TRANSCRIPT

ETF deep dive: What they are and how they work

Presenters: Steven Travali and Kristy Akullian

STEVEN TRAVALI: Thank you for joining both in person, and we have an online audience as well. My name is Steven Travali. I'm the regional brokerage consultant here in southern California. I work with clients, educating them on the tools and resources available to them on our website through mobile, Active Trader Pro, all the tools and suites available through Fidelity. For those of you online, there are regional brokerage consultants across the country. So, if you're interested in a consultation or speaking with any one of us, please contact your branch.

So, without further ado, I'm going to start to get this kicked off. I want to kick it off and introduce Kristy, who's going to tell you a little bit about herself. And I'll let her get right into the material from here.

KRISTY AKULLIAN: Perfect. Thanks, Steve. My name is Kristy Akullian. And I'm an iShares investment strategist. So, I'm with iShares, which is part of BlackRock. And I'm going to tell you today about what an ETF is. So, I'll also caveat that this is my first in-person presentation in about 2 and 1/2 years. So, if I'm a little bit rusty, bear with me. I was talking to my colleague over here just before I took the stage. And I said that my most important goals today is that everybody can walk away from the session and say what an ETF is, and also that I didn't trip coming on or off stage.

So, we're starting out in a pretty strong spot. I'm pretty sure we'll get to the second one too. So general sort of lack of coordination issues aside, I would just say I'm really excited to be here today to talk about something that's so close to home for me. So, I have spent the last 11 years of my careers specifically focusing on ETFs. So, I've worked in areas of how they're built, how they work, how they trade. And then really the most important thing is how investors can use them as tools to build better financial futures.

We're going to start with the basics today. We're going to answer the questions of, what is an ETF? So, I promise we will get there. And we're going to go through some of the specific ETF use cases. And then we're going to see how really investors are using these to enhance their portfolio. And then we're going to end with some of the potential specific advantages that you get in an ETF that you don't necessarily get in other fund structures.

So, you can choose the tool that's best suited for your investment needs. So first, and most literally, as I promised, what is an ETF? I'll start by defining it. An ETF stands for an Exchange Traded Funds. The exchange traded part because it takes on all of the characteristics really of a common stock. So, it can be bought or sold any time that the market is open. And you can trade it through your Fidelity account just like you would an Apple, for example. The fund part is because you get so much more than just a single company with that trade.

So, like a mutual fund, ETFs give you diversification by offering exposure to dozens, or sometimes even thousands, of stocks or bonds in one single ticker. So, the result really is a professionally managed, diversified fund that's easily tradable, it's tax efficient, and it's often at a pretty low cost as well. So, we'll dig into some of that and more on some of the slides ahead. So, I know I started by literally defining an ETF as an exchange traded fund. I'll say it again.

But I actually want to step back for just a second here on this slide because I want to make a claim that an ETF is actually bigger than that. It's more than just kind of a mashup of two different investment products. It's kind of more than the sum of its parts. So really, the way that we think about ETFs now is that they've really become a technology. So, it's one that's used by nearly every different player in the investing landscape. And we'll go into some more detail about who those people are and what types of investors use ETFs on the next slide.

But I actually like to say that the invention in the history of ETFs is actually a story in three parts. So first is that regulation in the US has evolved since the first mutual fund was launched in 1924. So, all of those lessons that we learned from the Great Depression, those were applied to laws to make investing safer for the public. But they also paved the way for new fund types to be launched as well. Second, in terms of this kind of history of how we've gotten to ETFs, index investing has really changed the investing landscape.

So, since the first index fund was launched in 1971, we've really seen this profound shift in investor behavior. So, moving away just from actively managed strategies, which may be more expensive from a management perspective, into lower cost index vehicles. And then finally, those things paved the way in 1993 for the first ETF to be launched.

So really, the ETF was capitalizing on both of those changes that had happened over the previous decades. So, you can think about the more modern regulatory structure that came into effect, and then also this increased demand for index investing as well. So, let's see here. As you can see on this slide here, ETFs have really grown exponentially in the more than 25 years since they were first launched.

Along the way, I would make the case that they've really revolutionized the way that individual investors, and also financial advisors, thinking -- think about building portfolios for retirement specifically, which is probably why many of you are here today.

Over time, and as we've seen the technology advance, these have really become tools not just for individual investors but for institutions as well. So, a couple examples quickly. Today, we see pension funds and we see insurance companies. They use ETFs in place of when they would have used derivatives in the past. So, things like total return swaps and futures. Even hedge funds use ETFs. They use that as a way to manage their risk often by taking the short side of ETFs.

