TRANSCRIPT

# New to ETFs? 5 must-ask questions to get started

**JOHN GAGLIARDI:** All right, thank you. I appreciate everyone that's on the line today as we're all on lockdown and being good citizens and being good people. This is a great way to spend your time and reinforce your education and learn about ETFs and answer all those questions that you've been thinking in your mind about ETFs. Hopefully we'll get all of those answers done during the course of the presentation, but if there's still a question out there on your mind, please let us know, and let us know what you think and how we did and if you learned a lot of things, let us know what you learned and what you appreciated the most. We really do like your feedback and comments.

So, if you're new to ETF, there are five must-ask questions just to get yourself started. So, the first thing that we like to talk about here is indexes. Because the better you understand ETFs and what they can do and how they function, the more confident you'll be to use them to strengthen your investment.

So, what is an index? Because I mention that right out of the gate. So, an index is something that's theoretical. It's made-up, usually by a publishing company, and most people don't know that. And it represents a segment of the market, but in today's world, when we think of the Dow Jones Industrial

Average, the S&P 500, the Nasdaq 100, for most people, that is the market, when it is in fact an index, not capturing the entire market, but enough of it that we feel that that represents what's happening in markets. It is not a direct investment vehicle, which means you can't knock on the door at S&P and say, "I want to buy the S&P 500." They would tell you to go to a place like Fidelity and buy either an ETF or a mutual fund, and we are happy to provide those to you, and the great thing about this is the low cost and structure of these things, and you're really going to be surprised at some of the value that these things present.

So, an index is a measure of a specific financial segment of the market. So, a few of the big indexes are the Dow Jones Industrial Average, the S&P 500, the Nasdaq Composite, and let's not forget the bond market. The Barclay's US Aggregate Bond Index used to be called the Lehman US Aggregate Bond Index, and that represents the entire bond market all in one name.

Before I leave that slide, I do want to mention, I'm going to go into a little bit of details here before we talk about what the underlying ETFs are. So, let's quickly do a review here. The Dow Jones Industrial Average founded in the 1890s by Charles Dow, who was the publisher of The Wall Street Journal. So, this man, in a very short lifetime, I believe he died around 65 or 67, in his very

short lifetime, he created the Wall Street Journal, which at the time was just a newsletter that was passed around to the folks that worked around the New York Stock Exchange. He even had an office at one point inside the New York Stock Exchange. He created this index. He was trying to figure out business activity. He wanted to see if it was a good time for managers to be hitting the gas and hiring people, or was it a time when they should be pulling back and not hiring people and not increasing production? So, he founded this index with 13 names originally, today it has 30. But there are some interesting things you need to know about it right now today that are vitally important. Number one, the names in the Dow Jones Industrial Average are still decided by one person, the editor of The Wall Street Journal, and the word "Industrial" is really just a hallmark. It really doesn't mean anything. The biggest name in the index right now is probably Apple. Now, what I don't like about this index is it was set up in the 1890s. It is actually still a price-weighted index, which means they take the 30 names, they add them up, and they divide by 30. And then there's a multiplier, and this is where it gets a little more complicated. Over the course of the last 120 plus years, a lot of names have been taken over, there have been splits, and because of all of these things, there's a multiplier. I wrote about this a few years ago, and the multiplier was over seven. I think the multiplier now is over nine. So, they take the average price, they multiply by nine because of all of these financial things that have happened in individual

stock names, and they come up with a number. This is probably going to be seen in the future as an index that's much more followed by prior generations, and what is starting to really take the limelight as what people view as the market is today, the S&P 500.

