FINANCIAL NEWS

When execution becomes the standout factor

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Exchange-traded funds may be seen as a low-cost investment option but the huge choice of how to trade these products can have expensive consequences for institutional investors.

“It can have a very significant impact. Get a bad execution and you start with a drag on the performance,” said Deborah Fuhr, partner at ETFGI, the research and consulting firm.

In Europe, unlike the US, only a minority of ETF trading is done on stock exchanges. About 70% of ETF trading takes place over the counter, off-exchange, according to ETFGI. That may mean going to an “authorised participant” that is registered to allow it to create or redeem shares of the ETF with the product provider, or simply buying or selling the ETFs without going through the exchange.

For smaller trades and big ETFs tracking a major index, such as the FTSE 100, that may not be necessary. There an investor may trade up to £3m on exchange with few problems.

Christopher Meyers, ETF sales trader at Dutch marketmaker Flow Traders, said: “If you’re not dealing in sizes larger than that, by all means go on exchange.”

For the bigger trades undertaken by institutional investors and for more esoteric ETFs such as those based on emerging markets or commodity indices, trading on exchange is likely to affect the price (since ETFs on exchange can trade at a discount or premium to the value of the underlying assets they track), requiring them to look elsewhere to avoid doing so, or just to get a better price than available on the exchange.

Either way, investors face a bewildering choice of options when it comes to who they want to handle the execution. For a start, they have the big investment banks, many with product provider arms, such as Deutsche Bank, with its db X-trackers ETFs, Credit Suisse (which recently put its ETF business up for sale), and Societe Generale, with its Lyxor range. All were in the top five in consultant Greenwich Associates’ October rankings of ETF brokers.

Thorsten Winkler, co-founder at Frankfurt-based Advanced Asset Management, which manages ETF funds of funds, said it is natural to turn to the investment banks linked to ETFs when looking to trade those products. He said: “You would think they should be able to provide the best execution of their own product.”

In other circumstances, such as trading an iShares ETF, for example, since BlackRock doesn't have a broking arm, many investors instead turn to specialist marketmakers, committed to providing continual prices to buy and sell ETFs, such as Flow Traders, Susquehanna and Knight Capital.

Peter Sleep, senior portfolio manager at Seven Investment Management, says that big investment banks will often turn to such firms anyway in order to deal with large ETF orders they are not comfortable keeping on their books. He said: "We may as well go straight to them rather than dealing with the banks, which don't have the capital to take these risks on anymore."

These specialist marketmakers bring greater expertise, argues Meyers at Flow Traders. He said: "The big difference is size. We have 100 people in Amsterdam, 30 in New York and 30 in Singapore, with 45 sales traders – and 11 sales traders covering ETFs. The big investment banks have three or four people dealing with these products."

Jason Warr, executive director of ETF trading at Morgan Stanley, which topped Markit MSA's half-year broker rankings for trading in ETFs published in July argues that brokers with a significant market share are more likely to give investors a good deal, even in a highly liquid ETF.

A FTSE ETF, for example, incurs a 0.5% tax on share transactions. A broker that already has an inventory of that ETF from another customer who is selling will be able to offer to sell it at a lower price – perhaps below that on exchange, where the price includes the tax. Warr said: "Dealing with a broker that has a good flow in a range of products is definitely an advantage."

He also argues that independence from product provision is another strength because many clients don't just look at price but rely on brokers' advice. They may consult them, for instance, on the best product for tracking a particular index or asset class, or even on whether ETFs are the best tool to express a particular investment view.

Other investors, however, prefer that third parties choose the broker.

Investment managers SCM Private places its trades through Pershing Securities, which selects the brokers or marketmakers for execution. SCM partner Simeon Downes believe it's more efficient to leave trading to those with better understanding of the market. He said: "Ultimately our expertise is an asset allocation."

At Evercore Pan Asset, another fund manager constructing portfolios of ETFs, co-founder Christopher Aldous is keen on WallachBeth, the US institutional broker that entered the European market earlier this year in a joint venture with North Square Blue Oak. It does no principal trading – in which the broker takes ownership of the ETF – but works purely on commission to try to find the best price for clients from marketmakers and other liquidity providers. Aldous said: "For us it is like outsourcing our ETFs sales trading service."

Laurie Pinto, North Square Blue Oak chief executive, argues that using agency brokers is the only way investors can be sure they are getting the best price. He said: "How can you trade with a marketmaker knowing he is making money out of trading with you – not taking a commission and getting the best price but making money out of the trade? They make their entire living trading against you."

However, the marketmakers counter that agency brokers have to deal with them. Matthew Holden, managing director and head of ETF trading for Europe at Knight Capital, said: "Agency order aggregators cannot exist without marketmakers."

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