TRANSCRIPT

iShares: Diversifying your portfolio with ETFs

Steven Travali: I'm going to introduce our next speaker. We have Brad Zucker, Certified Financial Analyst, with us, Director of iShares Product Consulting. Brad is a product consultant for iShares, he helps clients navigate the ETF landscape and choose the products that best align with their unique investment objective. In addition to working with BlackRock, Brad also does guest lectures at Columbia University on Asset Management.

With that, I'm going to turn it over to Brad, we're going to go through Diversifying Your Portfolio with ETFs, and then I'll jump in in the middle with a screener I'll show you guys. With that, let's welcome Brad.

Brad Zucker: All right. Thank you, Steve. And thank you, everyone, both in person and online for joining us for the session on How to Diversify Your Portfolio with ETFs. The material that we're going to cover in the session can meaningfully help improve investment outcomes, so I'm really excited to get started. And in terms of an agenda, we're going to talk about diversification and why it's important. We'll introduce ETFs and their benefits. Then we'll talk about the major types of ETFs that are out there and some tools that will help you find them. And we'll end with some tips on how to choose the right ETF for your unique investment objectives.

But let me start with a story on my personal investment journey. It started way back when I was 14 years old, that's when I became old enough to work, and I earned my first paycheck -- it was a whopping 82 dollars and 62 cents. I remember just how excited I felt to go and spend that money on things like video games, right? Normal kid stuff. But my dad had other plans for me. Before I was able to cash my check, he took me right to Fidelity, he opened an account for me, and he told me to get started on my retirement savings. So imagine that. I'm 14 years old, I thought my dad was an absolute crazy person. I only worked a few days in my life to that point, I wasn't old enough to drive a car, and he's telling me "think about your retirement." See, I didn't realize that my dad had just taught me the first of the two most important ingredients to investment success, which is you've got to invest. Right? It's impossible to generate good investment results if you're not saving and investing. So that lesson came quickly, that lesson came easily. It was a much longer and, at the time, bumpier road to learning the second key ingredient to investment success, which you might have guessed from the title of the session, is to diversify.

When I started investing, I had a process that I imagine is similar to how many people start. I bought just a couple of stocks that I heard about and that I thought were cool. That was the end of my process. When I went to school I studied finance so I learned some ways to properly analyze companies. So my process definitely improved. I built some spreadsheets, I analyzed hundreds of financial statements, spent hours and hours researching company operations. But after I let some time go by, and I reviewed "how was I doing?" I realized I wasn't really doing any better than the market.

There's a challenge that even financial professionals face. There's close to 4,000 stocks that trade today in the U.S., closer to 15,000 stocks that trade across the globe. Nobody has the time to learn the ins and outs of every company. So how do you avoid missing opportunities? And if you're only going to hold a few stocks, how do you protect yourself from ending up with just some underperformers? You diversify. I've also read plenty of great books on investments and the markets. And while there are many different opinions out there to which is optimal for long-term success, there is one piece of wisdom that's held pretty much universally, and that's that you should diversify. I've even read that diversification has been called "the one free lunch in finance." And when I read that, I thought to myself, I've literally never passed on a free lunch in my entire life. That's one thing that I'm very adverse to, is missing a free meal. So why am I passing on one when it comes to my financial wellbeing?

So I made another change, I started to diversify across many companies. I started investing in all sectors, all styles, all countries. And I wasn't going out and buying all the stocks on my own, I was getting easy access to them through diversified mutual funds and ETFs. I can say that confidently, that was the single most important action that I took to improve my investment results and put myself on track for a happier financial future. Not only did my performance get better, but I got my free time back to enjoy other aspects of life. It was really a win-win for me. So that's why diversification is important to me, let's get into some data now so we can show how diversification might help you improve your results as well.

As we heard from Mark if you joined us in the session earlier, the U.S. stock market has been really strong. It's returned a little bit more than 11 percent per year over the last five years. That means if you started with a 10,000 dollar investment, it would've grown to a little more than 18,000 -- so almost doubling. And while the market as a whole has been really strong, many individual stocks have actually struggled. 42 percent lost money, delivering negative returns to investors. That means it could have been pretty easy to lose in a winning market without proper diversification. Professional money managers understand this. That's why most funds are very diversified. The chart on the right shows that just one percent of funds investing in U.S. stocks lost money over that same time period. I thought that was pretty eye-opening. That shows the value that funds can provide to investors by giving them professional money management and making diversification easy.