And the reason that I mentioned that is because the result of so many different types of investors trading and transacting in the same vehicle has really created a virtuous feedback loop. So, it adds kind of economies of scale. And it brings down the cost for everybody. So, it means really that individual investors now have access to the same market quality and the same trading tools that much larger institutional investors have only had in the past. And also, because ETFs don't have different share classes, like mutual funds do, it means that everybody pays the same price, which is pretty revolutionary in the financial markets.

So, because the history of ETFs is really so intertwined with the history of index investing, I want to spend just a few minutes really talking through what an index is, and how they work. So, an index is a rules-based prescriptive, and this is really important, unemotional approach to investing, that removes the need to make specific decisions. It does-- so you don't have to stock pick. And you also don't have to time the market. So, indexes are often managed by third-party index providers.

So those are separate from fund companies like iShares, or from brokerage firms like Fidelity. And the goal of an index really is to represent the returns of a whole market by incorporating all of the different companies that make it up. And the goal of index investing is to deliver the returns of that benchmark index by buying all of the securities that may be included in it. So, index investing, again, it doesn't worry about stock picking. It just buys kind of the whole market.

So the easiest way, as you can see on the slide, that we think about conceptualizing of an index is to think of it like a recipe. So, the index instructions of the recipe, it contains details on what securities should be added, and which things should be excluded. And it also dictates the weight that each stock or bond should make up within an index. And then really importantly, it also describes how that should change over time. So, it's an incredibly important, but it's also often overlooked feature of indexes is that they evolve.

So, slide eight here. We're going to look at an example of an index methodology. I would say that this is a pretty simple one. It's definitely easier than the pie you saw in the last slide. This is really looking at just an example of a US large cap index. So, you can think of this as being something similar to the S&P 500, for example.

You can see that from this list, really only stock A and stock D would be included in this large cap US index. Stocks that are too small or that aren't based in the US, they wouldn't actually be eligible for this one. But I would say that the role of an index, it doesn't end there. Because the price of stock A and stock D might go in different directions, or stock A may go up a lot more than stock D, I think that it's really important to know that indexes go through a continuous realignment process.

So, those are needed to make sure that one company, or one stock, doesn't get too big or too small within an index. So, the indexes, they're recipes, if you will. They're always changing. And that's what's called index rebalancing or reconstituting. And those typically happen on a quarterly, or a semi-annual, or an annual basis. So that means that indexes are continuously adding new stocks or bonds that become eligible. So, IPOs, for example, will be included as those change over time.

And then they're removing the ones that are no longer eligible. So, there is this misnomer in index investing that I will address here is that they're sometimes referred to as passive. But as we just talked about, there's so much change and evolution that's happening in an index at all times. It's sort of this living, breathing instruction manual. So, it's always evolving with the market. So, we like to say that index investing is really anything but passive.

So, a couple of examples. Many of us are usually familiar with a handful of really well-known indexes. Some examples that you may know from the screen here are the Dow Jones Industrial Average. So that's going to be a really small select concentrated group of just the largest stocks in the economy. If you look at the S&P 500, that's a broader more diversified basket, but still just big companies. And then the NASDAQ 100 is primarily just tech stocks. You may see that as a shorthand for tech and how tech is doing.

But there's a lot of indices that you may not know about as well. So, some of those can be really incredibly broad like the MSCI EFA index, which is an index of international stocks. And then something that can be really targeted and specific, like the Global Autonomous Driving and Electric Vehicle Index, which I like to joke is luckily easier to invest in than it is to say. Because that is a mouthful.

So, OK. I warned you that this is called the ETF deep dive. I will say that we have reached the deep part of this presentation. So, I'll ask that you bear with me here for a couple technical slides. And I promise I'll bring it all home at the end. So, you probably did not wake up today and think that you were going to learn about ETF market structure. So, I will keep it nice and short. But really, I think that I needed to include some of this because the way that ETFs change hands, and how they're created, is so important in understanding why they're tax efficient.

So again, if we can get through this part that's just kind of technical around sort of the plumbing in the infrastructure of how ETFs work, we'll transition into how they're used. And I think it'll make a lot more sense. So, the first thing to know from the slide here is that there can be as many as four different players involved in ETF trading.

