

TRANSCRIPT

How ETFs may help improve portfolio performance

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KRISTY AKULLIAN: I am Kristy Akullian. And I am a senior strategist on the iShares investment strategy team based in San Francisco. So today I wanted to talk to you about performance and specifically how small decisions around portfolio composition and construction can have large impacts on what you make and what you get to keep. So the four topics that we'll cover today are the drivers of performance, portfolio construction, taxes and fees, and then finally we'll end with aiming for alpha. So an obvious but a very important place to start is just to figure out what it is we mean when we talk about performance. In investing as with life it's really hard to tackle a problem if you haven't defined it. So what does performance mean to you? That is obviously hopefully a rhetorical question. Because I think in 2022 everybody knows how to be on mute.

But when I talk to investors I hear a really wide range of performance goals. So sometimes it means being up by a certain percent. In 2021 the S&P 500 was up by 27 percent, which clearly was an impressive performance. But we probably shouldn't expect that going forward. For some investors strong performance means beating a benchmark. So those investors may have only

been happy if they had earned more than 27 percent last year. And then there's another camp of investors entirely who really just want to see green on their screens when they log in to their Fidelity account. So whatever your performance goals, whether they're absolute or whether they're relative, the first step in improving your performance is to define it. And importantly to stick with it. So consistent goals and consistent measurement is really key here. And that means starting with a benchmark. So for a lot of investors a sixty-forty portfolio, that is a portfolio that's 60 percent stocks and 40 percent bonds, that might be a reasonable place to start. But as with most averages it doesn't actually apply to most people. So whatever performance means to you and whatever benchmark you choose you should know that there are aspects of performance that you can control and then there are the ones that you can't. So today we're going to focus on maximizing performance with the things that you can control. And then constructing a portfolio that's really designed to protect against some of the things that you can't. So in doing so throughout the course of this conversation we'll touch on both what to invest in as well as what makes sense in the current markets, and then we'll transition to talk a little bit more about how to invest and do a deeper dive there since that's really where we have the most control. So on the next slide we lay out the various components of what comprises performance. So in the things you

can control column we'll start with asset allocation. Which is having the right mix of stocks and bonds in your portfolio.

And in fact many studies have shown that the mix of stocks and bonds is even more impactful than which stocks and bonds you hold. Also in your control is choosing a strategy for how you'll get those exposures. So will you use single stocks or index funds or will you use an alpha seeking strategy? And then lastly, selecting a vehicle or a type of a fund, which is not quite the same thing, they're often confused. That will determine the tax efficiency and the fees that you realize over the course of that investment. But at the end of the day underneath all of this I guess both in the abstract figurative sense and then also quite literally in the squiggly lines that you can see on the slide, there are these underlying macro factors that really drive the direction of markets. And they create the condition where certain investments can outperform others. These things can't be controlled. But let's start with a discussion about what our macro outlook looks like, and the types of investments that you can think about that focus on resilience and that tend to perform best in environments like today's. And on the next slide we can get a little bit of a sense of where we've come from to get an idea about where we may be headed. So last year was really one for the record books. We saw incredibly strong performance in stocks but negative performance from bonds. So where we are right now if

you were to plot 2022 year to date on this chart, we would be in the bottom left quadrant, the bad one. So negative performance for stocks, although I would say that they have staged quite a bit of a comeback just in the last few weeks. And then deeply negative performance for bonds. So in fact the quarter that is ending today is going to go down in history as the worst quarter for bonds since 1980. So what are those macro factors at play that are going to shape performance in the year ahead?

