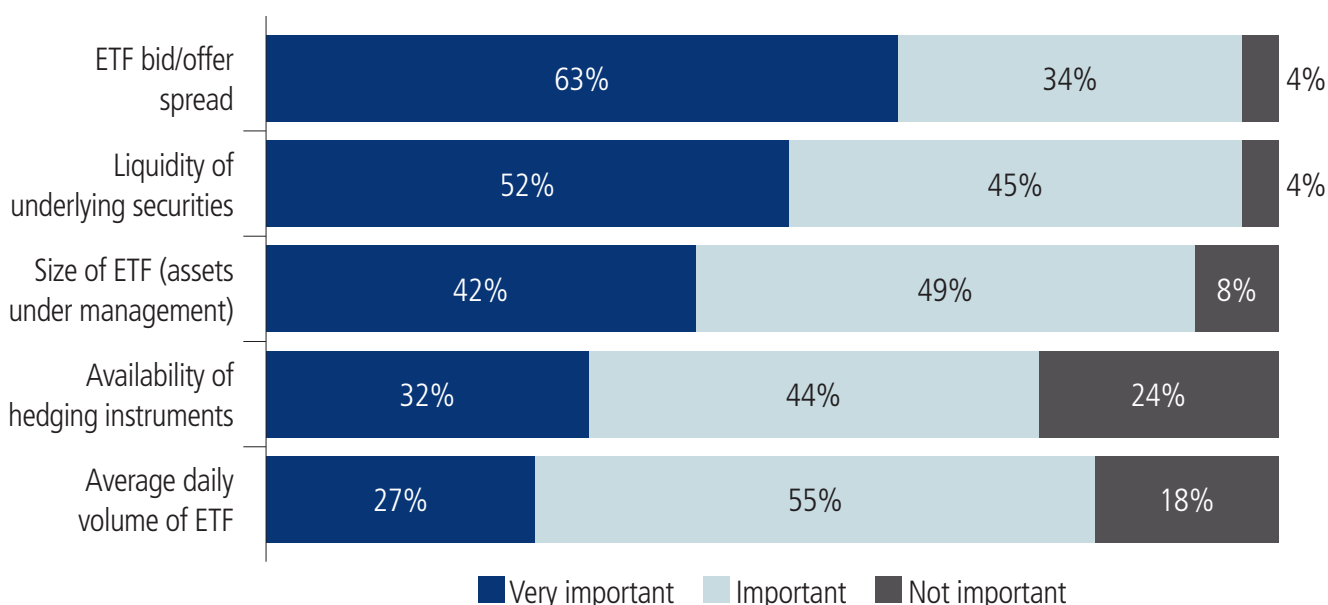
This year saw the majority of respondents report an ETF’s underlying liquidity as being among the most important criteria when gauging the liquidity of an ETF. ETF average daily volume fell for the third consecutive year in terms of relative importance for traders in their liquidity assessment. One possible explanation for this would be that, as institutions become more familiar with the creation and redemption process, they are more comfortable looking past the on-screen trading volumes.

HEDGING INSTRUMENTS AND ETF LIQUIDITY

When a liquidity provider decides where to quote an ETF, the ability to hedge their exposures and the costs of doing so are contributing factors to the price. Depending on their business model, there are a variety of ways a liquidity provider can manage risk. Some individual hedging instruments may do a good job of reducing risk, but may also be costly to trade. Other hedging instruments may do an imperfect job reducing risk, but at lower cost. Having an expansive menu of potential hedging strategies enables liquidity providers to improve overall trading efficiency through tighter spreads.

Availability of hedging instruments saw the strongest uptrend in trader importance under this year’s format, with close to one-third (32%) saying this was a “very important” element in their liquidity evaluation, whereas last year only 4% of respondents identified this option as the most important. Hedging instrument availability did rank as the most polarising, however, with 24% saying it was “not important” to their process.

