ETFs: THE INNOVATION OF INDEXING

iShares® by BlackRock

Audio Script

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Audio Script:

In this video we will be covering what an index is, and some of the different types of indexes. Then we'll examine the case for index investing, in particular, through the use of ETFs. Lastly, we will examine some of our index ETFs and the different approaches they take to achieve certain exposures as well as outcomes.

What is an index?

So what is an index?

An index is an indicator, or a measurement, of, well, anything. In investing, an index tracks the performance of a group of securities such as a group of stocks, or bonds. Investors use indexes though in numerous ways. Historically, they've been used to gauge the performance of a particular market or asset class. They are also often used to gauge performance, whether of your own personal account, or the performance of a third-party who is managing your money, maybe a mutual fund. Indexes are built in a standardized, rules-based way, with the objective of replicating the performance of a certain area of the market. An equity index, for example, groups together stocks with certain traits and takes some sort of average of their performance. This will provide an idea of how that particular market or industry is doing. Indexes come in all shapes and sizes, and although some might have the same ingredients, the recipes could be different. Why? Well just like people have differing tastes, investors have differing objectives. If you use the same ingredients, but put in different amounts, you can adjust the outcome in order to address those objectives.

All indexes have some rules or criteria to determine their "recipe". For example, an index that seeks to measure the performance of US large cap companies would only include those companies that are incorporated here in the US and are above a certain size. Companies that meet those requirements will be eligible for inclusion while those that do not, would be excluded. So looking at the grid on the right, Company A would be eligible for the index, but Company B would not, because it is a small, and not a large company. Company C would also be excluded. Although it is a large enough company, it's based in Canada and not the US.

Indexes are not new. But most investors are only familiar with a handful that they hear mentioned on the news. The Dow Jones Industrial Average, for example, is often the most referenced index, consisting of only 30 large cap US companies. The index chooses how much of each ingredient stock to add based on the price of the stock. But there's other indexes as well. Another commonly referenced index is the S&P 500, which consists of over 500 large US companies. The recipe for that index adds stocks based not by the price of the stock, but rather the size of the company, with a larger company having a higher percentage weight than a smaller company. But indexes can get more granular, with one index commonly used as a reference for the US Tech sector being the Nasdaq 100.

Indexing, though, is not just used in US markets. The MSCI EAFE index consists of large and mid-cap companies based in developed countries like in Europe, Australasia, and Japan as well. Indexing is used in other asset classes too, not just equity. The most well-known bond index, for example, is the Bloomberg Barclays US Aggregate Index, commonly referred to as "the AGG". It consists of US denominated investment grade bonds, made up primarily of bonds issued by the US government, as well as corporate issuers.

But indexing has evolved beyond these well-known, traditional approaches. Big data coupled with technological advances, have allowed indexing to delve into more precise and targeted exposures. One such index is the NYSE Global Autonomous Driving & Electric Vehicle Index, quite the mouthful. That index goes beyond just holding companies that make cars. Now we're going to talk a little bit about that index a little later.

Index and ETF investing

Although some indexes have been around for 100 years, index investing is much younger.

"Indexing" is a style of investing. Instead of an investor picking which stocks to own and when to buy or sell them, the investor builds a portfolio holding the securities of a particular index. The idea is that by investing in the constituents of the index, the investor will match its performance as well.

But this can be challenging for investors to implement on their own. For example, let's say an investor wanted to create a portfolio that included all the stocks in the S&P 500 at their respective weights. They would need to acquire the list of stocks, and then purchase all of them at those proper proportions, which means making over 500 purchases. And you're not done there. Sometimes those constituents change, which is called a rebalance or reconstitution, and so you might need to sell a company that is no longer in the index and purchase one that was added. This all assumes that the investor even has enough money to effectively buy all 500 companies.

Well index funds do all of this work for you. Index funds are simple, low-cost ways to gain exposure to markets. They're most commonly available as mutual funds and exchange traded funds (or ETFs). You can buy an index ETF like our IVV, which follows the recipe for the S&P 500, owning all the sectors and stocks at the same weight as the index.

Index ETFs have revolutionized how investors access these asset classes.

So let's take a closer look at what an ETF is. ETF stands for exchange traded fund, and they offer many of the same benefits of mutual funds: they are portfolios managed by investment professionals who have resources at their disposal that most investors don't. But unlike a mutual fund, they can be bought or sold at any time during the trading day. And where most mutual funds are actively managed, most ETFs track an index.

When we ask our customers what they like about our iShares ETFs, we typically get one of three responses. First, ETFs provide diversification, providing access to potentially hundreds of securities, even thousands, in one purchase. They also provide transparency. Well what do I mean by that? Well, most ETFs track an index, which means for any security whether a stock or bond, to be held within the ETF, it must be part of that index's recipe. The benefit of this to you, the investor, is that you know what it's going to hold, and also what it's not going to hold. In fact, you can go to iShares.com, type in the ticker of any of our over 380 funds, and find out as of this morning, what securities it owns. Knowing what it owns, allows investors insight into what risks they're taking.

ETFs provide this diversification and transparency at a fraction of the cost of mutual funds, with the fee of the average ETF being about 1/3 that of an active mutual fund.