First you may have heard inflation is high. You probably also felt this too. So inflation in the US and globally really is at levels that we haven't seen since the 1980s, which is not coincidentally the last time bonds had as rough of a time as they did. Inflation is really being driven by three things right now. First COVID changed the way that we spend money. Because we couldn't spend on things like vacations and haircuts, we spent money on barbecues and home renovations, or at least that's what I did with my lockdown. That had a really dramatic impact on inflation and the reason why is that it led to a huge surge in goods inflation as opposed to rises in the prices of services. It also led to supply chain headaches. Since the pandemic lockdowns sometimes meant that there were less workers available to build and ship and transport all those things. And a huge demand for goods at the same time that supply was falling led to higher prices. But we did expect those things to fall in line with the

reopening when consumers would start spending money on things like airline tickets again instead of washing machines. And to some extent we've seen that happen. But we're really still a very long way from the normal mix of spending between goods and services that we saw before the pandemic. The second reason why inflation is as high as it is right now is that the job market is incredibly tight. You've probably noticed lots of help wanted signs. I notice them particularly at a lot of my favorite restaurants if I'm even lucky enough to get in. I know that a shortage of labor and shortage of staff has meant that a lot of restaurants haven't been able to reopen fully and that's true across the economy as well with different types of businesses. So a really competitive labor market like we're in right now, it pushes wages higher. And then that in turn pushes prices higher. And then lastly and more recently and tragically I should say too, Russia's invasion of Ukraine has sent commodity prices soaring. So it's not just oil, even though that's probably what you see most of on the news, feel most directly as well. But the prices of wheat and corn and fertilizer and even the types of metals and gases and things that are needed to make semiconductors for example, those have been pushed to some multidecade highs as well as supply is cut off. So energy prices are a lot like wages in that when they go higher the impact is felt in all corners of the market from food to clothing and pushes prices up. So that's really why we're seeing inflation that's quite as widespread as it is right now and as persistent too.

And I should say that a little bit of inflation is healthy. But too much inflation can cause problems in the economy. So the other major macro factor in play this year that we're thinking about is the Fed, which we'll cover on the next slide here. So earlier this month the Fed announced that they would be raising interest rates to fight inflation. Raising interest rates makes it more expensive to finance and to buy things, things like cars and houses that typically households take out loans to purchase. So it should reduce some of the demand and therefore push prices down. One of the first things that you learn in econ 101 is that higher interest rates mean lower prices for bonds. So again that explains some of that negative performance year to date. But I think it's a little bit less well known what higher interest rate means for stocks. There's this widely held belief that the start of a hiking cycle when the Fed starts raising interest rates to fight inflation is a good time to get out of stocks because it might signal that a recession is coming. But in fact we find that the US stock market actually performs pretty well in the years after the Fed starts raising interest rates.

So the average annual S&P 500 return if we look at the last four hiking cycles was 17 percent. So it's not last year's levels, but certainly not too shabby. And then in particular we find that sectors like technology and communication services, so some companies like Facebook and Netflix and Google, those have typically

done the best. So really what does that all mean for the parts of your portfolio that you can't control? So our view at iShares and at BlackRock is that it's going to be an unusual year but it doesn't have to be a bad year. So we think that stocks can still do well even if the economy is slowing down a little bit, which it is. It's probably time to get a little bit more selective in terms of where you take risks. And while we still always think that broad-based low-cost exposures are almost always the way to go for long-term investments, for some of the shorter-term tactical trades right now we like picking the types of companies that have really strong balance sheets and strong margins and importantly for inflation strong pricing power as well. Those are the types of companies that are really set to perform well in this atmosphere of higher inflation and higher interest rates. They can weather that. They can weather the rising cost of borrowing and slowing growth a little bit better than other companies. So if you're looking to identify some of those, the sectors that I just mentioned, tech and communication services will generally fit the bill. And then there are also other ways to get that too. So factor ETFs like QUAL for example which screen for high quality companies, we think that's also another option to consider. And so transitioning here a little bit, I know I promised at the start that we'd talk both about what to invest in as well as how to invest most efficiently, the next slide here makes an incredibly important point about performance that sits at the intersection of both that what and that

how. And as much as we talked about identifying macro factors like whether interest rates and inflation and GDP are going up or going down, I should also point out that identifying the cycles is very different from timing one. So I love this slide. I personally think that I should make postcards or matchbooks of this slide. And I think everybody who works in financial services is used to getting a phone call or text from friends, often from a crazy uncle, that says something along the lines of the market is down 8 percent this week, should I go ahead and sell everything. It feels counterintuitive, and it can also feel painful at times, but I always tell them to stay invested. And sometimes I even suggest that it's a good opportunity to buy. So even the most skilled investors get the timing wrong. And for that reason we think about time in the market rather than timing the market, which is also just kind of a catchy little turn of phrase that's helpful too.