1. Criteria for gauging the liquidity of an ETF, ranked in order of importance



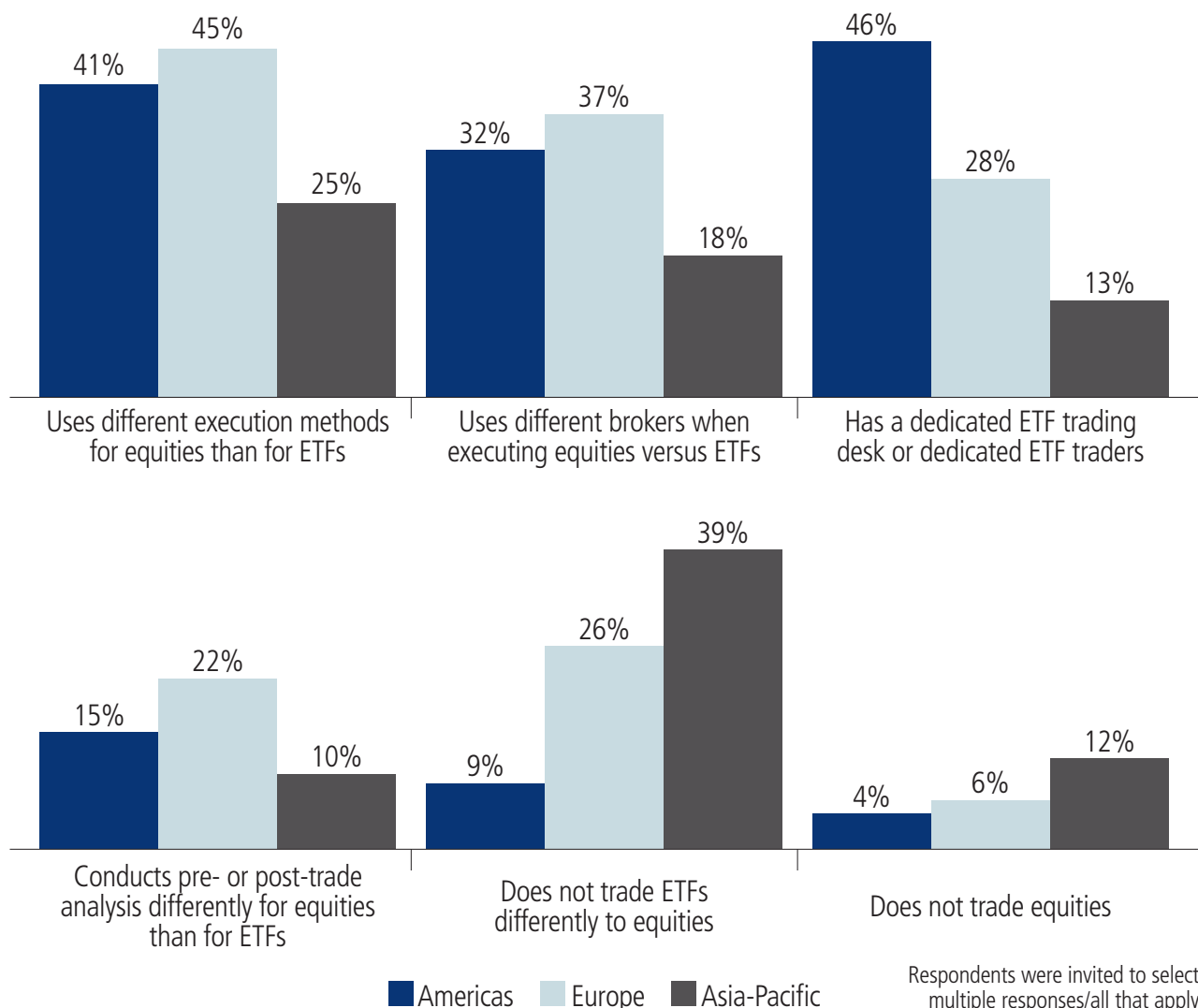
Although bid/offer spread and implied liquidity remained at the top of the identified liquidity criteria, this year's survey allowed traders to add an additional layer of transparency into their approaches. All five potential liquidity criteria received a minimum rank of "important" from over 76% of traders, suggesting that traders recognise that ETF liquidity is multidimensional.

Meanwhile, interviewees highlighted that there are distinct differences in ETF trading workflows compared with equity trading workflows. Of those whose firms trade both ETFs and equities, 74% reported differences in their workflows when conducting trades in each type of security. The most common difference, reported by 37% of global respondents, was the use

of different execution methods for ETFs compared to how they trade equities. The share is 41% for US respondents, 45% for European and 25% for the Asia-Pacific region (APAC). Across all respondents, 29% say they use different brokers for trading ETFs and equities, and 29% of respondents have a dedicated ETF trading desk.

"We always start with the provider of the ETF to get a feel for a product and its liquidity. They are in constant contact with the market-makers and authorised participants on who's trading their funds at what time. Providers have pre-trade tools that give a trader an estimate of potential implicit trade costs," says Scott Boone at AdventHealth.

2. Does your firm trade ETFs differently to equities? If so, how?



Execution styles

Few areas of the survey saw as much dispersion across regions as was observed in the execution methods traders are most commonly utilising. Risk trading, net asset value (NAV) trading and agency brokerage are the three primary execution methods that traders use globally, and in aggregate they are used roughly equally. However, there are stark differences among regions, far more so than in other areas of the survey.