There are buyers, there are sellers, there are ETF providers, and there are brokers. But really importantly, not all trades are going to require all of those market participants. So, let's start just at the top here, which is where really most of ETF trading happens. About 80% of all ETF trading happens just between buyers and sellers. So exactly like with stocks, existing shares of an ETF are traded between a buyer and a seller with a broker facilitating that trade in the middle.

So, if today, you were to log into your Fidelity account to buy shares of IVV, as an example, which is the iShares S&P 500 ETF, you would almost certainly be receiving shares of that fund that already exists. Because as of last night, there were 736 million of them outstanding. But what happens when there are more people who want to buy an ETF than there are people who want to sell?

So, this example is what we've modeled on this slide. So, there are more buyers than there are sellers. So, this is really when that second layer of liquidity comes into, which is what's labeled as underlying securities on this slide. And this is also where that fourth market participant gets involved as well. So, whenever a broker accepts an order from an investor who wants to buy an ETF, they actually have two options for how to satisfy that. The first one is the easy one, which we see on top, which is they can just go out and buy existing shares from sellers.

But when buyers outweigh the sellers here, as they do in this example, and there aren't really enough shares available, the other option that a broker has is actually to go out and create entirely new shares. So, to do that, the broker will go into the market, and they'll buy all of the underlying securities. So, in this example, they'll buy Apple, and Johnson & Johnson, they'll buy Berkshire Hathaway, and then the 497 other stocks that make up the S&P 500.

Once they have that, they'll deliver that basket to iShares, the ETF provider. And in exchange, iShares gives the broker new shares of IVV, the ETF, so the broker can fulfill their client trade. So, I think that this graphic makes it look a little bit complicated. But the concept is actually fairly straightforward. And in practice, you should know that this happens every single day.

New shares of ETFs are created and redeemed based upon if clients want to buy or sell them. The creation and redemption process, as it's called, or if you actually want to get very technical, the in-kind creation and redemption process, is really one of the key things that makes ETFs different for mutual funds. So, here's why. In a mutual fund, new units are purchased in cash directly from the fund company. The mutual fund manager, they take that cash, and then they go buy all of the securities within the fund any time somebody wants to come in or out.

So that creates capital gains and capital losses happening inside the fund. That's not the case for ETFs though, where nearly all of this trading, either of existing shares of the ETF between the buyers and sellers, or the shares that are traded in the underlying if new shares need to be created or redeemed, all of that trading happens outside of the ETF. This is almost the ETF's superpower if you will. So, it comes with two benefits for investors. First, what it really means is that every investor in an ETF pays their own way in and out.

So, transaction costs don't get mutualized within the fund like they do in a mutual fund. And then second, and this is the most important part, is that investors can enter, or they can exit the fund without triggering capital gains. So, the fund itself is really protected from the trading that happens whenever ownership changes hands. So, whenever a new investor wants to come in, or an old investor wants to leave. The always follow up question that I get whenever I talk through this, the next question, which I will address here, is that, no. ETFs absolutely do not mean that you get out of paying capital gains taxes.

I'll preempt that one. But what it does mean is that you have much more control over when you want to realize those taxes as opposed to being subject to when somebody else wants to buy or sell. So, with that, I will say, you survived the most complicated technical part of this conversation. So good job, everybody. I think we can move into one that is a little bit more fun, and it's applicable, I think, for everybody.

So now that you probably have a little bit better idea for how ETFs work, what makes them different from other fund types, let's talk about how people use them. OK, so if you think about a pyramid of ETF use cases, broad market exposure funds like these ones are going to be sort of that foundational level at the bottom. Funds like IVV, which we've talked about, and AGG. These can both give you exposure to really broad swaths of the market.

So lots and lots of stocks, lots and lots of bonds, all in a single fund. It's usually low cost as well. So, funds like this make up really the base, the building block, of most people's portfolios, my own included I should say.

So, you can really be price sensitive in these ones, I think. So, moving kind of beyond the basic building block here, I would say that ETFs can also be used to target a really specific outcome. So, for example, meeting income needs in retirement is a really common one that we talk about with clients. So, on this slide, we have examples of two income generating funds, one that's a bond fund, and one that's a stock. So, on the bond side, USIG, which is the US broad investment grade corporate bond ETF, sometimes these are a mouthful. I apologize.

What really get access to here is a diversified basket and a diversified exposure of hundreds, sometimes thousands, of really high-quality bonds. So, what happens is that the coupon payments for those bonds go into the ETF. And they're distributed to ETF holders in the form of a monthly dividend. So, you'll actually be getting money from that every month. Stock funds can also be used to generate income. Excuse me.

