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Best practices should be focus of trading ETFs

The article “ETFs can present pricing problems” (April 25), which addressed exchange-traded-funds pricing and best execution, is a welcome lever that should inspire greater focus on, if not clients or customers, use the greater scrutiny of, the overall topic of ETF execution.

However much the terms “best execution” and “less-than-best execution” might seem to be polar opposites, the two phrases can easily be confused because there are so many conflicting definitions of what best execution really means.

The estimate from The Charles Schwab Corp. that bad executions occur less than 5% of the time is therefore subject to interpretation. Instead of relying on the overused and ill-defined industry phrase “best execution,” the focus should be on best practices, which is where the proverbial rubber meets the road when it comes to best execution.

According to the standards by which the industry measures best execution, one could argue that the transaction cost analysis metrics used to determine best execution are based on less-thanaccurate inputs. Although current formulas are comprised of or compromised by current [best bid and offer] Level II, and historic pricing (as well as related ADVs), none of the various definitions of best execution consider execution prices that could have been obtained if a truly rigorous and granular price discovery process was employed — the type of process that any fiduciary should consider to be standard operating procedure.

Aside from today's screen-based markets' being highly fragmented, there is an even simpler reason why screen markets are unreliable when it comes to measuring actionable liquidity for small and large blocks in all but the most actively traded ETFs.

The nature of the electronic market is such that liquidity providers are loath to display their best bids and offers on actionable screens.

Liquidity providers are sophisticated arbitrageurs who vie to compete against each other for block trades by using seemingly unrelated products as hedging tools in order to improve upon existing ETF screen-based quotes. These providers have no obligation to advertise their best hand, no less divulge their proprietary hedging formulas, so why would they literally compete against themselves by being fully transparent on an actionable screen?

Best execution is delivered by those with fluent knowledge of the ETF landscape who employ a meticulous price discovery process that canvasses hidden as well as displayed markets, including liquidity sources often untapped by those other than expert, ETF-centric execution firms.

When a captive trade facilitation desk says that it is delivering best execution to a registered investment adviser client, the client should ask what their particular broker's definition of best execution is, and how they go about canvassing liquidity providers. If the answer is incomplete, the RIA's desire to “trade away” is therefore commendable and should be adhered to by the captive custodian, especially when the RIA's broker may have either “redlined” select sources of liquidity or may simply not be familiar with best practices followed by those that specialize in executing ETF orders for fund managers.

The best way for any RIA or fund manager to gauge responsibly what is real and what is not real is to proactively seek out a third-party ETF execution firm (ETF issuers can provide a list for you) and solicit them to provide quotes on your next five orders. After you compare those quotes to what your captive provider is offering, you will have a better understanding of how alternative execution providers might help you secure better pricing and, in turn, enhance your operating efficiency and your alpha.

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