So diversifying across many stocks is a great start, but it's not enough for most investors, across common economic factors are going to have an impact on all stocks to some degree. Right? Changes in interest rates, global growth, inflation -- that's going to have an impact on all stocks. If we enter a recession, it's probable that even the best companies are going to perform poorly. So we want to also think about diversifying into asset classes that behave very differently from stocks. For example, high-quality bonds, like those issued by the U.S. government, they tend to do well when the economy is slowing, so they could be adding gains to a portfolio at the same time that stocks are delivering losses.

Now I know this probably sounds obvious to a lot of you, all right, we've all heard the saying, "Don't put all your eggs in one basket." That saying has probably been around for millennia, so why is it that we still see so many investor portfolios remain meaningfully under diversified? As again, if you joined in Mark's session, you heard that sometimes our emotions can get the best of us. And hindsight in particular can cast a really powerful spell -- it makes us think that we were able to predict the future. Before I explain how that hindsight bias tends to impact our investment decisions, let me share with you my favorite example of hindsight bias that was provided to me unwittingly by my friend Jay many years ago.

One morning, Jay convinced us to go to the beach. I remember we checked the weather forecast, it was calling for like a 20 percent chance of rain, so clearly not enough to divert us from going to the beach. But as soon as we showed up, it was absolutely pouring, like not a speck of clear sky on the horizon. And the reason I remember this story is, plus what Jay said to me next, I really found it amazing -- he turned to me and he said, "I knew it was going to rain." And I'm thinking, of course you did not know that. If you did, you wouldn't have dragged us all to the beach, first of all. And secondly, you probably would have been wearing something like a raincoat, but he was wearing a T-shirt that said, "Sun's out, guns out." This was someone ready to go to the beach, expecting sunshine. When it comes to our investments, hindsight impacts us the same way. We tend to feel strong regret from holding assets that did not perform well. And we say things like, "I knew I should have held more of the asset that ended up performing best," but of course we did not know that ahead of time.

Again, you saw some of this looking at slightly different time periods here, but let's walk through again, the emotional ride that a diversified portfolio would have taken us on over the last 20 years. In the aftermath of the tech bubble, the S&P 500 fell about 38 percent. If you were more diversified beyond the S&P 500 into small cap stocks, foreign stocks and bonds, you would have done much better, but again, you're facing a double-digit loss. It doesn't feel great. And then you did not pick up as much of the growth in the rebound. The S&P 500 going up about 83 percent, you're only up 73, so 10 percentage points are lagging. Same story in the global financial crisis. The S&P 500 falls 37 percent, your diversified portfolio does better, it's adding value, but it doesn't feel good to lose almost a quarter of your assets. Think about how it would have felt in the recovery from the March 2009 lows to see the S&P 500 roar back, growing more than 250 percent and your diversified portfolio is only up 150 percent. For me, anxiety really set in in 2018, which was not a great year for most asset classes, and a diversified portfolio actually lost more money than the S&P 500 did. But again, when you look at how did the diversified do over the full period, it actually beat the S&P 500 by a pretty decent margin and it did so on meaningfully lower volatility. How is it the diversified portfolio ended up winning, even though it lagged the S&P 500 by so much in strong periods? It's because a portfolio could win by losing less in bad markets.

Now I know none of you showed up to the session or logged in for a math class, so I'm going to keep this point very brief, but it is extremely important. Let's assume that we started with a dollar and we invest it in the market today, and by some force of incredibly bad luck, the market immediately falls in half. It goes down 50 percent so you're left with 50 cents. What gain do you need to get back to a dollar and break even? You need your portfolio to rise by much more than 50 percent. You actually need a 100 percent gain to get back to where you started. What the chart is showing below is that as the loss that we experience increases, the gain that we need to get back to break even increases exponentially.

So what's the point? What's the takeaway here and how does it relate to diversification? Well, if we're able to reduce the losses that we experience, we do not need to capture as much growth to get back to break even or to end up ahead over time. And diversification, especially, into assets that behave very differently helps us to lower our risk, so we could reduce those portfolio drawdowns, reduce the losses we face, and then end up winning over time by losing less in bad markets. So that's why diversification's important.