One example that we have here is the iShares core high dividend ETF. So, this looks for companies that have really strong fundamentals, but also really high dividend yields. So just like those bond coupon payments are collected in the ETF and then distributed back out to ETF holders, the same thing happens with dividends.

So, this can be another way to just diversify sources of incomes. And I would say too, just in sort of a of the moment note here, that this is a really timely example. HDV in particular is a fund that we're talking about with lots of different investor types just given the incredibly uncertain market environment that we're in. So, investors who are concerned with slowing growth or even with the potential for a recession are looking at funds like this one as a way to add a little bit of defensiveness and resilience into a portfolio.

So, it's just one thing that I would call out that's really kind of of the world that we're living in today. So that was a bit more of a defensive example. But I also want to talk about how iShares, and ETFs in particular, sorry, can be used to capture opportunity. So even in sort of new and emerging technologies, like self-driving cars that we have here, and clean energy, are really just two examples.

So, these are both funds that we call megatrends at iShares. You can think of these as kind of plays for the future. These funds tend to be a little bit more concentrated than the core kind of broad-based funds that I talked about earlier. So, they typically make up a smaller portion of your overall portfolio. And my colleague Jay Jacobs is here. He is the expert on megatrends. So, he's going to cover these funds in this exact suite in a lot more detail in the next session. So, I'll just use this as sort of a placeholder, or a teaser. And I will try not to steal his thunder on this one.

Another way that I think ETFs can be used to really customize a portfolio to your individual goals is to include either ESG or sustainable funds within your portfolio. So, our approach to ESG investing, it gives you a menu of different ways where you can incorporate sustainability into your personal goals if you wish. So, there are really broad building block funds, like we talked about earlier, that have more of an ESG tilt.

So, these are funds that are identifying companies within each sector that have the strongest ESG scores. So that's part of our ESG aware suite. There's also more targeted exposures. So, if you want to look at something like USXF here, this is an example of the iShares ESG advanced suite. So, this is for the type of investors with the highest conviction in these types of funds. And then finally, there are thematic sustainable funds as well, like ICLN, which is our global clean energy fund.

So, all of that is to say that if sustainability is something that's important to you, there are many ways that you can actually match your conviction with sort of your portfolio construction, as well. And then kind of the last thing that I'll say about this particular use case is that while it's not necessarily the largest ETF use case, it is one of the fastest growing. So, we're starting to see more and more investors really think about long term risks, and also the opportunities that maybe aren't quite as appreciated by the market just yet.

Oh, sorry. That's a good one too. Environmental, social, and governance. So, thinking about things from that perspective rather than just a market cap weighted, for example. Yeah. I explained ETFs. I should have explained ESG as well. The final use case that you're going to see here today is also the easiest one. So, I always like to end on kind of a nice note with that one. This is also one that I use myself too. So, investors who are really looking for something that's more like a one stop shop, you might want to consider an asset allocation ETF.

So, when I'm talking to clients, just as often as I get asked sort of which stocks or bonds should I be buying right now, I get asked the question, how many stocks should I hold relative to bonds in my portfolio? What should that makeup look like? So, asset allocations actually answer that question for you by defining what your risk tolerance is. And then really importantly, they maintain that asset allocation over time with a regular rebalancing schedule.

So, without the discipline that comes with regular rebalancing, it's possible for portfolios to get really out of whack. So, if you're not trading to maintain those weights, it's possible that you have a much larger allocation to stocks or bonds than you intended. So, buying a fund like this means they're always brought back into alignment, so you don't have to think about it. You don't have to trade them all the time.

So, asset allocations really do that automatically. They can be a very good option for an investor who wants sort of a low touch, set it, and forget it, kind of a outlook for their portfolio. So, investors with a lower risk tolerance, or maybe who are closer to retirement age, for example, they might consider a conservative asset allocation fund. So that would be something that has about a 70% allocation to bonds and a 30% allocation to stocks.

But investors who have a higher risk tolerance, so they have more stomach for some of the volatility, or the near-term changes in prices, and they maybe have a longer investment horizon, they would also maybe consider something like an aggressive asset allocation. So that's as much as 80% in stocks and just 20% in bonds.

And then also, the last thing I'll note about these ones is that you'll see at the bottom here that depending on which flavor makes most sense for you and your portfolio, there's also a sustainable version of each of these. So, it's possible to choose your risk tolerance and also your sustainable goals and solve that in one tick or two.

