Riding the ETF wave in Asia Pacific: How to unlock alpha

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The appetite for exchange-traded funds (ETFs) within Asia Pacific is surging, with ETF volumes for the region reaching nearly $4.6 trillion in 2023, up from $1.1 trillion in 2020[1]. There are good reasons for this growth. ETFs provide exposure to a wide range of assets, helping investors diversify their portfolios. The versatility of ETFs also means they can be used to support different investment strategies.

To seize the benefits that ETFs provide, it's important to understand how their use is evolving, how to access liquidity, and how to efficiently execute trades.

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ETFs – not just for passive investment

ETFs have traditionally been viewed as a passive investment option, and they remain effective as part of a long-term investment strategy. However, ETFs also support several tactical, short-term strategies.

If an investor or trader takes a micro view of a particular market and decides to increase their allocation in this area, they can do so relatively quickly with an ETF as opposed to buying a basket of stocks and bonds. ETFs can also be used for cash equitisation when switching investment options or other situations when investors need to manage a temporary cash position.

Risk management is another tactical use of ETFs. For example, investors may use ETFs to diversify their portfolios or short-sell them to hedge against potential losses in their long-term portfolios.

With these use cases, traders need access to the best liquidity and to execute quickly at the best possible price.

The advantages of electronic trading

ETFs can be traded in three ways. The most obvious one is on-exchange transactions given that ETFs are listed. However, there are some limitations to this approach. ETFs are typically denominated in more than one currency and listed on multiple exchanges, resulting in liquidity fragmentation on exchange. Asian ETF markets are also highly fragmented, forcing investors to navigate a degree of complexity. Access to liquidity is, at times, a challenge.

The second way to trade ETFs is through a creation and redemption process. This approach is quite manual in nature, making it slow and time consuming. It's also not necessarily the most price competitive approach.

The third, and highly efficient way to trade ETFs is electronically through a request-for-quote (RFQ). This allows investors and traders to execute large trades at competitive prices. It also provides access to greater liquidity and expands the range of ETFs that can be traded.

For example, when trading on-exchange, if a portfolio manager or trader requires higher volumes than what they see available on-screen, they may disregard usage of that particular ETF. In reality, though, the volumes they seek could be easily traded via a venue like Tradeweb.

RFQ protocol provides greater access to liquidity at competitive pricing

ETFs can be traded electronically via the request-for-quote (RFQ) protocol. This provides a single trading approach that uncovers an ETF's multiple layers of liquidity. The first layer is on-screen, the second layer is liquidity that market-makers are able to price but are not displaying, and the third is primary market liquidity.

With RFQ, traders can also submit price requests to multiple market-makers at once. These market-makers are then placed into a live price competition, with the trader able to select the best price and execute at speed.

By putting market-makers in competition with one another, there is noticeable price improvement. In fact, in European ETF trades on Tradeweb, we have seen average price improvement compared with on-exchange best bid-offer (BBO) of 2.2 basis points across the calendar year 2023.

Further, there is the ability to trade almost round-the-clock (23 hours) with electronic trading. Tradeweb has market-makers quoting during Asia Pacific hours, enabling the region's buy-side traders to act on news flow with immediacy.

Full automation offers even more efficiency and control

In Asia Pacific, we see that as traders explore moving away from voice and manual processes, full automation can be very valuable once they get comfortable with RFQ.

Tradeweb offers an automation solution for ETF trading which we call AiEX, or Automated Intelligent Execution. AiEX offers total control over every order, with Tradeweb working with clients to fine-tune pre-defined execution rules for a solution that is fully tailored to each trading strategy. What's more, there is almost zero technology build involved, allowing the leveraging of the existing FIX set-up for simple and rapid implementation.

How this works for the most prolific AiEX users on our ETF platform is that automation helps them manage a large quantity of orders on a straight-through-processing (STP) basis, while being able to access potential price improvement via an RFQ.

In European markets, transactions can be concluded in half a second using STP. While we have yet to reach that speed in Asia Pacific, electronic trading and STP can bring things down from days to minutes.

In addition, traders can access features like AiEX Time Release and put an order in the market when it's most beneficial or convenient for them.

Next steps: How to evolve ETF trading strategies and generate more alpha

To maximise the benefits of ETFs, portfolio managers and traders need to come together to discuss their strategies and methodologies. For example, many portfolio managers still place orders using the volume-weighted average price (VWAP) and time-weighted average price (TWAP) benchmarks. However, these benchmarks limit traders' ability to select the best execution method for ETF orders. They also introduce risk of information leakage as orders may need to be executed over a large number of hours or even days. Trading via RFQ, meanwhile, enables execution in minutes.

Another challenge that must be overcome is the entrenched view that ETFs should be treated as an equity and should never be used as part of a fixed income portfolio. However, fixed income ETFs have become quite efficient and can serve as effective building blocks for a fixed income portfolio.

It is also important to recognise the intersection between fixed income ETFs and the underlying credit markets which has had a positive impact on bond market liquidity. This, along with the rise of portfolio trading, makes trading on multi-asset platforms like Tradeweb even more beneficial for those seeking to evolve their ETF trading strategies and generate more alpha.

[1] Source: BlackRock, Markit, big xyt.