Following our recent feature in IndexUniverse.eu, we explore the subject of ETF Market-making in greater depth with Laurent Kssis, Head of ETF trading and Advisory @ Bluefin Trading Tel +442075097059

IU.eu: Laurent, what is the role of the ETF market maker?
Kssis: His main responsibility, once heĉs signed a contract with the European stock exchanges, is to quote fair market bid and ask prices for the funds heĉs obliged to deal in.

IU.eu: Aren't these obligations with the European exchanges very broadly defined? In some cases the market maker can quote with a bid-offer spread of several percent and still be in compliance with the contract.
Kssis: They are broadly defined, but since there are typically several market makers involved with specific products, competition tends to drive spreads down to much lower levels. I
always tell retail investors who are interested in a particular ETF not to look at the quoted trading
volume, but to look at the number of market makers involved. Also, investors can look at the exchangesô
websites to get a feel for the trading liquidity. If you can see continuously-quoted bids to buy and sell
ETFs in round numbers, say in 10,000 shares, or 2,500 shares, thatĉs likely to be a market makerĉs
quote, and you know there is likely to be a fair market for that product.

IU.eu: But don't European exchanges typically insist on a minimum of one market maker for an ETF, and if there is just one wouldn't that affect the competitiveness of price quotes?
Kssis: That is true, although the exchanges and the ETF issuers have an interest in
more market makers becoming involved with particular funds, as that helps to improve the
efficiency of the secondary market, which will in turn attract more investors. But there have
undoubtedly been cases in the past where there was only one market maker involved with a particular ETF,
and where the ETF secondary market quote was, as a result, less competitive than the quotes for the
underlying securities. Investors can check the number of market makers for a given ETF on the
relevant exchange website, or on the issuerĉs website, or both.

IU.eu: What other functions does a market maker fulfil?
Kssis: The most important role the market maker has is in the creation and redemption process foran ETF. Most ETF investors have heard the terms ñcreationò and ñredemptionò, but
itĉs quite a complicated process, which involves trading a basket of securities, putting up
collateral, and a large amount of leverage from the point of view of the market maker. The creation or

redemption is timed to coincide with the index providerĝs calculation point, which is usually at the
end of the day, but can be at any time. Most investors, though, donĝt need to concern themselves with this actual process too
much.

IU.eu: How many ways of trading an ETF in the secondary market are there?
Kssis: I would say there are five main ones that investors should be aware of. The first way is the standard method of trading on-exchange. Here, you pay the quoted screen prices, including the bid-offer spread. For smaller, retail investors, this is typically the only method you are likely to use. The second way is more used by institutions, and is a so-called risk trade. The
investor goes to a market counterparty and says, for example, ñWhatĝs your bid-offer price in ú5 million
of the MSCI World ETF?ò The market maker gives bid and offer prices, the investor decides
whether or not to trade, and if a transaction takes place the investor knows that heĝs fully transferred the
risk or exposure to the market maker, and there can be no price slippage. The institutional
investor will also often choose this method as the bid-offer spread is likely to be tighter than if he
trades at quoted screen prices. The reason for this is that, since market makers are obliged to
maintain live two-way quotes on several exchanges in the same ETF, they will often quote a
slightly wider bid offer spread to protect themselves against the risk of being ñhitò on several dealing systems simultaneously. If you call the market maker up, you are quite likely to get a more
competitive price. The third option is to work an order, particularly if you are dealing in large size. You
might split a large transaction into smaller lots and try to execute it over a period of time,
particularly if you are expecting a market movement, say around the time of some economic release, and
you want to stagger your purchase or sale.
The fourth option, which has become less popular than it used to be, is to trade at the closing stock exchange auction. A lot of passive fund managers have their performance
benchmarked to the closing market price, and so they have an incentive to trade in this way. Although
there is typically extra liquidity in the underlying stocks at the closing auction, there may not be the
same liquidity in the ETFs, so you need to coordinate this with a market maker if you are planning to
do it, since otherwise you may find your order doesnĝt get fully executed.
The fifth and most popular method for institutional investors is to trade at the net asset value, which removes the bid-offer spread, although you have to pay the ETF providerĝs creation or

redemption costs. This is not the same as trading at the closing auction, since at the auction an
ETF might well end up at a premium or discount to NAV.
For institutions, there is also a trade that can take place throughout the day, called exchange for physical, where you can exchange a basket of stocks for an ETF. This is a so-called
ñbasis tradeò, where a basis or spread between the ETF and the basket of stocks will be priced by
the market maker, and usually the execution will be agreed by both parties to take place at a
given time of day.

IU.eu: How does the market maker then create a price in the ETFs he is quoting on a continuous basis?
Kssis: The market maker will start by calculating the net asset value of the ETF, that is, the value of the underlying basket of stocks. If the underlying market is closed we look at the
futures market, or we can use our own correlation models, to set an ETF price. Our quote will also
reflect any creation or redemption fees that the ETF issuer charges. We also typically quote without
specifying where in Europe the ETF will actually be delivered ï that is, in which depositary system ï and
the investor can choose that himself. If you trade using screen prices for a given ETF you often find
that the most attractive quotes may be split across several countries and you may have to deliver or receive executed ETF orders within different depositary systems.
IU.eu: How do you hedge yourselves if youôve completed a transaction in an ETF and end up with a long or short position that you need to cover?
Kssis: We use sector products such as swaps, futures on country indices, and individual stocks, to do this. Each market maker will have its own team of quantitative analysts, which
calculates the fair value of the ETFs it offers two-way prices in, and also the best ways of hedging.
Different market makers wonôt necessarily agree on the same fair value for a given ETF, by the way.

IU.eu: What, then, are the most important things that a European ETF investor should know about secondary market trading?
Kssis: The investor should be aware that quoted stock exchange trading volumes do not necessarily reflect true trading activity or secondary market liquidity, he should check how many
market makers are involved with a particular fund to ensure that secondary market quotes are
competitive, and he should be aware of the many different ways of placing a secondary market trade, in
order to get the right kind of execution for his requirements.