So the market doesn't rise and fall in steady lines. It's full of peaks and troughs and it's really impossible to know the extent of them in advance. So in fact our research finds that just a handful of excellent days can account for a disproportionate amount of total returns. And often those best-performing days follow really closely behind some of the worst days. So as the graph here shows in this hypothetical \$100,000 investment, missing just 25 of the best trading days over the last 20 years would have cost you almost \$482,000

relative to just staying invested throughout. There's a lot of things that I can think of to do with \$482,000. Especially with inflation as high as it is. So if the correct strategy is really staying invested through near-term volatility, which is almost always the best option, then on the next slide is where we start to address the question of what to stay invested in. This slide gives us a menu. This is the opportunity set if you will of the investments that we can use to reach our performance goals, as well as the reasons for why to use each of them. So single stock positions. These should represent great companies that you have high conviction in. A lot of investors, this is a question I get from my friends all the time, they really like to invest in the industry that they work in. So an example that's very San Francisco and probably Silicon Valley-specific here is if you work in something like lithium-ion batteries for example. You probably know a lot about other battery companies. And then you probably also know about electric carmakers and other high-tech fields that rely on some of that technology. But to go back to that framing that we started with, the performance that you can control and the ones that you can't, I would say be careful here about taking concentrated positions in single stocks, even in multiple stocks that are in the same field. So those macro factors that we talked about often mean the companies that are in the same sector or the same industry tend to move together which can add to the riskiness of your portfolio. But we'll talk about that more in just a few slides too. So moving

down a little bit here in terms of the slide. Sorry. Wrong gesture. Same slide. Just moving down a little bit. Perfect. We'll come to active managers. So either in a mutual fund or increasingly in ETFs as well active allocations in a portfolio seek not just to match a benchmark but to beat it. So they don't always do so, and I should point out that they do always charge fees. Typically those fees are higher than what you'll find in an index product. So I think that active management should really be reserved here for areas where you believe that a skilled manager has an edge in a specific market. And then at the bottom of the slide in our food pyramid if you will of products we have index. So we really believe that index funds can be the core building blocks of most portfolios. They give you the most efficient exposure. They give you access to the broad market. And then they often maximize the benefits of diversification as well. So how you put all these menu items together is really the basis for portfolio construction, which we'll get into in the next slide. Perfect. So let's start with a case study. So if I asked you which one of these two e-commerce companies that you would like to hold, the answer on the slide looks very obvious. But if we zoom out a little bit on the next slide, you can see that that incredibly highflier in 1999 flatlined by early 2000. And I realize this might look a little bit silly with the benefit of hindsight. But remember that at the time one company sold toys on the Internet and the other company sold books. And the people who bet on toys, they weren't

actually wrong. So even as recently as in 2019 Americans spent \$26 billion on books and they spent \$27 billion on toys. Which makes me a little bit sad. But that's beside the point here. Imagine really getting that trend right. Correctly predicting how consumers would spend money and predicting that they would choose to do so online. In 1999. And still losing money. So seemingly very similar companies in similar industries experienced really drastically different outcomes. And that's normal. That's what we call idiosyncratic risk. Which is a little bit of a mouthful but that's fine. Luckily for us there is a mathematically proven way to reduce idiosyncratic risk and reduce the risk of being a loser in a winning market or a winning sector even. And that's diversification. So as we can see on the next slide here, whereas a full third of individual stocks lost money over the last five years, which was an incredible bull market by the way, just a tiny fraction of mutual funds and ETFs did. That's because in addition to macro risk like whether the economy is strong or weak, investing in single stocks also exposes you to the risk that the company itself might be poorly managed or that it might invest in things that people don't want to buy. But the good news here is that for all of the things about investing that you can't control, idiosyncratic risk is not one of them. Diversification minimizes that risk. If you invest in a fund like an ETF it often does that for you as well. So there's one last thing that I wanted to talk about

in the section, this portfolio construction section, before we move on to taxes and fees, everybody's favorite topic obviously.