For example, consider the use of agency brokerage. Globally, agency brokerage – including sales traders, algorithms and direct market access – was the leading choice, with 38% of responses. However, this was heavily influenced by the responses from APAC where an overwhelming 57% of traders favour agency brokerage. In Europe, on the other hand, just 31% cited agency brokerage compared with 48% who prefer risk trading. Meanwhile, in the Americas, NAV trading and risk trading were the preferred methods at 45% and 28%, respectively.

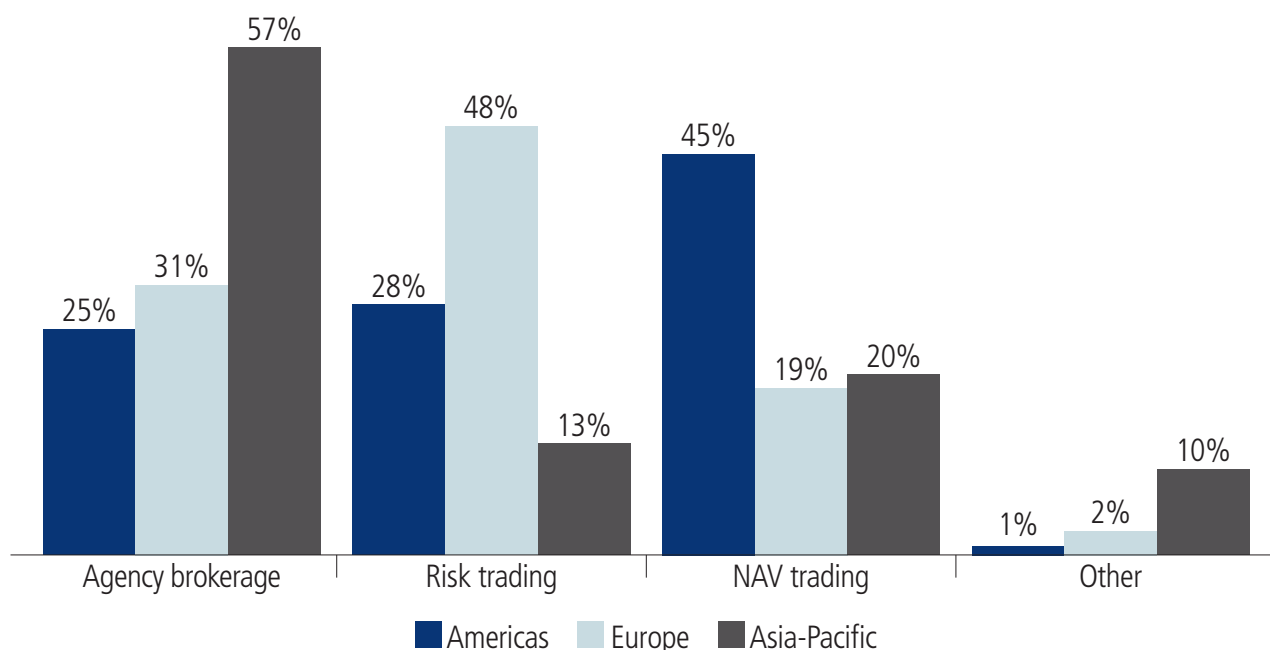
The preference for agency execution among APAC-based traders could reflect the fact that they are often



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Will Wall, RiverFront

3. Execution methods most commonly used by institutions for ETF trades



buying or selling ETFs that trade in a different time zone. For example, over half of the APAC-based traders surveyed trade US-listed ETFs. Spreading out the execution of an order over a longer time period with, for example, an agency volume-weighted average price trade (VWAP) may appeal to a trader who won't be awake when the relevant market is open and is happy with an average price.

For traders based in the Americas and in Europe, direct interaction with a dealer – either via an NAV trade or a risk trade – is more popular. In the Americas, one common application of NAV pricing is for switch trade scenarios where a trader is moving between a mutual fund, which only prices at NAV once a day, and an ETF. This limits the total exposure an investor would have compared with trading the ETF intraday prior to the mutual fund NAV being struck.

The traders interviewed expressed a view that competition among dealers has greatly reduced the cost of risk trading in recent years.

“We don't trade that often; we use ETFs more as a strategic building block and they make up around €1 billion of our portfolio. We run 100% on risk price and we are definitely seeing increased competition and tighter spreads,” says Riccardo Rasi, head of public markets and absolute return strategies at Fondazione Enasarco.



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Increased competition was a trend that was observed across regions and with those who favoured risk pricing in an effort to obtain best execution.

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EXECUTION STYLES

Institutions can fill large ETF orders in a number of ways:

Agency/algorithmic

The institution or its agent executes a transaction on exchange or other trading venues. Trades are generally executed piecemeal over some time period and tied to a benchmark, such as the volume-weighted average price or time-weighted average price.