Now, the S&P 500 was created by McGraw Hill, the publishing company. So, if you like Harry Potter, you might also like their other work, the S&P 500. So, the S&P 500 is 500 names, but it is market-cap weighted, and it is not picked by size. That's one misnomer that's out there quite a bit. The S&P 500 is actually chosen by a committee, it's ranged in size from 20 to 30, so there's 20 plus people in the committee, and the committee are lifetime Wall Streeters, they have no other financial obligations, they're not on any boards, there's no conflict of interest, their only job is to pick the name in the S&P 500 with no conflicts of interest. So, once this committee picks the names, next the math kicks in, and the math was created in the 1950s and it's pretty smart. The larger the company, the more the index owns. The smaller the company, the less it owns, which is why most people think it's done by size.

Now, most people focus on the top ten names. The top ten names compromise over 20% of the index. That sounds like a lot. So, the other 490 names have to make up the other 80 or so percentage. And that means they

have a very small weighting, and I don't think so much that the genius is in the top 10 names. The genius really comes from the bottom 200 names. The bottom 200 names probably make up about 5%. Think about that. So, if they decided to make it the S&P 400, the market would go down a percentage point for the day, you wouldn't even notice, and life would move on. And the genius in that is, as companies start to fail and their market cap goes down, they leave the top tier of the S&P and they work their way down, and eventually they get deleted.

Now, the S&P 500 is important for another reason. The turnover ratio in the last 10 years was 50%. Half the names in the S&P have been deleted. Going forward, according to S&P in the next 10 years, 75% of the names will change. I have seen the CEO of the S&P say this. He said in this presentation when talking about the rapid rate of change, he said, "This is not only the most rapid rate of change, but we can't even figure out what names it'll be." There are plenty of names that are not publicly traded yet, they're expecting big public offerings, and eventually they'll make the ranks of the S&P. Now, some good things, you're fully diversified, unlike some of the other indexes. You do get all 11 sectors, that's one of the factors they use in the stock picking.

So, let's talk about what are you getting. When you buy the S&P, you're getting stock picking. You're getting risk management. All the dividends pass right through top you. So, this is really an ideal for someone that's looking for diversification in a single name, and I would say this is probably the leading factor in people relying more on indexes rather than trying to stock-pick themselves, and the S&P makes a fine anchor for any strategy as a core position in your portfolio.

Next up, we have the Nasdaq Composite, and most people will use the Nasdaq Composite or QQQ, which would be the Nasdaq 100. They are different. The Composite has all Nasdaq stocks in one name, and the Nasdaq 100 is, again, another index created by the Nasdaq market site which has decided these are the names that really represent what the Nasdaq does. Now, you have to remember that these were created in a time where the New York Stock Exchange ruled, and the Nasdaq marketplace was the other marketplace. It's where if you couldn't make it onto the big board, you went to the Nasdaq. And a lot of that has changed largely because technology has changed America.

So, there was a good arrival in the '90s where companies like Dell, Cisco, Microsoft, and Intel were all primed and ready to go on the New York Stock

Exchange. They had the market cap, they had the breadth, they had the liquidity, they had all the things that the big board wanted. And when they were approached by the New York Stock Exchange, they said, "No. Why are we going to go to a place where people are trading with pencils and papers? The computers that run the Nasdaq are built by Microsoft, Intel, Dell, Cisco, and we're not going to leave." And the New York Stock Exchange had symbols all lined up for them, I for Intel, M for Microsoft, which is now Macy's. But they had all those symbols lined up to try to woo them over, because having a single-letter name was something of some prestige, and it used to be a rule, three letters or less New York Stock Exchange, four letters or more, Nasdaq, five letters or more, it's probably going bankrupt, don't touch it. But a lot of those rules have come by the wayside these days.

And lastly, the Barclay's Aggregate Bond Index. Now, this is the entire bond market all raveled up in one item, which is not easy to do. There are nine million individual bonds out there. There's only 55,000 individual stocks. So, this is made up of corporates, munis, treasuries, you name it. It's all raveled up, so you can get an idea of the total bond market and not have to figure out which bonds to pick. So, it becomes a favorite of people that like to do a 60-40 split. You might buy IVV to represent the S&P and AGG to represent the Barclay's. Some people say, "I want to have exposure to stocks," they'll use

the Dow, the S&P, and Nasdaq. So, these things really come in handy when you're planning an ETF portfolio, but you have to know these structures before I move forward. So, now we'll pick up the pace a bit, but I thought it was really important to talk about those indexes, because you have to know what's the underlying of what I'm actually buying.