This last topic I think that I've always argued that it really should be called more of a portfolio maintenance. I think portfolio construction implies that it's something that you build and then it just stands forever. But investing, that's not always true. In investing regular and disciplined rebalancing is a key component of optimizing performance. When you define all your performance goals and assess your risk tolerance and investment horizons and then you construct a portfolio that's designed to deliver on those things, it's equally important that you make periodic adjustments to keep those holdings in line. Not to make things more complicated after I already threw out idiosyncratic risk a few minutes ago. But I should point out that there are actually two types of rebalancing. There's portfolio rebalancing and then there's fund rebalancing. But luckily really only one of those is something that you need to worry about. So portfolio rebalancing which we can see on this slide, that addresses asset allocation. So the mix of stocks and bonds, and in the current market maybe also commodities, that make up what your portfolio looks like. And as an example of portfolio rebalancing we can take that hypothetical sixty-forty portfolio that we talked about a few minutes ago, take that at the start of 2020, so the before times. After the really dramatic sell-off

in the equity market that we saw in March when those lockdowns were first implemented, your portfolio would have dipped down to a fifty-fifty ratio. So it's no longer sixty-forty, it's down to fifty-fifty. In other words meaning the value of your stocks fell so much that they accounted for just half of the total market value that you held. So after a sell-off like that portfolio rebalancing would have required you to sell bonds and then go buy some of those now cheap stocks. And as we know looking back, hindsight twenty-twenty, that was one of the best times to be buying stocks over the last two decades.

So what rebalancing does is it enforces the discipline to sell high and to buy low that might not always feel intuitive. But it can be hugely important in achieving your performance goals. So the other type of rebalancing, fund rebalancing, this is one of the benefits that you get out of professional management. So just as investors regularly should review their portfolio holdings and make adjustments accordingly, index providers do the same thing. So I think there's a misconception that an index is just a static list but it's really not. So index providers, they regularly review companies' performance. They look at their profitability, their market cap. Sometimes depending on the index they may even look at other factors like ESG scores. And then they're regularly adjusting their indexes to reflect changes in the overall market. So for example Standard & Poor's reviews their S&P 500 index twice a year. And they're constantly

adding and removing companies based on their qualifications. So in that way indexes really adapt and evolve along with the market and they continuously deliver the exposures that they're meant to reflect. So it's that dynamism along with all the benefits of diversification that we talked about which are why so few funds lose money when even a significant percentage of individual companies might do so. So if you do choose to use funds in your portfolio at least one level of rebalancing is already built in. iShares ETFs for example rebalance mostly on a quarterly or on a semiannual basis. And that means that even for so-called -- sometimes they're called passive products, BlackRock portfolio managers and traders are actively managing your holdings and responding to changes in indices that are designed to prevent a single company from getting too big or a fund becoming too lopsided. So moving on to taxes and fees. I have a theory that there are two types of people in this world and the first is the types of people who get really excited about taxes and fees and all these nitty-gritty details of investing and market structure. And then there's obviously normal people. But I will fully identify as the former for this section too. So let's start with some basics. If we're looking at the slide. When you're choosing what you want to trade, whether that's an index or an active fund, whether it's an ETF or a mutual fund or even single stocks and bonds, some of the most important considerations are going to be around where you're planning to invest and how you're planning to invest. So in

general ETFs offer more flexibility than mutual funds in terms of the size of the investment. So if you're adding money to your brokerage account each month for example rather than in one lump sum, that might be beneficial. And with recent changes to market structure it's often as cost-efficient to trade a single share of an ETF or actually even fractional shares, I know since Fidelity launched their Stocks by the Slice program which is very cool, as it would be to trade 100 or 1,000 shares. So this idea of round lots is sort of going away. With mutual funds there's often fund minimums to consider. And then of course trading is limited to just once a day as well. So the question of where, meaning what type of account that you're trading in, is so important that we're going to give it its own slide here. If we move to the next slide. Perfect. So let's zoom in on that question a little bit. And we'll start with the recap. So investing in different types of accounts can be used to achieve different types of goals as well. So we'll mix it up a little bit. Let's start on the right here. Tax-deferred accounts, things like a traditional IRA, these should be used for long-term retirement-focused investing. Since this can benefit from the tax-advantaged growth potential. But most investors, myself included here, have goals before we turn 60. And those interim goals are often best met in a taxable brokerage account. So these aren't necessarily part of retirement planning. So there's no limits to how much money you can contribute or to when you can take that money out. But the taxable nature of the account does