NAV pricing

The trade is typically benchmarked to an ETF's official net asset value (NAV), and executed at a price that is NAV plus a spread. The NAV is usually calculated using the closing

prices of a product's underlying securities. The institution is exposed to any price impact and timing risk (the risk of any move in price between the time of the trade and when the NAV is calculated).

Risk pricing

Trades are executed immediately at a transparent and fixed price. Information leakage can be mitigated by the immediacy of the transaction. Prices can be accurately compared across different liquidity providers, aiding in certainty of best execution.

Execution benchmarks

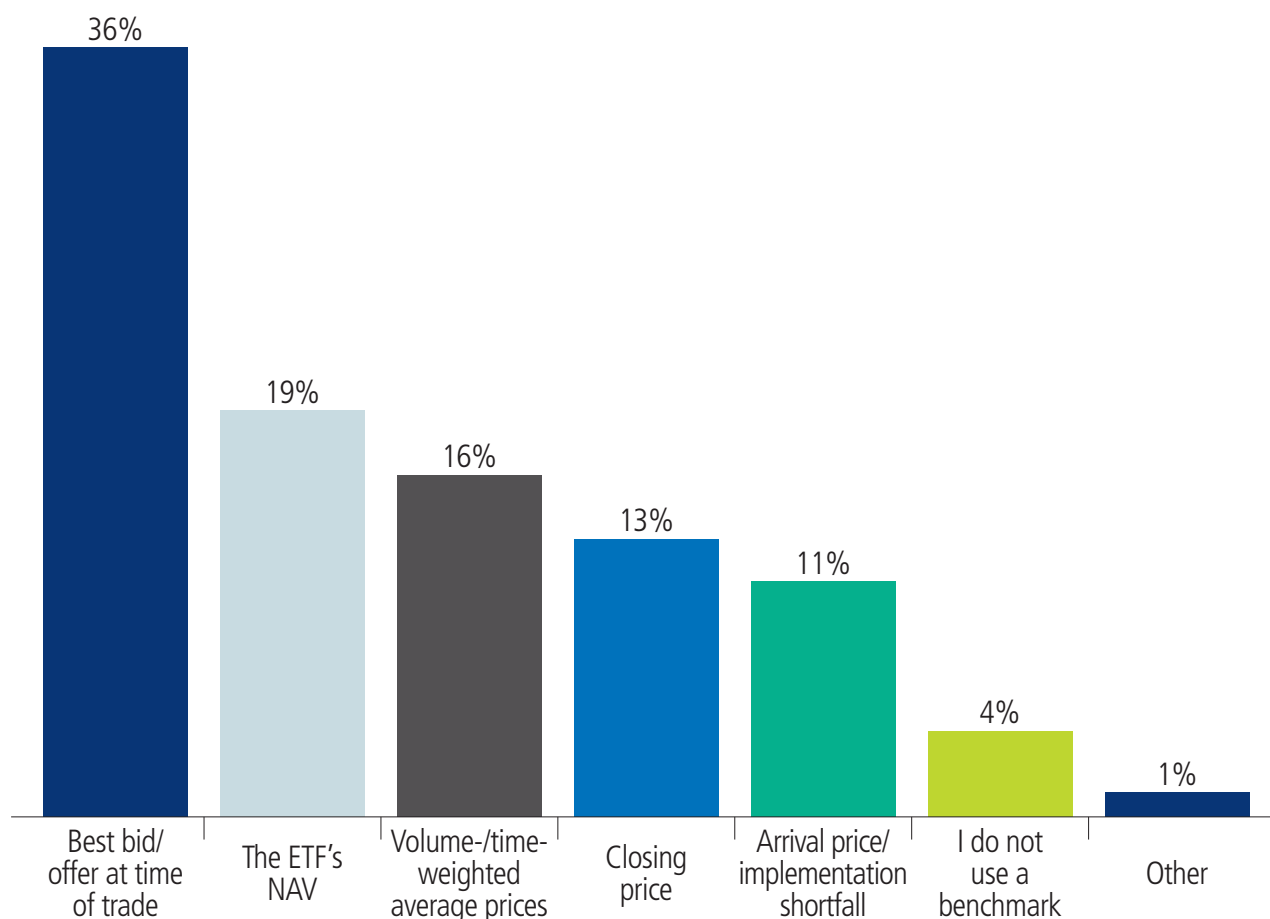
Regional differences in execution methods may also influence the different ways institutions are measuring the quality of their executions, as no single measure was consistent across all regions. European traders tend to focus on the best bid/offer at the time of trade, whereas their APAC counterparts rely more on average prices. Generally, this aligns with each region's respective preference for risk trading and agency trading.