Now, let's talk about what an ETF is. So, an exchange-traded fund, because it's exchange-traded, it trades much like a stock. It offers you passive management. And by the way, they do even have some managed solutions in ETFs as well now. So, some of these lines are getting blurred. And the last thing is, why use ETFs?

So, first, what is an ETF? It's a basket of securities designed to offer exposure to a certain segment of the market. Like, if you said, "I want technology," you might find an ETF that is only technology. However, don't be fooled. Technology has become such a broad name that today, the way that sectors are done, they've removed a lot of names out of technology and given them different sectors. For example, Amazon, you may see as a technology company. It is not. It's actually in consumer discretion, because you don't have to use Amazon. We use it because we like it. Same way we buy a car, we could take the bus. So, it's actually in the consumer discretion category. So,

you might have to search through your ETF to see what you actually own. But they do offer both technology ETFs, you could use consumer discretion to own Amazon, or you could use QQQ, which is an index covering multiple sectors, technology, communication services like Google and Facebook, as well as consumer discretion like Amazon, as well with biotech and others. The only thing not in the QQQ, the Nasdaq 100, I should mention, is financials. They have a separate index for that, so they don't put it in.

Next up, an index is a measure of a specific financial market or segment of that market, and like we mentioned, these are the different things that we look at. I think we already covered what the Dow, the S&P, and Nasdaq are. If you have questions, put them in the queue, because I'd like to hear what your thoughts are. And also, if you learned something new.

So, strengths of an ETF, intraday pricing. It trades all day long, just like a stock. So, I like to say in some regards, it's stock-like. It does offer you diversification, which makes it different from the stock. You're buying a portfolio of something, not just one individual name. So, you're eliminating individual stock risk by using an exchange-traded fund.

Next, transparency. Unlike mutual funds, you get to see everything in the fund at all times. Some of them even intraday, so you know every single thing that you own. There's no magic sauce, it's public.

Next up, they are generally low-cost, very often less cost than some other competing things like mutual funds, however, that's a guideline, not a rule, because there's plenty of things out there that are breaking the rules.

And lastly, tax efficiency. They don't incur capital gains, but they could. I have to make this very clear, we've all become very accustomed to seeing these things not issue capital gains, however, if you have an issuer who fumbles the ball, because there's some very high math and trading going on to make sure these things are tax-efficient, they could incur capital gains. The very efficient ones out there, the folks at Blackrock, State Street, and Fidelity, if these things ever do incur capital gain, they're usually very, very small, and they won't have a huge impact. But you have to know what you're buying, so having a good issuer will count, and it will be important to maintain that tax efficiency. And we'll talk about that a little more in our comparison to mutual funds.

So, how do they compare to mutual funds? First up are the costs, the trading attributes, which we began to speak about, and the access and transparency,

as well as the taxes. So, there's a lot of differences here. First off, ETFs will have an expense ratio. Commissions no longer exist, yippee, we're trading for free. Next up, discounts and premiums. So right now, if we went out into the ETF markets, here is a fantastic example from a client I spoke to yesterday, the float ETF. I think the symbol is F-L-O-T, or F-L-O-A-T. If you look it up, it is a short-term paper index. So, people that need short-term loans, they reset every 30 days. This thing is trading at a huge discount to the NAV, but like I tell people always, there is no free lunch on Wall Street. If you observe something with high risk, high reward, it is high risk, high reward. Don't assume that you're getting something for free. You have to remember, that particular ETF is short-term paper. The Fed has cut interest rates 150 basis points in 30 days. So, when this resets, and it will reset, it has to buy all new paper. It's going to be resetting at a much, much lower interest rate. That's the reason you're getting the deep discount. There is no free lunch on Wall Street. Pay very close attention to what you're buying. If you're buying something as sophisticated as that, you have to know what you're buying, and very often I find clients with things in their portfolio, and they have no idea what they actually own. So, if you see something with a deep, deep discount, it may not be a bargain.