So, the very last section that we have on this deep dive today are going to be some of the specific advantages that you get from using an ETF. So specifically, we'll cover diversification, we'll cover low cost, and then tax efficiency. And hopefully, none of these will come as a major surprise since I know we've touched on all of them already this morning.

But I think it really brings these concepts to life a lot more to show you some specific examples and to give you some hard numbers behind these too. So, the first benefit of ETFs, excuse me, is just the simplicity with which you can get really broad diversification either across or within asset classes. So, diversification is incredibly important. It's important in minimizing what we call idiosyncratic risk, which sounds big and scary but really just means the risk that a single stock may go down, or the risk that a single company might fail.

So, I think this is an incredible example of the importance of diversification. So, what we're looking at here is in 2021 when the S&P 500 index was up by 29%, so an incredible year for stocks, more than a third of all stocks in the US lost money. It's really the power of diversification that means that mutual funds and ETFs did so much better. Only 2% of funds lost money when 36% of stocks did. So, I think that really highlights and exemplifies the importance of diversification in an up year.

It's even more important in down years like we're having right now. And then, let's see here on the next slide. So, while both mutual funds and ETFs benefit from diversification, you'll often find here that when we get to cost, it's that ETFs really do have the edge. So, we're going to look at some examples here. If we look at the average net expense ratio[1], ETFs are in black on the screen.

And mutual funds are in white. You'll see that in the largest categories in stocks and bonds, which is where most people hold most of their money, the average annual fee of an ETF is less than half the average annual fee of the mutual fund.

So, it's really important, because keeping those costs low lets you keep more of what you earn, which is a benefit that really compounds over time. And it can have a huge impact on achieving your investing goals. And then lastly, this one should not be a surprise, I would say this is kind of the punch line, if you will, to the creation and the redemption, those technical slides I made you sit through earlier. And that is that ETFs are more tax efficient.

There are two reasons why ETFs are more tax efficient. The first one, and the one that's more well known, is that ETFs and mutual funds often employ different investment strategies. So, the majority of ETF assets are actually in index tracking funds, while most mutual funds are pursuing active strategies. So, because active strategies tend to turn over more often, there's more churn in that portfolio, that results in more realized capital gains, within the fund. And then that's passed back to mutual fund investors.

But back to my structural points earlier, even when the investing style is similar, ETFs often have a structural advantage for tax efficiency too. So, this goes back to the ETF superpower. That structural edge comes because, again, nearly all of the trading happens outside of the ETF, not inside of it. So that leaves those transaction costs and the taxes to the individual rather than mutualizing them across all of the investors within the fund.

So, the last slide that I have to show you here today is really the outcome of all of that. So, the results of those three key benefits of diversification, of low fees, and of tax efficiencies, can result in better outcomes. Because that's why we're all here today, right? Especially when that's compounded over time. So, over the prior 20 years, which is what this slide is showing you, iShares' broad based equity funds have really outperformed the average actively managed funds in their Morningstar categories.

So that-- if you're looking at these dollar-value differences, so IVV as the large cap example, outperformed. IJH is the mid cap example. And IJR is the small cap example. They all outperformed their corresponding active fund. So, I think that the most important thing to take away from this really is that that can mean the difference between taking that special trip, or buying a new car, or what I am personally investing for myself is hopefully to retire a little bit early, and ideally somewhere like this too. But with that, I'm going to end here.

Hopefully, I've given you a pretty good understanding for what ETFs are and how they work. And then most importantly, how you can make them work for you. So, I'll pass back to Steve. And I look forward to taking your questions later.

STEVEN TRAVALI: All right. Thank you, Kristy. Thank you.

KRISTY AKULLIAN: Sure.

STEVEN TRAVALI: [INAUDIBLE] I'm going to run a little bit of a demo here and go through the Fidelity website to sort of tie this together. As Fidelity clients, we want you guys to be able to understand how to find some of the things that we're talking about today as well. So, give me just a quick second. Here we go. So, this is a test account. It's not my own, thankfully. So, if we go to News and Research right here, we've got ETFs on my dropdown. I'm going to jump into the ETF world right here and give myself a second for this page to load.