The reality is that there is no one-size-fits-all approach to every possible trading scenario, a fact specialised traders are well aware of. Traders often don't use just one method for trade evaluation or execution method, and will switch back and forth depending on what is best for that individual trade.

"For worked orders, we target VWAP over a certain period and just try and hit VWAP. For risk price, we would check a couple of brokers, see who has the tighter risk market and go with whichever broker has a better market," says Rob Dailey at Stadion Money Management.

One interesting observation is that less than 4% of survey respondents stated that they don't use any type of benchmark to evaluate the quality of their executions. In 2018, that number was 19%. This observed increase in benchmarking shows how traders and executing portfolio managers (PMs) are becoming more conscientious and data-driven in their measurement of execution quality.

4. What benchmark does your institution primarily use to evaluate the quality of its trade execution?



Counterparty selection

Institutions are sensitive to how their choice of counterparty can influence trade performance. Firms have become adept at identifying those markets in which their favoured liquidity providers excel and under what conditions.

According to the survey data, the choice of counterparty can also be influenced by the chosen execution style. For example, for traders who say they prefer to trade on risk, independent market-makers are the most commonly used counterparties. For traders who prefer NAV trading or agency trading, investment banks and agency brokers were the most popular counterparty choices, respectively.

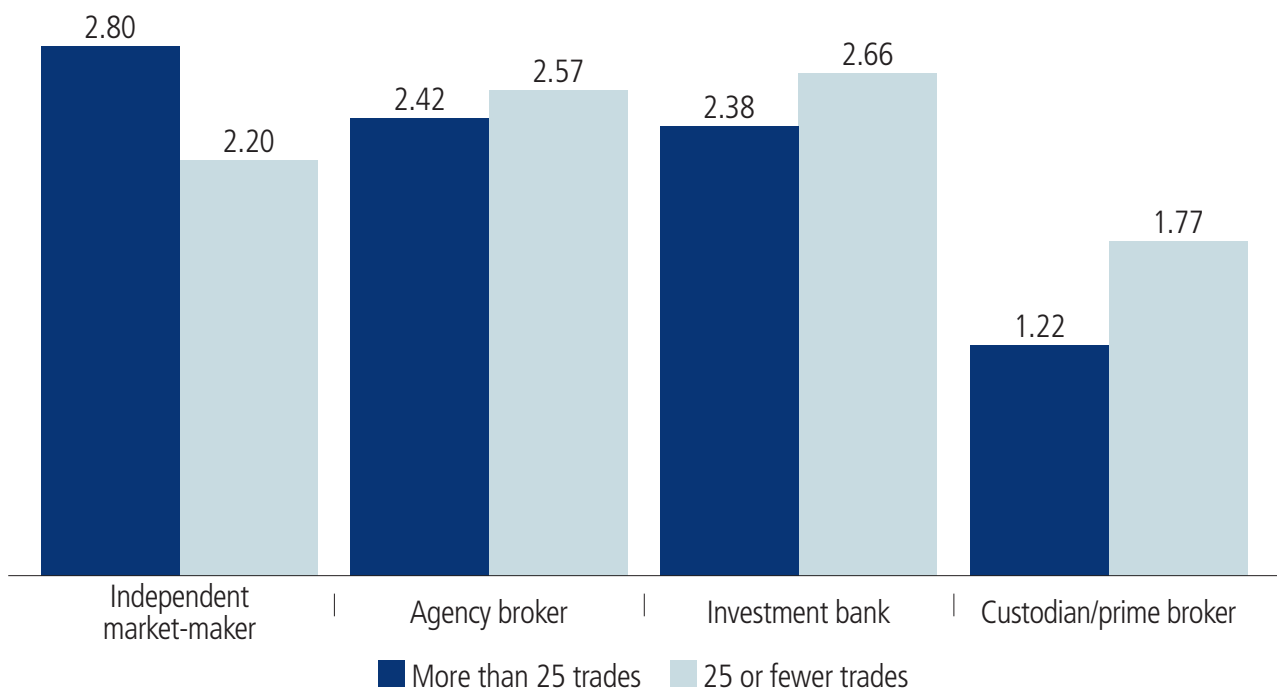
"There are particular products where, in our assessment, we know that [specific market-makers] are particularly good or particularly bad. We actually go to the individual ETF level, so for each product we have our databases where we have a historical analysis of which counterparties typically give us the best price," says Darshan Bhatt at Glovista.



"Your calculation should be at the ready. And that's basically where the alternative market-makers and some of these banks are – constantly at the ready"

Dan Zrally, 3Edge

5. Counterparty selection by trade frequency



Responses were weighted and scored using a placing scale of 1st to 4th. Scores were aggregated whereby 1st choices received 4 points, 2nd choices received 3 points, 3rd choices received 2 points, and 4th choices received 1 point.



