Trader Insights

Actionable Ideas for the Power to Optimize Your Trades

Tip #8: Can Trading More Passively Help You Find Liquidity?

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Mr Unterstein: Index Funds and retail investors have altered the landscape creating an overall shift toward passive trading. Over the last 11 years, more than $1.1 trillion has flowed into passive vehicles, including ETFs, compared to outflows of $1.5 trillion from actively managed vehicles. Total assets under management in these actively managed funds have grown at a compound rate of 6%, while passive net assets have grown in excess of 15%. In 2016, ETFs made up 30% of the volume traded in US equity markets, up vs. prior years. Due to the way passive vehicles rebalance and trade, we've seen a significant reduction in portfolio turnover, which explains the decline in overall trading volumes in U.S. equity markets. Market structure aside, this phenomenon may also continue to affect not only the way investors, specifically activist investors, behave, but the broader corporate governance landscape in the US as well.

So why is this important? The increase of passive flow continues to push trading volumes toward the end of the day and remove liquidity from small and mid cap names. That means if you're looking for a liquidity opportunity, it may be prudent to have less urgency throughout the day, and trade nearer the close.

In a slower market with less volume, greater concentration, reduced total market cap and lower volatility, being overly urgent may ultimately work against you — moving prices and increased information leakage. To minimize impact and potentially see narrower pricing, it's becoming increasingly important to trade more passively and allow for higher duration risk.

For other actionable ideas to help optimize execution across asset classes, check out the rest of our Trader Insights video series.