OK, so we're going to start with just looking at market capitalization. I'll close that out. Since we talked about different market caps and the exposure of ETFs, we're going to look at just a large cap to keep it pretty simple. And one of the questions I did get past too was looking at the expense ratio of ETFs too. So, I'm going to integrate that right into the presentation ad-hoc here. So, if I look at my list of ETFs right here, and before I even go any further from the screener tool, there's a whole bunch of stuff here on the left I can start to include in the criteria.

I'm just going to click on that expense ratio right away. I don't even have to select which one. Obviously, there's zero very high ETFs. But as I look, most of them are very low. But right here on the right, I can see immediately that the expense ratio has been included already. So, I know before I even click on anything that I'm looking at what the expense ratio is right away. And then we're going to use IVV as an example just to tie back to what Kristy was talking about as well.

And we're going to see just a little bit of what we have available in terms of composition. So, let's take a look at our portfolio composition here. We can see our holdings, our regional exposure, country exposure, market capitalization, sector exposure. So, we're getting an idea. If we have an existing portfolio right now that we're looking to integrate this into, we can kind give an idea of what the impact is going to be before we make the trade. So that's really the key here is getting a better understanding of what we're going to be doing to our portfolio as we integrate this in there.

And we even have industry exposure here. So just to clarify, industry exposure is a subsegment of sector exposure for those of you that may not know that. So, within information technology, I have software technology, hardware, software, semiconductors, et cetera. So, it's just a further breakdown that 27% is comprised of a few of these. And then it goes a little bit deeper from there. So, you'll see this kind of match is pretty mirror image of what the S&P 500 is itself as well.

And then just to get another idea of another one that we have here, we'll jump to AGG. And we're going to do the same thing. We're going to look just at portfolio composition just to kind of look under the hood, see what's going on in here. So here, we've got some different criteria. We're now looking at industry, or sub industry sector, et cetera. We're looking at debt type, country exposure still. But we got credit rating maturity, et cetera. Things like that.

So, as we pop up in quite a few US treasury bonds as well. So, we can get an idea, again, of what the holding types are, and the impact of our portfolio would be on a fixed income side as we're looking to integrate that in. And then one last one, just to switch it up a little bit, we'll do HDB. Same thing. Portfolio composition. So now, we got country exposure, market capitalization is back.

And we're industry exposures back, even though our focus is a little bit towards the dividend focused, which is more of an income base. So, it's sort of a hybrid between the two of the IVV and the AGG that we just looked at.

So, with that, I know we've got a couple questions as well. And I think Kristy got handed a few good ones just now too. Do you have any that look good to you?

KRISTY AKULLIAN: I'm supposed to hand these to you. But yeah.

STEVEN TRAVALI: Oh, all right. I love it. [INAUDIBLE] So this one says, you said ETFs can be traded, but mutual funds cannot. Can you please explain that a little bit more in terms of the difference?

KRISTY AKULLIAN: Sure. So, ETFs in that way are just like a stock. They can be traded during the US stock market open. So, you can buy and sell those on exchange. That's a really important difference. Mutual funds, when you actually invest in a mutual fund, your money doesn't go to exchange. You're not buying a share of a mutual fund from an existing shareholder of a mutual fund. Instead, you're giving your money to the mutual fund investment company, to that fund manager, and then they go and buy the underlying securities that they need as a result.

So, it's not buying and selling from-- you're not buying from a different seller. You're just giving money to the investment company. And then they go invest it on your behalf.

STEVEN TRAVALI: Right. This is a good one. So, can you use 401(k) accounts, such as IRAs invest in ETFs for retirement?

KRISTY AKULLIAN: Do you want--

STEVEN TRAVALI: Sure. Yeah. So, you can absolutely use IRA asset money to buy into ETFs. Some 401(k)s do offer ETFs as A alternative to invest in as well. But yeah, there's no rule that you can't use retirement assets for ETFs at all. What are the risks of buying an ETF? Are they riskier than a mutual fund?

KRISTY AKULLIAN: It's a great question. So, to the extent that they hold the same things inside them, you get the exact same exposure in an ETF or mutual fund. So, if you buy an S&P 500 mutual fund and you buy an S&P 500 ETF, it's exactly the same. You're getting the exposure in both of them. It's just the different structure. So different way of how you get in and out and different way that you would realize or be forced to realize taxes in them. But they're no different in terms of the actual underlying exposure that you get.

STEVEN TRAVALI: Right. I think in hindsight, they look a little bit differently day to day. The ETFs are going to be streaming that quote price in real time while the market is open while the mutual fund is sitting stagnant. And it gets updated at 4:00 PM Eastern Standard Time, 1:00 PM for San Diegans. But it's going to be updated at that close of the market. So, you don't know what the impact was for the day until you see that closing price, where the ETF is kind of like owning a house with a ticker right above the house just running in real time.