And lastly, for taxable investors, ETFs are more tax efficient. ETFs are less likely to distribute a capital gain, which means you are less likely to have to pay a capital gain tax while still holding the fund. This is often an overlooked component of the investment selection process.

It's for these reasons that ETF adoption has been nothing short of exponential. The first stock ETF was launched in 1993. But, as mentioned, ETFs are not just used for equity exposure, and the first bond ETF was launched in 2002. Now, institutional investors may have been the first adopters of ETFs, but retail investors quickly followed suit, thanks to the low cost, diversification and simplicity they offer. Although it took 16 years to reach the 1 trillion dollars in ETF assets, it only took 4 more to reach the second trillion, and 3 for the third, and so on and so forth. ETFs closed out 2020 with 7.8 trillion dollars in global assets, with the bulk of that, about 5.4 trillion, in US ETFs.

ETFs Today

So now that we've covered indexes and accessing them through an ETF, let's take a closer look at the different assets and approaches to index investing through ETFs.

Early indexes and index ETFs were primarily focused on providing exposure to large groups of stocks. These products sliced up the stock market by the size of the companies, large, mid, or small. Other ETFs might

focus on providing exposure to specific asset classes, like bonds. But indexes are not one size fits all. Many investors have more specific objectives in mind, like income. There are a number of ETFs that will therefore look at specific attributes of a company, like whether or not it pays a dividend. But index ETFs have evolved to target not just specific asset classes, but attributes or themes as well, like clean energy, or driverless cars.

Let's start by taking a closer look at some broad-based index ETFs. IVV tracks the S&P 500, which is a market cap weighted index of 500 large cap US companies. Because it is market-cap weighted, the recipe calls for larger companies to make up a higher percentage than smaller companies. Many of the names held within IVV are familiar to most people, like Apple and Amazon.

IJR, on the other hand, tracks the S&P small cap 600. The recipe for that index calls for exposure to much smaller companies than you would find in IVV. Small cap stocks tend to be riskier than larger companies, but they could provide more growth potential. Now because of the way S&P builds their indexes, a company would not be found in more than one size bucket.

Indexing and ETFs are not specific to equities. Bond ETFs are increasingly being used by investors as well. But the way bond indexes slice up the market is different. Rather than by the size of the issuer, like with stocks, they tend to be broken down by credit risk. AGG, for example, tracks an index comprised of all investment grade bonds. These are bonds issued by companies that credit rating agencies view as having low chance of defaulting on their debt. It consists mostly of bonds issued by the US government, as well as corporations.

Another product, HYG, tracks an index that is comprised of riskier bonds that are not investment grade. This means the credit rating agencies view these issuers as having a higher risk of default than investment grade bonds. Because they are riskier though, they tend to provide higher yields.

The previous ETFs target specific exposures in differing ways, but some ETFs target a combination of exposures and securities with specific attributes. Many investors have very specific objectives in mind, and one such is generating income. One fund that can help address that is D. G. R. O. or DGRO, which is our iShares Core Dividend Growth ETF. The methodology tries to narrow down the list of ingredients. Only those US stocks that have a 5-year track record of growing their dividends are eligible to be included, along with some additional criteria.

But maybe DGRO just isn't generating enough income for you. Well, we also have HDV, our High Dividend ETF. The index HDV tracks examines a company's strengths to identify those that have a better chance of fending off their competitors, and therefore sustaining those dividends. One such company is Coca Cola, which has a strong brand name that competitors just can't easily replicate. It's that brand that is why we so often pay more for Coca-Cola at the store, than the store brand that is right next to it on the shelf.

But stock attributes go beyond dividends and other fundamental characteristics. Some of our newest ETFs track indexes that are targeting specific innovations or trends. But choosing which company is going to be the chief beneficiary of a particular idea can be very difficult. You can go broad, with a broad index ETF, but that might water down exposure and conviction with this idea. Our Megatrend index ETFs, though, allow you to target high-conviction trends without going too broad.

Sometimes companies that benefit from a trend are not associated at all with a particular idea or technology. Take self-driving and electric vehicles for example. We have an ETF, iDrive, IDRV, which tracks an Autonomous Driving and Electric Vehicle Index. Tesla is the first company most investors think of when they think about electric vehicles. But Tesla, and other EV manufacturers are reliant on other companies as well. For example, EVs need charging stations, which a company named ABB is involved in manufacturing. They also need batteries, which LG Chemical is involved in the manufacture of…. and those batteries, well they need lithium, which Albemarle produces. We employ a similar approach with our clean energy ETF, ICLN, which finds companies that build the equipment needed to generate clean energy, and not just clean energy providers.

So to recap, "indexing" is a style of investing. Instead of an investor picking which stocks to own and when to buy or sell them, the investor builds a portfolio holding the securities of an index based on that index's recipe. But this can be challenging for investors to implement on their own. iShares index ETFs can help you in that regard. They provide competitive performance at a fraction of the cost of many other investment options, and are more tax efficient than traditional mutual funds.

An investor can get exposure to potentially hundreds of securities in an index with the purchase of just one index ETF. And indexing has evolved so that investors can find an ETF for not just a particular exposure, but also a specific objective or trend. For these reasons, index ETFs have revolutionized how investors access markets build portfolios, and achieve outcomes.

Thanks for watching.

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