You may also find something with a premium. If a portfolio is extremely hot at a given moment, you may see people overpaying for that ETF. Now, generally, ETFs should be running at no premiums or discount. They should be running exactly to their NAV. I think the example I gave you of float may be a huge exception to the rule that it is an efficient maker, but it has to wait until it gets new bonds in in order to reset what the NAV is. Basically, at the end of the month, their paper will be matured, and when they reset for lower interest rates, people will realize what they actually got on their hands.

Mutual funds. They have expense ratios. They may have loads or no loads, you may have to come an incoming fee, an ongoing fee, or an outgoing fee, classes A, B, and C. They are bought and sold at the net asset value. So, this is one of the advantages mutual funds have that ETFs do not. If you experience the flash crash, which some of these things feel like ancient history, the flash crash. But if you've experienced the flash crash in your exchange-traded funds or in your stocks, you would not have felt anything in a mutual fund, because it trades at the net asset value at the end of the day only. So, it's impervious for intraday volatility. It only shows you the end of the day. Now, some people might see that as an advantage, others may see that as a disadvantage. They'd like to be able to move in or out intraday, as they desire. So, ETFs will offer you a lot more freedom in when and how you trade, mutual

funds will offer you a bit more stability in that it's free from exogenous things like a flash crash.

Some more differences, the trading attributes. As we mentioned, ETFs trad intraday. You can put in limit order, stop orders, conditional orders. Now, I can tell you and every client I've ever met with, I feel it's my moral obligation to show them whenever you buy something, you should be thinking of how much money you're willing to lose, and, equally, how much money you need to make to justify your risk. What you will find when you do this process of risk management, actual risk management, you will find yourself taking less trades and being much more accurate, because you're no longer flying by the seat of your pants. And I tell all my clients with the use of technology, the days of buying and hoping for the best are long-gone. You have the tools, and you may want to look at something called Trade Armor from Fidelity.

Next up, they also do allow things like shorting and margin. And options, which is not here, which not all ETFs are optionable, but some, I should even say today probably most are, but you have to check what you're buying first, because not all ETFs offer options. Mutual funds, they transact once a day at the close, no limits, no stops, no condition orders, no shorting, no margin. Well, margin, 30 days. You have a 30-day window before you can margin

them. So, mutual funds, you have to think of as a different sort of vehicle, where if you're looking for those things like hedging using options, or you're looking for the risk management tools, you do not have them. The best that you have in mutual funds which you can do, and you should do, you should be placing alerts, the same way you would place a stop order on a stock, you could place an alert. However, there is a big caveat. Mutual funds are dividend heavy. The dividend does not come from the sky. Whenever you're paid a dividend in a stock, an ETF, or a mutual fund, it comes directly out of the price of the underlying vehicle on the ex date.

So, if you see a mutual fund that all of a sudden, and I'll tell you a true experience. Around 2016, I owned a Fidelity Biotech Mutual Fund, and I had an alert on it, because I wanted to know if something catastrophic happened in the fund, I wanted to be able to act at the end of the day. So, I put an alert on it, and I received an alert that it was down $20. A $200 fund down $20, it's down 10% intraday, or overnight I should say. When I received the alert, I immediately went to my screen, I was prepared to exit, as I had planned to do should I get this alert, and then I thought, "Wait. It's December. There may be a dividend." And sure enough, it was a $19.82 dividend on the Fidelity Biotech because it had a phenomenal year. And the dividend comes right back to you, the investor, in the form of more shares. If you wanted to reinvest dividends

on ETFs, you would have to check off dividend reinvestment. So, they are different vehicles, you have to know the rules and you have to treat them differently. Mutual funds will automatically reinvest your dividends, ETFs, you have to let us know dividend reinvestment is what you prefer.