Let's shift gears and talk about exchange traded funds, ETFs, which help make diversification very easy and very efficient. Before you can talk about the ETF, we have to talk about the mutual fund, which I think was one of the most important innovations that the financial services industry ever brought to the world. Mutual funds gave all investors, even the smallest investors, access to professional money management and it made diversification easy. They help people access markets that they can't access on their own, they help you invest in sophisticated strategies that you might not be able to replicate on your own. The mutual fund simply helped millions of households achieve better financial futures than they could have done before the mutual fund came around, and the ETF preserved everything we came to love about the mutual fund and even added some benefits on top.

ETFs are structured, so they can be managed with lower costs in more tax-efficient manner than an equivalent mutual fund. That means you can see an S&P 500 ETF and an S&P 500 mutual fund, and the ETF could deliver better investment results over time. ETFs are also more transparent than mutual funds in two ways. First, ETFs disclose their holdings every single day, so if you're an ETF investor, you always know exactly what you own. Mutual funds only tend to disclose their holdings only on a monthly or a quarterly basis. And ETFs also trade on exchanges like stocks do. That means you know what they're worth at every second throughout the trading day. Mutual funds only show you their new net asset value at the end of a trading day. So if you want to buy and sell shares of a mutual fund in the morning, you don't really know the price you're ending up getting per share. So let's summarize by saying ETFs are diversified like mutual funds, they trade on exchanges just like stocks do, so they preserve everything we came to love about the mutual fund and they add greater transparency, lower costs, and greater tax efficiency, all of which can mean better investment results over time.

We spent the first part of this session talking about why diversification matters, let's now move into talking about why low cost and having a tax-efficient portfolio matters as well. The reason that we have to care about costs and taxes is because when it comes to our investments we get what we do not pay for. Now when I first looked at this slide, it made me think back to my days in high school, when I used to run track. I was actually a really good sprinter. I was very fast at short distances. But what those of you online can't really see about me is I'm pretty short. Actually since I'm standing close to this podium, you might be able to see that I kind of disappear if I move over here behind it, but I blame my height on the reason why, at least statistically speaking, I was one of the worst in the entire state of New York at running the hurdles. I was terrible. You put something decently high in front and say, "Now jump over it," and suddenly I went from one of the faster runners on the field to someone who really struggled to reach the finish line. And that's related because costs are a hurdle that we face as investors, and if we're able to lower those costs, it's easier to cross that finish line which is our financial destination. And I thought of that because when you look at the chart on the left, they kind of look like hurdles, right?

What we're looking at there is the average expense charged by a mutual fund compared to the average expense charged by an ETF in the same category. So as an example, take a look at small cap. The average small cap mutual fund charges about one-point-two percent per year compared to the average small cap ETF, a full percentage point cheaper. That means that the mutual fund would have to outperform the ETF by one percent just to break even. That's a high hurdle. Why do we have to care about taxes? Well, if we could lower our tax bill, we'd get to keep more of what we earn.

That's a great case study for what I've been saying, how ETFs are designed to be more tax efficient. We can go back just to 2018, that was a record year for the dollar amount of capital gains distributions that was paid out by the fund industry, and while you saw the super majority of mutual funds making capital gains distribution, just five percent of iShares' ETFs did. To give a sense of how important that tax bill could be, take a look at the chart on the right. Here we're looking at just top core title funds, that means the best of the best, those that outperformed the majority of their peers. And for example, in the large cap space, we saw that the best large cap managers outperformed to the S&P 500 by about zero-point-nine percent per year. That's really, really good. But that's before tax. Once you factor in the impact of taxes on the capital gains distributions that those funds distributed, they actually underperformed to the S&P 500 by close to zero-point-six percent per year. That means the impact of taxes could be so strong that it could take the best outperformers, the strongest performers out there, and turn them into underperformers in the same year. ETFs are structured to be lower cost and more tax-efficient so they lower those investment hurdles and make it easier for us to get to our financial destinations.