So, it can create a little bit more of an emotional response as you're watching that move up and down during the market. But it's important to remember long term approach. And essentially, the exposure is the same in the end. You're just getting that excess liquidity through it. Let's see. How do you figure out expenses of an ETF? Are there charges to buy an ETF at Fidelity? So, I did include the expense ratio in the search. And there are no charges to buy ETFs at Fidelity. They are free commission, free just like all equity stocks.

Do ETFs push up the market when people buy and push down the market when customers are liquidating?

KRISTY AKULLIAN: I feel like this is being asked by a regulator. Right? I will assume it's not. But no. I think that exactly the point that Steve made earlier, the ETFs tick in real time can maybe be a little bit stressful if you log into your account and you see what's happening in real time. If the market is moving up or down a bunch in one day. But really, ETFs are just reflections of the underlying stock that they hold.

So, they're not moving any more or less than the underlying stock. They're just giving you visibility into how that entire index is moving it at once. So, they're not responsible for moving the market. They're just responsible for reflecting what the market is already doing.

STEVEN TRAVALI: And then there's a question that ties back to your presentation: I'm interested a little bit more in the differences of capital gains between mutual funds and ETFs. So maybe reiterate the differences there of how those work again.

KRISTY AKULLIAN: Sure. So, the difference really is that in mutual funds, capital gains are realized much more often. So, a higher percentage of mutual funds will pay capital gains, pay capital gains every year, which then you'll have to pay taxes on your own obviously. The vast majority of ETFs over the last five years, I think it was 92% or 93% of ETFs, didn't pay out capital gains.

So, it wasn't something that you had to realize on your own taxes that year. But again, both fund structures, you will pay capital gains. The difference is just that with ETFs, you don't usually have to pay a capital gain until you decide to sell the fund. So, you have a lot more control back in your own hands of when you want to realize that.

STEVEN TRAVALI: All right. And why wouldn't I want to invest in an ETF? What goal or life stage wouldn't they be good for?

KRISTY AKULLIAN: So, I think the important thing to know too is that even though ETFs trade like a stock, they aren't just stock funds. There's bond funds, there's really much safer, more conservative things that you can get within an ETF. And so, you can buy treasury bonds, you can buy investment grade, you can buy the AGG. So, it's not necessarily a stage of life, or an investing risk tolerance, that means an ETF is better than a mutual fund, or vice versa.

It's just a different way to get exposure. So, there is ETFs for every walk of life, there's ETFs for every risk tolerance.

STEVEN TRAVALI: Next question is, how do you see an ETF performance history? So, I'm going to take that since I have this live demo going right here on an ETF. So, I can go to my Performance and Risk page right here. I can see hypothetical growth over the last 10 years and a premium to discount. And then I can also go into an advanced chart if I want to see a little bit more--

KRISTY AKULLIAN: We're going to get your password there for a second.

STEVEN TRAVALI: I had it copied and pasted ready to go on that one.

KRISTY AKULLIAN: Follow you to the ATM.

STEVEN TRAVALI: Not my first rodeo, I guess. All right. So, here's HDV. So now I can get a little bit more of the ups and downs. Reds are bad, greens are good. So, I can see the movement of that ETF over the history. And then I can scroll through and scan that history over time and make the time periods longer if I want to. If I want to see a five year, a 10 year, a max, et cetera. I can see the fund times here. If I want to get exciting and see, OK, well, what really happened back in the day? I got a couple big blips on the radar.

And if I'm trying to anticipate a future market event like that, how that might shock my portfolio as well. All right. How does an ETF share price relate to the underlining asset?

KRISTY AKULLIAN: That's a good technical question.

STEVEN TRAVALI: It is. It is.

KRISTY AKULLIAN: So, ETFs, like mutual funds, will have a net asset value. So, all of the stocks or bonds that are held in an ETF are going to be priced at the end of the day. So, you'll get a total value for the whole fund. So, I talked about how IVV has 729 million shares outstanding I think it is. So basically, what happens is that at the end of every night, we value the entire fund. So, it's like $300 billion. And then it gets divided by the number of shares that are outstanding.

