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WORKS

Liquid Alternative ETFs

CONSIDERATIONS FOR ALTERNATIVE ASSET MANAGERS

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Contents

Introduction

Canada's alternative mutual fund ("liquid alt") market has seen rapid growth since the new NI 81-102 rule hit the tape in January 2019. Hedge funds and asset managers are increasingly launching liquid alts as they offer asset managers more flexibility in deploying capital than traditional mutual funds. Liquid alts also allow for strategies to enhance portfolio diversification and potentially better optimize risk and return for investors.

Although investors have accepted the vehicle, investing more than $21 billion in approximately 150 funds[1], there still appears to be significant asset-gathering upside, as liquid alts represent only 1% of total mutual fund assets under management (AUM) of $1.88 trillion[2].

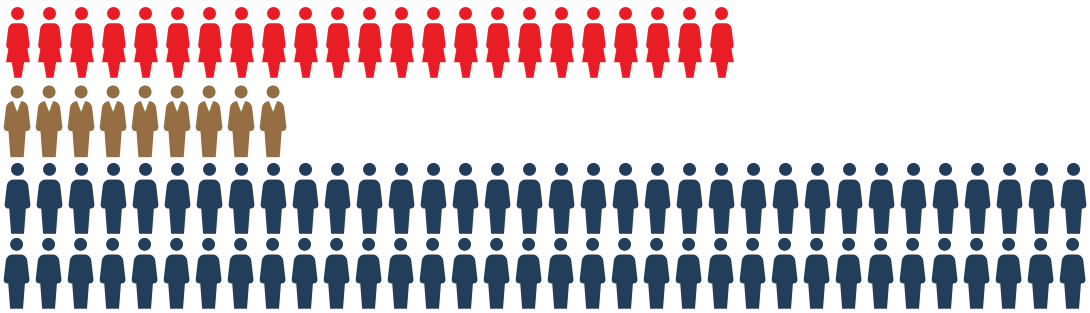
Alternative asset managers are also launching liquid alts in ETF structures. This is not surprising given ETFs' popularity with investors – ETF AUM in Canada have grown 201.3% (a 25% annual growth rate) over the past 5 years to $322.6 billion[3], well ahead of the mutual fund AUM growth of 53.6% (or at an 9% annual growth rate[4]).

This white paper discusses some of the key operational and investor considerations for Canadian asset managers interested in launching liquid alt ETFs.

[1] Source: Fundata via AIMA Canada as of September 30, 2021
[2] Source: IFIC as of August 31, 2021
[3] Source: as of August 31, 2021
[4] Source: IFIC as of July 31, 2021

Figure 1: Alternative Asset Managers in Canada

NUMBER OF FIRM PROVIDERS



SOURCE: Fundata via AIMA Canada as at June 30, 2021

Operational Considerations

MARKET MAKERS AND AUTHORIZED PARTICIPANTS

The biggest operational consideration for managers when launching a liquid alt ETF is the need to have third party market makers facilitate investor flows into a fund. These market makers are sometimes known as "authorized participants" or APs.

APs are dealers that have the ability to create and redeem shares of an ETF by transacting with ETF issuers. Market makers in liquid alts are typically APs, however, some APs may not routinely engage in day-to-day market making.

These intermediaries perform several core functions:

- Provide liquidity to investors
- Establish prices at which they are willing to buy and sell units of an ETF
- Engage in ETF creation and redemption
- Assume trading and market costs

Investor Liquidity

Market makers play a key role in intraday market liquidity and efficiency as they are the counterparty to investors going into and out of the ETF. Further, multiple market makers typically compete against each other – ensuring both marketplace resilience (the market isn't reliant on a single firm) and fairness (egregious pricing will be uncompetitive, and mispricing will be arbitraged out of existence). This helps create an efficient market.

Establishing Prices

Market makers establish the prices at which ETFs are traded on equity marketplaces by entering firm orders to buy and sell ETF shares. The bid-ask spread of an ETF reflects the bid-ask of its underlying assets, the risks and uncertainty of the market and underlying securities, as well as the costs of hedging and trading the ETF's basket.

To establish reliable and fair market prices, ETF market making desks rely on daily disclosure of an ETF's portfolio composition (supplied by the fund manager or their custodian) to accurately price the ETF's underlying securities. The daily portfolio composition file, sent at the end of every trading day (and occasionally intraday), is an important technology requirement for managers, and it is essential to fair pricing for investors. Without this, ETF desks would be unable to assess what an ETF is worth at any given time and would need to build in an additional risk premium to their quotes in the market.

The fund's underlying securities can also impact pricing. Certain liquid alternative funds - such as long/short equity - use derivatives to achieve their investment strategies, posing additional pricing constraints as derivatives are often difficult to price in real time. Since the price of the ETF reflects the market maker's best estimates of the prices of the underlying basket, difficult-to-value products in the basket hinder accurate pricing which may cause spreads to widen.