Now let's talk about the major types of ETFs that are out there. By far, the largest category of ETFs are called core ETFs. These are designed to mirror a broad market or a market segment such as large cap stocks in the U.S., small cap value stocks, and many others. They're built to hold basically every security that's in that target market, at their current market values, so they represent what the market is doing. These funds tend to be the most diversified, tend to have the lowest fees, and they also tend to be the most tax-efficient. So again, they could help lower those hurdles to investment success. While core ETFs are designed to mirror the market, other ETFs intentionally deviate from the market in an attempt to enhance returns. And those ETFs are going to be called factor or smart beta ETFs. The way that seek enhanced performance, is both scientific and intuitive.

Remember earlier I said that a challenge that even financial professionals face is that there are thousands of stocks out there, so no one, not even professionals that have armies of analysts at their disposal, has enough time to do in-depth, fundamental research on every company in the world. So what do the pros really do? They start with some smart screens. They'll probably throw out any company that's trading on an extremely high price relative to its earnings or other fundamentals, they'll screen out companies that have obvious red flags on the balance sheet like loads of debt, they might screen out companies that are trending in the wrong direction. With the goal of these screens to narrow down the universe to a subset of stocks that all have some attractive attributes and then from there they're going to do their homework and determine which ones they're going to hold in their portfolios.

Well, academic research over the years has shown that those initial screens actually capture a tremendous value in their own right. And when you hear the term “factor” or “smart beta ETFs,” what they’re doing is they’re just passably implementing those very same screens that active investors have been using successfully for decades to enhance performance. The major types of factors that you’ll see out there are value, which just screens for companies trading at low prices relative to their fundamentals, quality, which is screening for companies that are profitable with healthy balance sheets, momentum, which screens for stocks that are on an uptrend, because, at least over short periods of time, winners continue to win and losers continue to lose. Size screens for smaller companies. And then minimal volatility screens for companies that have lower risk or lower correlations so that they can be used to build a portfolio with meaningfully less risk in the market overall. The third major category of ETS are those that can be used to pursue specific opportunities. For example, there are what are called Thematic or Megatrend ETFs that help you get in front of a trend such as the growing use of robotics or artificial intelligence. There are also ETFs that help you pursue sustainable opportunities, such as the reallocation of assets towards a lower carbon economy.

Let me spend a few minutes now on each of these categories so we can understand how they’re used in practice. Remember core ETFs, they’re designed to look like the broad market. These are great tools for implementing asset allocations. The term “asset allocation” just means, how much of my portfolio am I dividing amongst stocks, bonds, and other asset classes? Figuring out your asset allocation is the first and the most important step to any thoughtful investment program. We need to consider what’s the mix that’s going to best allow me to meet my needs? I want to make sure that I’m building in the right amount of growth and safety. For investors that have higher growth objectives, they’re going to increase the allocation to risk-year assets like stocks. For those that want to build in more safety to their portfolios, they’re going to increase the allocation to fixed income asset classes like bonds. And once you’ve settled on “this is the right mix to help me meet my investment goals,” core ETFs make great implementation tools, because remember they’re mirroring the asset class. They’re giving you the returns of those markets, and since they have such low fees and they’re tax-efficient, it’s just going to make that implementation easy.

As an example, ITOT is the iShares’ U.S. total stock market ETF, it gives investors ownership of close to 4,000 stocks in just one click, for an extremely low expense ratio. Similar ETFs for develop market stocks and for those that invest in stocks from emerging market countries as well. There’s also core bond ETFs that are going to invest across the fixed income landscape into treasuries, corporates, even mortgages.

A very important component of building an asset allocation is that we have to periodically rebalance back to those target weights. Market movements are going to shift your allocation over time based on relative performance. We saw, again, that last year, U.S. stocks did incredibly well. The market was up more than 30 percent. So a portfolio that included U.S. stocks would have seen the allocation to those stocks increase more and relative to everything else. So to rebalance back to your target weights, an investor would have had to sell some of the U.S. stock ETF and reinvest the proceeds elsewhere. That is a very important part of your plan because it instills discipline. It makes us sell high and buy low, and that rebalance effect has really added value over time.

Now what if we don't want to be responsible for monitoring our portfolio constantly to see how are we shifting from our target weights, and we're not exactly sure, how do we trade those to get back to the weights we desire? You should know that there are also ETFs that do this for you. They're called core allocation ETFs. An example would be AOR, that's the iShares' core growth ETF. Periodically throughout the year, it rebalances back to 60 percent stocks and 40 percent bonds, so it's a one solution tool for an asset allocation for those investors that have a growth objective.