“[Our] RFQ process will approach traditional brokers and alternative liquidity providers as a matter of process. Generally we find the alternative liquidity providers offer a better price and service than the traditional brokers”

Peter Sleep, 7IM

This level of sophistication pertaining to counterparty selection was a trend communicated across multiple interviews. Buy-side traders are keeping score of which counterparties are able to consistently offer the best execution for each trading style, product type and geography, and are allocating their trades accordingly.

Overall results on trade frequency – the number of average ETF trades per month – highlighted counterparty preferences among respondents. The most active ETF traders – those survey respondents who execute more than 25 ETF trades per month – were shown to most commonly use independent market-makers. Those who trade ETFs less frequently reported investment banks as the preferred trading partner, potentially influenced by historical relationships trading individual equities, and receiving value-add services such as research. For those who trade often, consistency could be the key in driving this trend toward independent market-makers.



“Alternative market-makers are constant, over all types of products, whereas banks are more driven by axes, so they can be so-so most of the time and suddenly perform well on a single trade request”

Cyrille Combes, Lyxor

Regardless of market segment, execution style, or how frequently one trades, executing at the best price is the priority. Asset managers are cost-conscious, as they are under pressure in an environment of low and falling fees. The incentive to shop around market-makers for the best price for a given ETF is therefore high. According to Peter Sleep at 7IM: “[Our] RFQ process will approach traditional brokers and alternative liquidity providers as a matter of process. Generally we find the alternative liquidity providers offer a better price and service than the traditional brokers.”

Broker criteria

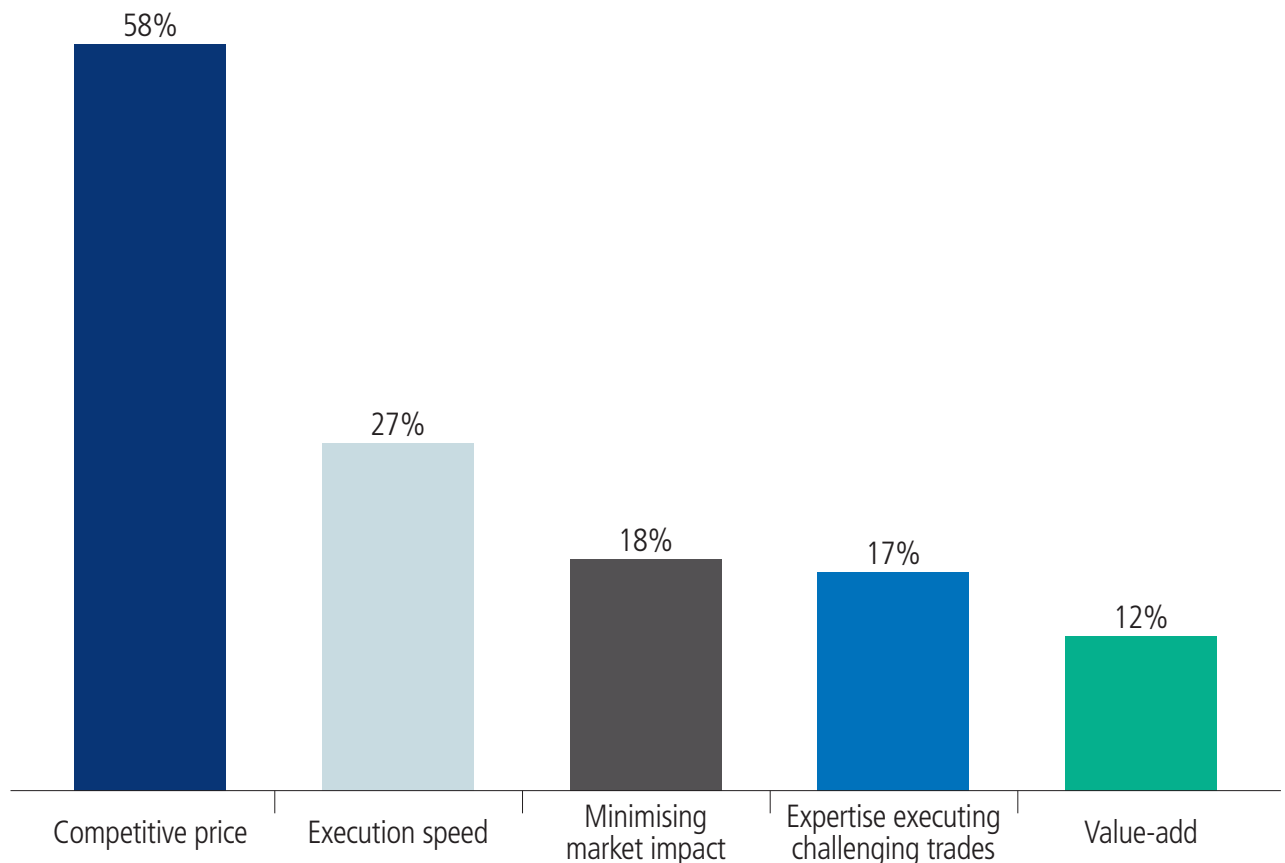
ETF traders are most concerned with the all-in cost of execution, and least concerned with value-add offerings. When asked to rank the factors that most influence their broker selection, 58% of survey respondents cited the ability to make a competitive price – a prime determinant of execution cost.