Finally, execution and hedging costs are also factored into bid-ask spreads. A wider spread generally reflects greater costs of execution for the market maker.

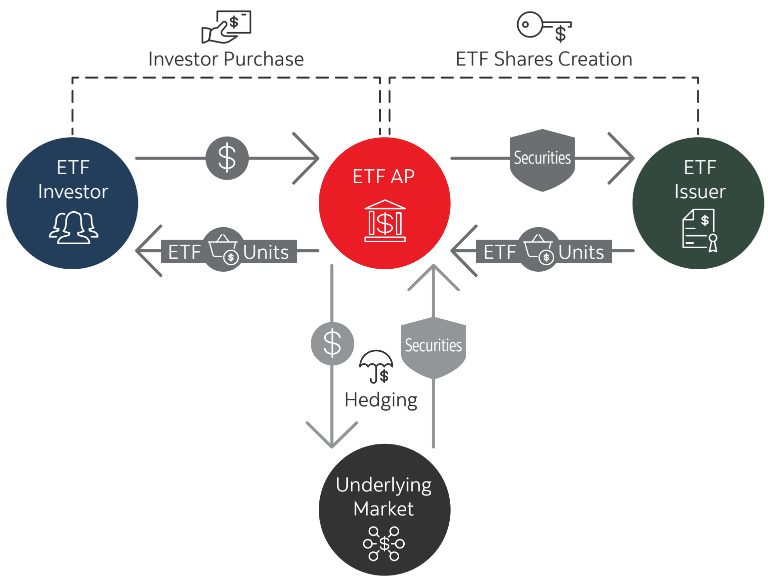
Creation and Redemption Process

APs and market makers are most frequently associated with the creation and redemption process. Units can be created "in kind," through "cash", or a combination of the two. The creation method chosen will impact the degree to which transaction costs are allocated to new or existing investors and the bid-ask spread.

Note: redemptions generally work the same way as creations, but in reverse.

Figure 2:
ETF "In Kind" Creation

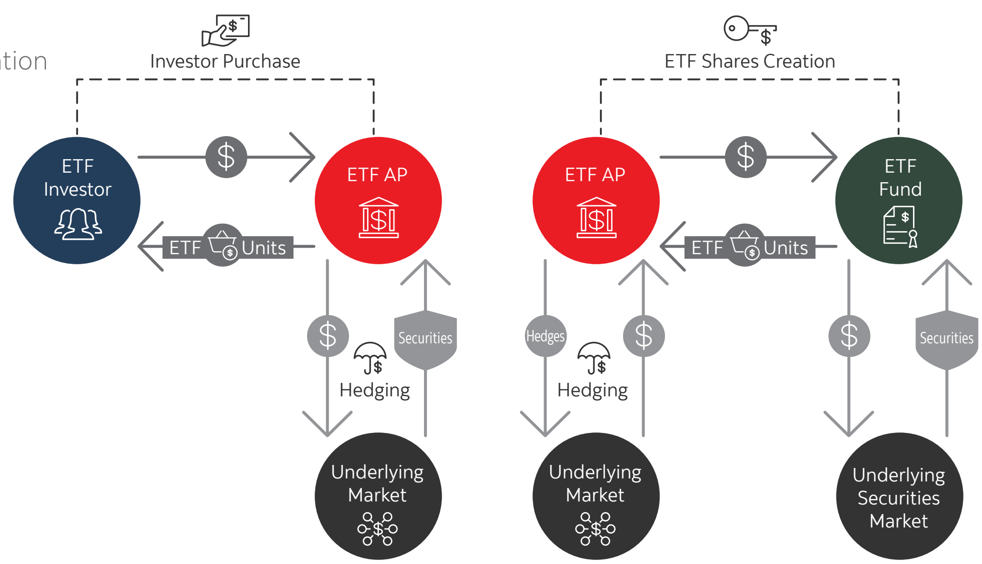
SOURCE: Scotiabank ETF Services



In a "cash creation" arrangement, the ETF functions similarly to a mutual fund: the fund manager issues new shares, receives cash, and then invests this cash in the fund's portfolio, bearing some market impact costs. However, ETF issuers are able to impose costs on the creation and redemption transaction that offset the market impact costs incurred at the fund level. This is a key distinction of the ETF structure, as traditional mutual funds cannot do this.

Figure 3:
ETF "Cash" Creation

SOURCE: Scotiabank ETF



Assuming Trading and Market Costs

When a mutual fund holds assets with large transaction costs, all investors in the fund pay, but in the ETF world, there is a way to make the investor who is causing those costs (with inflows and outflows) pay.

For fund managers, the ability to transfer market and trading costs to the market maker is a key and little-discussed benefit of the ETF structure, as this helps mitigate costs at the fund level. Ultimately, these costs are passed onto investors via the bid-ask spread, and are borne at the time of purchase or sale of the fund solely by the investor doing the trade.