Next up, ETFs do offer things like subsectors. They're generally transparent except for some of the newer managed ones are not fully transparent. And, capital gains tend to be lower due to creation redemption process. Now, that is how the sausage is made. So, if there is not a natural buyer or a natural seller, the folks at the ETF company may need to create or destroy shares. On the mutual fund side, most funds focus on broader markets. There are a few subsectors. You could, of course, buy all the sectors at Fidelity, you could buy a healthcare ETF, or you could also get things like medical devices. We have a separate mutual fund for that. There are some subsectors that are covered, and Fidelity is one of the fun families that does branch out fairly broad in that regard. You don't have to just buy financials, you could buy insurance companies, you could buy banks. So, that would be an example of two subsectors within financials.

In the ETF world, it is also kind of random. Not every subsector is done, but most are. So, if you do your homework, you'll notice there will be a lot of

those advantages as well in the ETF marketplace, some of them even shocking. Yesterday I looked at a China small cap technology, that is a pretty small slice of life out there in the universe of what trades. But there is an ETF for it. Lastly, for mutual funds, they are less tax-efficient in their structure. This is just the way they are built. All shareholders bare the tax burden. Now, you might be wondering, why would mutual funds be so tax inefficient compared to ETFs, and there is a purpose to this. You have to remember that mutual funds were created in the 1780s, the first one was a Dutch ETF, it owned 10 companies. And the rough Dutch translation was, "Unity equals strength," or "Strength through unity." And the idea, instead of owning one company, if you own 10, you'll do better in time.

Now, those original shareholders said, "How can we trust the manager if there's gains, if there's trading going on, how do we know they're not keeping the profits? How do we know that we're getting the profits?" So, the Investment Company Act of 1940 was formed, later in history, because of unscrupulous managers in the 1800s, and the Act of '40 says all of the gains that are generated have to go back to the investors. Now, the mutual fund business realized we're going to reinvest this back into shares, and it becomes, a dividend essentially becomes a way to get more shares, and that's how mutual funds have grown so much in popularity. But it's really to protect you,

the investor. That is the purpose. They hand you back all the money that the fund makes in a given year through trading, there's also a passthrough for dividends that go in the form of lower capital gains, and you are responsible for the tax bill, but don't worry, you're getting more shares. It is really to ensure that you're getting what you're due.

So, where can we research more about these? First off, the ETF Research Center. So, if you go to fidelity.com and you go to News and Research and you come down to ETFs, you will find a world of information there. You can search for ETFs using things like "I only want Fidelity ETFs," or "I want a particular theme or a particular sector." Also, you can use your ETF screener to find what's right for you. If you're looking for stocks that pay dividends, there are plenty of ETF screens you could use to do that. And you can think of it more like the stock market, where, how do we pay for these dividends? The bottom, bottom line for companies' cashflow? You could say, "Yes, I want high-yields, but the company has to be growing cashflow." You have to know that the companies are able to pay those dividends. This is one space where I like to always remind my clients, you don't want to fall into things like a yield trap, where a yield looks so good to be true that it turns out not to be true, because if the ETF is tracking a bunch of smaller high-dividend paying

companies that can't sustain those dividends, you might find yourself in something that's not sustainable.

Lastly, the good thing, you can buy these commission-free online. So, the world of ETFs has changed our marketplace in a very broad way, because these were the first things to trade commission-free, and as you know, now stocks have followed suit. So, this is one thing that I tell my clients all the time, it has never been a better time to be a small self-directed investor than now. You've never had more choices, you've never had more advantages, and it's never cost you less. If you were starting a business, this would be the lowest-cost business in the world to start up. It would be the cost of your internet connection, a great computer, Fidelity will give you all the news, tools, research, creating capabilities. It will give you the world of access of tools on an institutional level, but it is up to you to use them.