mean that you want to be more selective about which types of investments you hold there, which we'll explore a little bit more on the next slide. So broadly speaking, and I guess a little bit obviously speaking as well, putting the most tax-efficient vehicles in taxable accounts typically makes the most sense. So that means products like active mutual funds on the top of the scale here, which tend to have higher turnover, and typically generate more capital gains, those generally fit best in a tax-deferred account like an IRA or 401(k). And then moving down the spectrum, individual stocks and bonds, those can pay dividends or interest payments, which are taxable distributions if they're held in a taxable account. But even more importantly, going back to that portfolio maintenance idea that I belabored earlier, they also need to be bought and sold as a part of that regular rebalancing process. So the turnover that's generated from rebalancing can also result in tax impacts over time when those are held in a taxable account. So even so though, when you're trading individual stocks and bonds and ETFs, investors are generally only impacted by their own actions. Meaning that they typically pay capital gains taxes only when they choose to sell their shares that have gone up in value. But let's dig into how that plays out in mutual funds on the next slide. So there's a few differences between ETFs and mutual funds. The first one that you'll see here is just cost. So the average cost of a mutual fund is typically higher than a corresponding ETF and that's really true across different styles and sectors of

the market as well. And I keep bringing us back to that control dichotomy of what you can and what you can't. And really importantly fees are one of the key areas that are under our control. So using low-cost ETFs particularly at the core of your portfolio, that's a really important way that you can use to improve your portfolio performance. But it's not the only one. And sometimes it's not actually even the most impactful. So in mutual funds investors may be impacted by the actions of other shareholders. It's entirely possible that you might have to pay capital gains taxes in a year even if you haven't sold anything. So ETFs operate a little bit differently. And the way that new shares are created and redeemed, it allows for a little bit more of a tax-efficient rebalancing process within the fund when the fund needs to go trade. And it also means that large shareholders who enter or exit an ETF have to pay their own way. So they alone are responsible for those trading costs that are associated with their movement rather than having those costs shared across all investors like in a mutual fund. The upshot we can really see on the graph on the -- let's see here.

On the right. So our industry research shows that over the last decade 54 percent of all active mutual funds generated and paid out capital gains while just 8 percent of ETFs did. Again that means that ETF investors often have more control over when their tax bills are incurred, which can let them better

optimize around them. And then on the last slide in this section, perfect, we can see how all of these differences really add up in terms of performance, which is of course the focus today. So I mentioned a few minutes ago that fee differentials while large, those can often be trumped by the impact of taxes. So this slide shows how that has played out in large-cap US mutual funds over the last decade. So while expense ratios shaved off a bit less than 1 percent each year from overall performance, the impact of tax costs, so things like the taxes that are paid on distributions, whether you sold or not, those reduced performance by more than twice as much. So in dollar terms, which I think really drives this home for me at least, that resulted in an almost \$7,000 difference on a \$40,000 investment. So that's real money obviously and that's real performance that can be made just by focusing on some of those nitty-gritty details and then choosing the right investment vehicle for the goal and for the specific account. So we can move on to the last section here, because I know taxes and fees don't necessarily do it for everyone. So in this last section, aiming for alpha, this is for everybody else, the normal people. For those of you who define performance as beating a specific benchmark or even a specific friend or family member if that's relevant, I wanted to focus and close here today by introducing the range of the broad market all the way up to alpha seeking strategies that are available in ETFs. So hopefully I made at least somewhat of a compelling case that ETFs deserve some place in your