Execution speed came in second, earning a score of 27%. This capability is especially valuable when trading on risk. Traders want to execute on prices before markets move and cause the spread to widen. “If a buy-side shop comes to a bank and asks: ‘Where are you on a price?’, you should always know where that price is. Your calculation should be at the ready and that’s basically where the alternative market-makers

and some of these banks are – constantly at the ready,” says Dan Zrally at 3Edge in the US.

The regional differences were not particularly stark, with one exception: value-add. APAC respondents showed the highest weight towards value-add research, whereas European respondents ranked it the lowest on their list of considerations. It’s highly likely that the unbundling of payment for research from payment for execution that was mandated in the recast Markets in Financial Instruments Directive (Mifid II) explains the near-zero response among Europeans citing value-add as an important factor. Under that regulation, traders at Mifid II-regulated firms are prohibited from using dealing commissions to pay for investment research.

6. Criteria institutions consider when choosing brokers to execute trades, ranked as first in terms of importance



Multiple selections were permitted to be ranked first.

Trading workflow

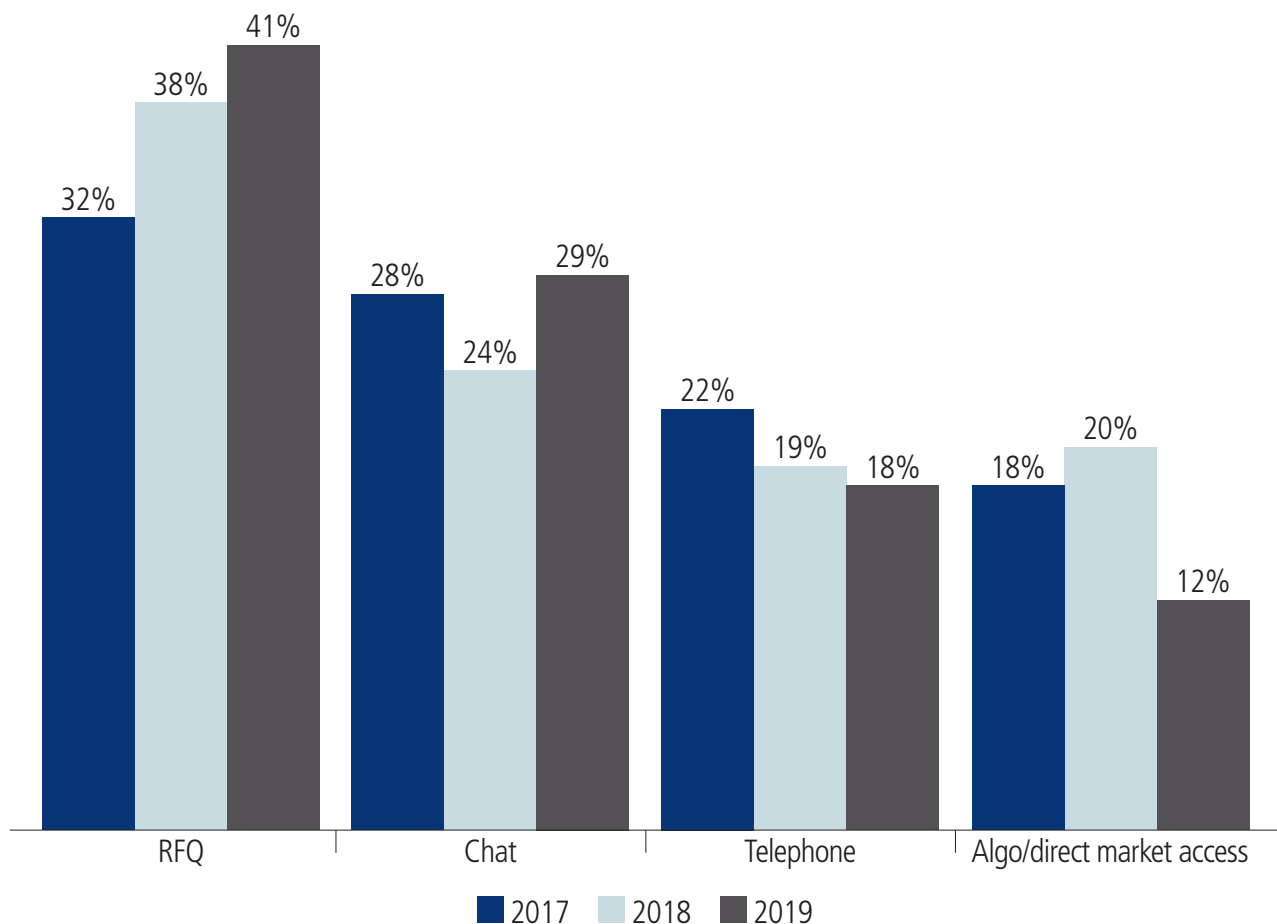
Preference for trading on electronic RFQ platforms continues to rise, with 41% of respondents saying they use these venues to submit RFQs for block trades. That's up slightly from 38% last year. RFQ platforms are a useful tool for traders seeking competitive pricing and execution speed. Placing two or more counterparties in competition by initiating an RFQ can ensure an investor secures the desired level of execution certainty at the best possible price.