So, in review, today we talked about what is an index, we reviewed the four big ones, the Dow Jones Industrial Average, the S&P 500, the Nasdaq 100, and the Aggregate Bond Index, AGG, which is the ETF symbol. We talked about what are ETFs, why do we use them. We talked about the differences to mutual funds because mutual funds are really the predecessors to ETFs that had been around for hundreds of years. We have to remember, everything

we're seeing in the ETF world is still a work in progress. When I started in this business in the early 90s, there was a handful of ETFs, five or six. They replicated the Canadian market, because the very first one was formed in Canada. Then the company that took that over said, "No, we're going to do one based on the Dow, DIA," which became the oldest and most well-known. And then SPY followed suit, and QQQ for the Nasdaq 100 and Aggregate Bond Index. So, these are some of the major indexes, and of course, there are mutual funds that replicate these things too. And, again, this one breaks the rule - the cheapest way to own the S&P is FXAIX, which is a mutual fund. It trades at 0.015. One and a half basis points.

Let me translate: That's $15 per $100,000. That's your total management fee. All of the dividends pass right through to you, and the thing trades as a mutual fund end of day, with all the rules and capital gains included. If you wanted to jump into the world of ETFs, the first one you'd probably think of is SPY, which is the popular one for the S&P 500, but it is more expensive. If you're day trading, swing trading, or you need options and you need the liquidity, you might be using SPY. If you're an investor and you just want the lowest cost vehicle as an ETF, IVVY, which is a product from our friends over at Blackrock, it's four basis points. Now, four basis points is almost three times as expensive, although less than three times as expensive, as FXAIX in mutual

funds, however, it is an ETF and that is the lowest cost ETF, along with DLO, which are our competitors over at Vanguard. They both trade at four basis points. So, whichever vehicle you choose, choose it for the right reasons, whether it's cost, if you're a trader and you need liquidity, you may need a different vehicle, and if you're a very long-term investor and absolutely obsessed with lower cost, the mutual fund may be the right move.

Lastly, I welcome all of you to research and learn more on fidelity.com. I tell clients all the time, fidelity.com is like a warehouse of unlimited knowledge. Everything in blue is a hyperlink. So, if you start with News and Research, come down to Markets and Sectors, you can start at Markets and Sectors. You can see sectors on the right, you can do your sector research, and then from sectors, you could choose ETFs for that sector, so you could find investments. There's actually a tab that says "find investments" once you're looking at sectors.

And if your goal is to beat the market, which so many of my investors say their goal is, you don't have to start with 5500 stocks. That's a big universe to choose from, and you then have to know companies. You can make your life a lot easier by owning the market, and getting market returns, but if you're choosing to beat the market, there are only 11 sectors, and it's much easier to

pick from 11 sectors than 5500 stocks. I don't have to know much about the underlying companies, I just have to know how that sector's doing, and I promise you, if you choose the best three sectors of that year, you will beat the market that year. But you will be shocked when you try this in real time, how difficult it is just to choose from 11 sectors, and if you're a beginning investor, it's a much easier lesson to learn.

Generally, things like technology, healthcare, none of these things are going away in our lifetime. They'll still be around as a sector. Just, they may get stuck like energy has been stuck for five years. So, at some point, energy could change, if we see oil continue this route that we're in, you know, the markets could adapt and change just like it changed to technology. Technology was 27% of the S&P 500, they broke technology into different sectors, and now it's about 15%. It was a necessary step that the S&P knew they had to do.

So, some of the other next steps, you can review the material and you can read our Fidelity Viewpoints, which are usually very timely, and at a time like this, you both have the time and I'm sure the market has got everyone's attention. And attend additional seminars. I think you'll find that this was fairly informative, and I tried to keep it fun, interesting and kind of top-of-mind of

some of the questions I get from clients every day, and real-life examples. So, attend these seminars and let us know what you think. Tell us what you liked most or didn't like. We really do pay attention to your feedback. Thank you all, be safe, and have a great day.

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