portfolio as a way to express investment views in a highly efficient and diversified format. And then of course enhancing performance by optimizing around the things that you can control. So on the next slide, yeah, this one, we have a spectrum. Sorry, my bad. We are on this slide already. We have a spectrum of fund types that are really laid out according to performance goals. So I want to walk through what these are and then briefly go through a few examples too. So asset allocation and broad market ETFs are the type of funds that seek to track broad benchmarks. So whether that's a balance of stocks and bonds or whether that's an index like the S&P 500, these funds aim to give you marketlike returns. If we venture to the right we'll encounter a range of product types like factor, ESG, and thematic ETFs that seek to do a little bit more than that. So in some instances that may mean that they're taking a little bit of additional risk and seeking to make a little bit of additional performance. And in other instances it may mean that they're seeking to avoid a specific type of risk. So for example climate risk in ESG funds. Or volatility risk in minimum volatility funds. And then by doing so improving performance that way. And then all the way to the right on the slide we have active ETFs. And I'd say this is a relatively new category as well. This is combining the benefits of active management which historically has always taken place inside a mutual fund with the more modern and more efficient fund structure of an ETF. So our BTEK fund, it's just one example. That's run by our fundamental

equities team. So for example instead of an index they have a team of researchers and then they turn that research into trade ideas and they invest in companies that are at the forefront of technical innovation. So for investors who prefer active management style and who are comfortable taking a little bit more risk in concentrated exposures, active ETFs may be worth considering as well. And then quickly because I know I'm bumping up against time and I want to leave some time at the end here for questions, I'll walk through examples of three of these strategies along the spectrum. So on the next slide we can see that one of the fastest-growing investment strategies over the last five years has been ESG investing. So there's two primary ways that ESG tilts can potentially enhance your performance. The first is by avoiding risks, as I was mentioning earlier, that will ultimately carry a cost to the company, like climate risk or the risk of being hacked even. And then the second is by identifying opportunities that haven't been adequately rewarded by the market yet. So maybe a company is highly efficient in terms of the resources that they need for their operations relative to competitors. Or maybe they have a high rate of employee satisfaction and a lower rate of turnover. ESG investing looks to identify those features and then invest in the companies that do them best. And you can see on the next slide here that this isn't just a feel-good strategy, this is a performance story as well. So looking at ESGU we can see that the ESG version of that MSCI USA index actually outperformed the

standard one over the last five years. And then for those of you who may have defined performance as beating the S&P 500, this fund did that too. And then on the next slide, the other really fast-growing segment of the ETF market is thematic. We call our suite of iShares thematic products megatrends, because we think those are going to be the forces and trends that are driving the future. So this slide shows you how two popular funds, IDRV and ICLN, great tickers, how those are constructed. So they start with a concept and then they dig down to the theme's value chain, so they identify the beneficiaries of that trend, not just a specific company. They use big data, fundamental research, and then that's used to pick stocks and then to weight them within this fund structure too. So if you're thinking along that spectrum this is probably the closest thing to active management but it's also available at a fraction of the cost. So I think that thematic ETFs should fit into your portfolio where you have high conviction around a specific theme but you don't want to take that idiosyncratic risk of having to pick the right company. And then on the very last slide here, I wanted to close today with what is absolutely the simplest strategy available, so if the huge array of topics that we covered today felt in any way overwhelming or if you just don't want to be responsible for construction and ongoing maintenance but you do want to benefit from low fees and efficient tax structures, then there is a shortcut. So asset allocations here. These asset allocation ETFs carry the benefit of

handling both types of rebalancing for you. So they do the portfolio rebalancing and the fund rebalancing. And they benefit from tax efficiency of the ETF structure at both steps along that way. So these are also some of the funds that you can find here. And some of the benefits is that they're set up according to risk profile. So you can find one that best fits your performance goals, whether that's going to be mostly stocks or mostly bonds. So for me this is that ultimate expression of the things that I can control, meaning asset allocation and portfolio construction and minimizing taxes and fees in one single ticker. And then I often use other ETFs like thematic or factor or ESG funds to optimize around the things that I can't control. So I use those funds to adjust for the current macro factors and the current market conditions. So I hope I was able to give everybody something to think about today and at least a few ideas in terms of how to improve your portfolio performance. And I'll stop there and I'll pass back to Don and just say thanks so much for your time.

END OF AUDIO FILE

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