LIQUID ALT ETF STRUCTURE AND SET-UP

The second main operational consideration for an asset manager is the liquid alt ETF structure and set-up. The most common structure is generally a standard tri-party arrangement with separate custodial and prime broker accounts. If a manager already has a relationship with a prime broker for a liquid alt fund, very little would change in the day-to-day relationship if launching a liquid alt ETF. Your prime broker would still act as an intermediary to provide securities lending, margin financing and centralized clearing. The custodian's role does not change either, they would continue to hold long assets and free cash.

For asset managers familiar with a traditional hedge fund arrangement, the tri-party set-up adds in a custodian, as well as operational steps for pledging and releasing collateral. Managers should get comfortable with managing these processes and understand specific margin requirements. It is also worthwhile to ensure that your prime broker has experience working with your custodian, to better ensure operational efficiency.

When selecting a custodian and prime broker for a liquid alt ETF, managers should consider

The service provider's knowledge and expertise with tri-party arrangements including margin, collateral and shorting	The integration of the service providers platform and how it supports a tri-party arrangement to ensure it fully satisfies operational efficiencies	Desired account structure and ability to leverage existing workflows	The custody services provided, including fund administration and accounting	The custodian's ability to provide ETF specific functionality, including generating portfolio composition files, handling creation and redemption mechanics, etc.

Investor Considerations

There are both advantages and disadvantages for investors when liquid alts are offered in ETF form.

ETF Adoption

ETFs have become a popular product with investors. In fact, there are Investment Advisors (IAs) that are orienting themselves as ETF-only, and the ETF structure is table stakes for accessing them. Further, some wealth management platforms have been encouraging the use of ETFs, and there are indications ETFs may become a preferred structure over mutual funds.

Relationship with Investors

In dealing directly with investors on transactions, market makers are, in effect, an outsourced third party managing a fund's interaction with investors. This puts an addition layer between the fund manager and investors, making it much more difficult, if not impossible, for asset managers to know the investor base of their ETF.

Increased Trading Flexibility, Lower Operational Intensity

One of the key advantages of liquid alt ETFs over liquid alt mutual funds is the ability to buy and sell across multiple accounts in bulk. IAs can place block orders for ETFs and allocate the trades across their accounts. Bulk trading and allocation is not possible for mutual funds, where individual orders are required for each account.

Trade Volume Considerations

A significant portion of ETFs have relatively low Average Daily Volume Traded (ADV). With liquid alt ETFs, as with any ETF, investors should evaluate liquidity considerations based on the liquidity of the underlying holdings. Thus, the ADV of an ETF holds less significance than the ADV of the underlying securities.

More importantly, asset managers working with a recognized AP can attain multiple layers of liquidity for an ETF. In addition to finding an offsetting order on the exchange, an investor's order can be met by an AP, who in turn creates or redeems the shares of an ETF for its constituent securities. In effect, the primary and secondary market work dynamically to fill investors' orders for ETFs.

Externalization of Fund Transaction Costs

With liquid alt mutual funds, investors buy and sell their units at the fund's net asset value (NAV), calculated after the close of the trading day. NAVs will include transactional costs over time for the fund to purchase and sell underlying securities as well as the costs of creating and redeeming units. All mutual fund unit holders share these costs daily, and the more transactions that take place, the higher these costs to the funds and existing investor.

This is in contrast to ETFs, where the costs of acquiring the portfolio can be passed on to the AP or market maker facilitating the investor trade in the first place. The market maker in turn passes along these costs to purchasers and sellers via the bid-ask spread. As a result, holders of ETF units only bear these costs when they buy and sell their unit. The more an investor transacts, the higher their share of transactional costs, leading to what can be described as a more equitable allocation of costs versus mutual funds.

Managers must carefully consider the investment strategy when determining whether to launch a liquid alt ETF. If a liquid alt ETF's underlying securities are easy to value with low trading costs, bid-ask spreads should be narrow, which are more suited to an ETF. Conversely, when the basket of underlying securities is difficult-to-value, or has higher execution costs, spreads can widen. Hence, this type of strategy may be best suited in an open-ended alternative mutual fund with a daily NAV. The size of the bid-ask spreads could impact how investors embrace and trade your product.

Closing thoughts

Investors have accepted liquid alternative products and increasingly these products are being offered in ETF form. Alternative asset managers should be aware of various operational and investor considerations before launching a liquid alt ETF. From an operational perspective, liquid alt ETFs add in the services of market makers, adding complexity to the structure, while also more equitably passing on costs to investors transacting, rather than holding the funds.

Alternative managers should understand that, from an investor perspective, ETFs are very popular, can be less operationally intensive to transact over multiple client accounts, and can provide lower frictional costs for long term holders. However, managers should also consider synergies between ETF market maker capabilities and fund strategy as, certain strategies may be better suited for a mutual fund structure.

For more information on alternative mutual funds, or liquid alt ETFs, please reach out to our Prime Services and ETF Services teams.

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