So, everybody gets an entitlement, or an ownership to a share of that whole fund and the underlying basket. So, there is a net asset value very similar to what there is with the mutual fund as well. So, it doesn't have to mean, for example, that because the S&P 500 is at the 3,800 that the IVV trades at $38. There's not a perfect ratio between them. But all you need to know is that the total value of the assets within the fund are divided up each night and a net asset value is calculated based on how many shares there are outstanding.

STEVEN TRAVALI: Nice. Next question is, is Tesla part of an ESG ETF? So, if I look at ESG as an ETF, I can see that ETF right here. And we can certainly take a look together and take a look--

KRISTY AKULLIAN: This is a controversial one.

STEVEN TRAVALI: Is it?

KRISTY AKULLIAN: Yes, it is.

STEVEN TRAVALI: Lovely.

KRISTY AKULLIAN: Somebody is stirring the pot a little bit with this question.

STEVEN TRAVALI: So, we can see it is a part of the ETF right here. Here it is at 3.58. If I had a question of something smaller below this 1.93 in Chevron, I can always look at all holdings by weight. It's going to pull up every holding itemized for me to review there. So, this way, just another idea of how to pull the microscope on that. And then here's a good question. How do ETFs perform during market volatility? I think I kind of touched on it a little bit. I don't know if you have some color to that.

KRISTY AKULLIAN: Yeah, I guess I would just reemphasize the point that ETFs reflect what's happening in the stocks that they hold, or the bonds that they hold, in real time. So, it's always going to look more volatile if you log into your Fidelity account and you look at an ETF holding, than if you look at a mutual fund holding. But again, that just goes back to that point the ETFs give you real time information. And mutual funds give you end of day information. So, there's one price that's calculated at the end of the day.

So, ETFs actually hold up very well in market volatility in terms of trading. That's the question that we get asked most often is, if the market is down a whole bunch, or up a whole bunch, can I still buy an ETF? Will there be shares available? Or will I be able to sell it? Because that's the only part that's really different between-- in periods of market volatility between the ETF and the mutual fund is that trading element. And so yes. They do trade a lot. A maybe relevant stat is that as much as 35 or so percent of all trading that happens in the US stock market happens in ETFs each day.

So, they're really, really big. And they're really liquid. So, lots of different investor types use them to manage around that volatility. Although I would caveat that that's probably more relevant for some of the hedge funds and bigger institutional traders who are trading in and out of things intraday. I think that most of the investors that we speak to use ETFs for more of a long-term investment horizon. So, we're certainly not encouraging people to be trained day trading in your ETFs. But it is possible if you wanted to. And there tends to be a large amount of liquidity available to trade to.

STEVEN TRAVALI: And the last question is, I'll have to close this out and give ourselves 10 minutes to refresh and regroup for the next session. But the last question, how are dividends determined, estimated, distributed within the ETF? Is it monthly? Will the amount change from day to day, month to month?

KRISTY AKULLIAN: Yeah, that's a great question too. So, it's actually the answer is that it's going to vary by fund. Different funds have different dividend schedules. Usually, the most common for equity funds is quarterly dividends. And what's going to happen within the fund is that that doesn't mean that all those stocks within the fund pay a quarterly dividend and it all happens on the same day. So as the quarter goes on, and as dividends pay out on those underlying stocks, maybe every single day.

What's happening is that the portfolio manager for the ETF is taking that money and reinvesting it back into the market, and then also preparing to pay out that quarterly dividend. So, you're getting one payment that represents the dividends that were received over the course of the entire quarter from all the stocks that paid them. So, you're getting all of them. They are pass through vehicles, as it's called. So, all of those dividends that the fund receives, you're going to receive in the form of a dividend payment for holding the ETF.

STEVEN TRAVALI: Perfect answer. Love that. OK, so in closing, we're just going to take a quick peek at the ETF landing page just to reiterate where we would start from -- from the research center. iShares has a great landing page, as well as Fidelity. We can look by market cap, sector, fixed income, and our new active equity ETFs as well.

Definitely want to give a thank you to Kristy for your time. And thank you guys all for your attention today. I know it's a precious commodity. And really appreciate you guys coming out in person. It's been 2 and 1/2 years since we've done an event like this. And it's great to get the rust off the wheels and get it rolling again.

END OF AUDIO FILE

Footnotes

[1] Expense ratio is the total annual fund operating expense ratio from the fund's most recent prospectus.

View top 10 holdings for the iShares Core S&P500 ETF (IVV)

View top 10 holdings for the Flexshares Stoxx US ESG Select Index Fund (ESG)

Disclosures

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