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Best Execution in ETF's, Does Your Custodian Meet It?

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WITH THE EXPLOSION AND POPULARITY OF

ETF's over the last few years, many advisors have moved a large portion, if not most, of their assets from single equities and mutual funds to ETFs. These orders started as SPY, DIA, QQQQ and the buy/sell orders were given to the Custodians' trading desk for execution, with fills routed back to the advisor, with minimal market impact. There were no issues with order size, or execution price since the ETF's were so heavily traded.

How has that changed today? The ETF landscape is full of hundreds of similar products with differing expense ratios, weighting of underlying securities, and components of the basket. The proactive advisor knows that true liquidity is in the underlying basket and not ADV (Average Daily Volume) and screens based on what ETF gives them the best correlation to the exposure they seek, without worrying about the ADV. Or at least that is the way it should work. We are actually seeing that the proliferation of ETFs, while giving the advisor better correlation and exposure at lower cost, may be causing bigger issues in significant increases in true cost of trading.

You've heard the saying, "Traders at a custodian are like advisors at a bank." This saying started for a reason. Most custodial firms are designed so that ETF orders are either executed internally through basic algorithms that show smart trading firms what your side and size are, resulting in greater market impact, or by going to one or two counterparties for a position bid (if you ask) and giving you the better of those two prices (usually with a rebate to the custodial firm baked into the price). In both of these cases, the execution price you receive is much higher than you could have received and you have literally thrown away 5-10 bps in poor executions, that could have been added back into your annual performance numbers. How much better would your performance be and how much easier would it be to attract new assets if you added 5bps back to your asset base on every trade?

The main issues we have seen with trading ETF orders with your custodial desks is the lack of in-depth knowledge on the different products, or contractual obligations they must meet on routing out your order flow. An example of limited knowledge would be in cases of low ADV/high liquidity ETFs, like Revenue Shares products. We have seen many examples where the custodian looks at the ADV and trades an order in

the marketplace by taking offers or hitting bids, moving the market well past the IIV, giving the advisor a fill near the high/low of the day. Then you watch the market bounce right back in line with the underlying basket, resulting in an immediate paper loss due to market impact.

A second example would be where contractual obligations result in your order being routed to a venue who only trades on the screen or goes to one counter-party. If all custodian orders get routed to one bulge bracket firm by contract, what is the incentive for the bulge bracket firm to seek out the best market and not just fill the orders through the box? Finally, spreads are tightest and markets are best when you send your order to a company that has the other side naturally and can cross it internally. So why do custodians limit themselves to two or three counterparties when the odds are greater to find the cross with a larger network?

Your custodian is charging you a fee for your assets, a fee for trades, a fee for trading away, ticket charges, etc... These fees are warranted when you trade domestic equities, options, fixed income and they get you best execution. But in the world of ETFs where the nuances of the underlying basket and true liquidity differs from ADV, the custodians have been falling down.

As advisors you need to be concerned with fiduciary responsibility, best execution and true cost of trading. If you pick the right ETF and it costs you ten cents increased market impact on each side of the trade, at \$40 a share, the extra twenty cents in impact just cost you 50bps in performance on that trade.

Advisors need to demand better executions from their custodians or the right to trade away sans excessive fees to assure that best execution metrics are being met and that the performance that should be in the customer account, stays in the customer account and does not go to a market maker or AP because the custodian does not have a better way to trade. There are too many other companies that specialize in minimizing trade impact and actually looking after the best interests of the advisors for the custodians to keep providing poor executions on ETF orders. While there is no way to make your custodian trade with a better counterparty, there are ways to make sure your custodian knows that you can get better pricing and you can "hold their feet to the fire."

1. Work with an ETF specialist firm and ask for a liquidity analysis with estimated market impact. This will show you what price to expect.
2. Work with an ETF specialist firm, or seek out for yourself, the underlying basket that makes up the ETF you want to trade and identify any problem stocks in the underlying basket.
3. Make sure that the firm trading for you does not rely on receiving rebates for order flow since that price is usually added into the execution price you receive resulting in

your fill being +/- a penny or more from where it would have been filled without a rebate.

4. Continue to pressure your custodian to meet their best

execution obligations for you and your customers. The custodians need you more than you need them. Even if you have a smaller AUM, you can facilitate change and better pricing for yourself by pressing the issue.

These four steps will not only result in better trade executions for you, but will keep you from throwing away bps in trade execution and allow you to increase your annual performance without doing anything different than you are doing today. I wish you all the best of luck and hope to see and hear that many of you have implemented these steps to better trading.

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