There is also a clear relationship between the preference for trading on risk and the take-up of RFQ platforms by buy-side institutions. Though, globally, 41% of respondents use RFQ platforms most commonly, the

share was 57% among European firms and 55% at US institutions, compared to just 10% of APAC investors. Directionally, this mix across regions correlates with risk trading as the preferred method of execution.

Select funds have even adapted semi- or fully automated workflows developed for cash equity markets to handle certain ETF trades on RFQ. "From an equity trading perspective, we've had an element of automated trading since 2009. When it comes to trading on risk for ETFs of RFQ platforms we heavily leverage those platforms on the more liquid, smaller orders," says Neil Joseph at JP Morgan Asset Management.

7. How do you most commonly submit orders or solicit quotes for block ETF trades?



Though APAC firms lag their US and European peers in take-up of RFQ platforms, the savviest institutions are well aware of their capabilities.

"The biggest innovation helping institutional investors in the ETF space is the RFQ platforms available for use," says the head of trading at a large institutional money manager in Hong Kong. "Almost all ETF trading we do globally is conducted on a multidealer platform. Occasionally we may work ETF orders on the screens, but this isn't the norm," he adds.

A plurality of firms execute using RFQ platforms whatever the scale of the order, too, with 34% saying that size isn't a factor. However, a significant number of buy-side traders – 88 out of the 238 who reported using them – said that they avoid using the platforms for trades above a certain size. It's typical for traders with very large orders to put a smaller number of dealers in competition, and in such situations electronic chat or telephone can be an efficient means by which to communicate.

At the same time, 48 survey respondents said that they avoid using RFQ platforms for trades below a certain size. The selective use of RFQ platforms is yet more evidence that traders are not married to any single execution style or tool, but rather are happy to sift through all of the available options in pursuit of best execution.

"If an ETF is trading at a large discount to NAV we do not mind working slowly through electronic venues. The reason for that is, if we went to a market-maker, most likely they would give us a price much closer to the fair value, unless they have a particular axe," says Bhatt at Glovista.



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Conclusion

This 2019 survey highlights how the role of the ETF trader continues to evolve in both skill and importance. With institutions developing specialised models for how they execute trades, select counterparties and evaluate the quality of their execution, institutions increasingly look to those who best understand ETF trading protocols and dynamics. As the industry matures, institutions are adopting more multidimensional, nuanced approaches to assessing ETF liquidity and evaluating individual products. Technology continues to drive the way trades are conducted and, in an environment characterised by ever-increasing competition and fee compression, price and speed are the most cherished attributes institutions look for when trading ETFs.



Survey respondent profile

ETF trading: Evolving workflows and execution strategies is based on a survey commissioned by Jane Street and conducted by *Risk.net*. Its findings are derived from surveys conducted with senior buy-side ETF traders around the world, complemented by a series of telephone interviews. This report outlines changing institutional sentiment around ETF liquidity, criteria for counterparty selection and preferred execution methods.

From March to July 2019, *Risk.net* surveyed 304 buy-side ETF traders globally.

- 33% of surveyed institutions have assets greater than \$100 billion
- 22% have assets between \$10 billion and \$100 billion
- 23% have assets between \$1 billion and \$10 billion
- 21% have assets less than \$1 billion

In terms of institutional investor types:

- 51% of responses were from asset managers/hedge funds
- 22% from wealth platforms/family offices/registered investment advisers
- 10% from insurance companies
- 4% from pension funds
- 13% from other entities

Geographically, the respondents' profile was:

- 35% of respondents came from the Americas
- 31% from Europe
- 34% from APAC

Percentages/totals are rounded to the nearest 1% and, as such, some figures may not total 100%.

