

Cover Story Part 1: The Big Impact

How Exchange Traded Funds Are Shaking Up the Industry

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James Armstrong

Kweku Adoboli, the alleged "rogue trader" at UBS who was arrested in London after supposedly losing \$2 billion, has put renewed interest in the desks that handle exchange-traded funds.

From zero to \$1 trillion in assets. That's how much ETFs have grown in 18 years--and this could just be the beginning. Experts predict the next few years could see even more explosive growth in ETFs, having an enormous impact on the entire trading industry.

Earlier this year, ETFs made up between 25 percent and 30 percent of total market volume, but as trading heated up this summer, they rose to as high as 40 percent of volume for some days. That has made the industry pay new attention to these instruments.

"Everyone is looking to support ETFs because they are 40 percent of trading volume," said Dan McCabe, chief executive officer of Precidian Investments, which specializes in developing ETFs and mutual funds.

When the first ETFs were launched 18 years ago, they were handled by former options traders who had to cut their teeth on the floor of the American Stock Exchange. Expertise in portfolio pricing, portfolio management and indexing are important for trading ETFs, which is why many people who trade them today have a background in index arbitrage.

Traditionally, single-stock traders have rarely gotten involved with ETFs, but with these teenaged instruments finally coming of age and taking their place as a dominant part of the industry, all traders are going to have to get schooled in ETFs.

There are now 1,300 exchange-traded products available, offering exposure to not just equities but commodities, currencies, futures, fixed-income and other asset classes. And more options are coming. According to recent data from Birinyi Associates, the top 10 ETFs by trading volume each month now track not just U.S. stocks, but also emerging markets equities, commodities, even the VIX volatility index.

Some of the biggest growth in ETFs has been from funds that track non-stock indexes, and Segal points out that GLD, which tracks gold, recently had more assets than SPY, which tracks the S&P 500. After market turmoil calmed down a bit, GLD's assets receded and SPY shot back up to its number one slot.

As there are more and more ETFs trading non-equities, it brings up the question of who gets to trade the ETF. Briton Ryan, head of U.S. ETF sales and trading for Newedge, said while equity desks have traditionally had authority over ETFs, the vehicles can also be traded by those with the most knowledge of their underlying assets, whether commodities, bonds, or something else.

Coming Together

Rather than sparking turf wars, though, ETFs tend to bring different sides of a firm together, even though an equities trader and a commodities or bond trader might normally have little reason to collaborate.

And institutional investors are increasingly turning to ETFs. In a recent Greenwich Associates survey, nearly half of asset managers and 32 percent of pensions, endowments and foundations said they planned to increase their allocations to ETFs over the next two years

One of the biggest changes brought by the ETF revolution has been the rise of ETF-specific desks, with traders dedicated not to stocks or bonds or commodities, but to trading a multitude of exchange-traded products.

"A specialized ETF trading desk has evolved at a lot of the firms with whom we work," said Kevin Quigg, head of ETF global capital markets at State Street Global Advisors.

The level of expertise a trader needs on ETFs can vary. Andy McOrmond, managing director of the ETF desk at WallachBeth Capital, said traditional SPDRs don't really trade much differently than traditional cash equities. The problem is second- and third-tier funds can act drastically differently, in part because liquidity can be more of an issue for ETFs.

According to McOrmond, an ETF that trades less than 2 million shares a day needs to be treated differently than an equity that trades less than 2 million shares a day. That's because the makeup of market participants is so different.

"Arbitrageurs are not always inclined to post their best bids and offers on the screen," said McOrmond. "An equities trader needs to understand that there's probably always a better price on an ETF than he's traditionally seeing. He just has to find the right sources to go get it."

For McOrmond, the secret is a combination of learning what the ETFs are worth and who the proper players are in providing the liquidity. For more lightly traded ETFs, filling an order at the best price might then have to be done the old-fashioned way-with a phone call rather than a click of a mouse.

For these second- and third-tier names, trading desks might be strong in some areas but not in others. ETFs cut across a wide number of asset classes, and it can be impossible to find a desk that will give you the best price in fixed-income, commodities, international equities, currencies and everything else.

"There are so many different asset classes now," said McOrmond. "It's very hard to put together a shop of professional traders that are good in every single asset class."

In order to trade ETFs beyond the top hundred or so names, a firm needs to be able to go to different sources to get liquidity. But that takes much manpower and brainpower, especially when it comes to products a desk might only trade occasionally.

That's why shops like WallachBeth have emerged as go-between firms for certain lightly traded ETFs. They act as a sort of broker's broker, connecting other trading desks with liquidity at prices they might not normally be able to find.

"Traders have to do a good job on every single order, so they can't drop the ball on an ETF order," McOrmond said. "That's where ETF specialty shops like us come in."

Trading ETFs necessarily requires more of a quantitative or mathematical background than just trading single stocks. David Silber, head of equity derivatives at Jefferies & Co., said that's because ETF traders need to have an understanding of how various stocks move together as a basket and relative to one another.

Learning the Ropes Fortunately, the learning curve does not seem to be as steep as it was for traders a decade ago. Silber said that in the last seven years or so traders have become more sophisticated, in part due to concerted efforts by the industry for education.

And education isn't just necessary for traders on ETF-specific desks. All traders have to learn at least something about what has become clearly one of the hottest trading vehicles around. ETFs have become so pervasive that they affect every institutional trading desk, according to Ken Marschner, head of U.S. quantitative trading for UBS.

To Be Continued on Monday, October 10, 2011