Remember the name that we used for ETFs that seek enhanced performance is factor ETFs. When I think about how they're used in practice, I think about my two informal clients. The first is my mom. My mom is wonderful at many things, investing, not exactly one of them. She is extremely risk-averse, which tends to lead her to want to make bad investment decisions. She's retired, so she's can't be, though, in just a hundred percent bonds and cash, she needs some stock market exposure in order to meet her retirement spending needs. But if she was to use a core ETF that mirrors what the market does, when the market shows its volatility is when she's really prone to want to make a bad decision. The number one investment mistake that we see investors make is they get jittery in bad market environments. The market starts selling off, it's fallen, they decide to sell, locking in those losses. And then they don't reenter the market until it's stabilized, until it's strongly rebounded already. So, in other words, they participate in the downside and then they miss out on a lot of the upside. How do I prevent a risk-averse investor like my mom, who needs to be in stocks, how do I help her stay invested and avoid making that mistake? I move to her to the left of the spectrum you see on the top of the slide here, into a minimum volatility ETF that are designed to capture some of the market's upside, while meaningfully protecting on the downside. So she's going to be more likely to stick to her asset allocation and stick to the plan that should lead her to success over time.

My second informal client is my brother. He's very different from my mom. It's almost amazing that he's my brother and she's his mom. Obviously he is much younger than my mother is, so that means that he should have a higher risk tolerance, but he's also an entrepreneur, so he has a better understanding of how taking more risk can lead to higher returns. He's got a high return objective as a result, so I move him to the right of the spectrum into the ETFs that follow return seeking factors like quality, momentum, value, and size. They follow robust, academic theory and empirical evidence that show these are factors that could lead to long-term success, and so it allows investors like my brother with a high return objective to seek that enhanced performance in a transparent way, at a low cost, in a very tax-efficient wrapper.

Why would we use the ETFs that pursue opportunities? Has anyone in here read about, heard about, maybe seen a trend and just said "Wow, is this really going to change the way we kind of operate as a society?" Right? Hands up. And then, have you then started to think about, "Well, what's the list of stocks that are most likely to benefit from these trends so I can get ahead of that and invest for profits?" Megatrend or thematic ETFs, they do that homework for you. They do that by tracking indexes that will do things like select and weigh companies based on their revenues from that specific theme. If there is a trend that you're interested in investing in, I encourage you to first take a look if there are ETFs that invest in that trend before you go out and buy some individual names, for all of the reasons that we spoke about earlier, how diversification could really help improve your results.

Just to give another example of why diversification is still extremely important in this space, let's think about one of the trends over the last 20 years that completely changed the way that I live my life. That was the growth of ecommerce. It changed my consumption habits entirely. And I think a lot of people saw this coming, if you go back to the late '90s. We knew that ecommerce was something kind of big, so we started to look at -- What are the types of companies we can invest in to get ahead of that trend? Well two ecommerce companies IPO'd at roughly the same time. One focused on selling toys online, the other focused on selling books online. And right out of the gate, it looked like the toy company was the sure winner. Its stock price almost tripled in its first few weeks on the market. Well, if you only fast-forwarded a couple more months, that toy company went out of business and the book company -- as you might have guessed -- was Amazon, and it was on its way to becoming one of the biggest companies in the world. Investors in both of those companies spotted the right trend. They knew ecommerce was real and was going to change the future. But if you only invested in one of those stocks, you might have seen your portfolio go down and actually lost money, instead of being able to get ahead of the trend. So using these ETFs will be a great tool to help you invest in that theme that you're excited about in a diversified, sensible manner.

Let me just give an example of two of the trends that we see at iShares today. The first is increasing demand for clean and renewable energy sources, and ICLN is the iShares' global clean energy ETF. Its index is going to hold the companies that are most engaged in producing clean energy sources like solar, wind, hydro, and other renewables. Another trend that we see is increasing demand and use of self-driving and electric vehicles. Now if the technology continues to improve and we see these cars come to market at lower costs, and more importantly, in a safer manner, it's, you know, feasible to think that there's going to be a lot more of these cars on the roads in the future. IDRV is the iShares' self-driving and electric vehicles ETF, and it's going to invest across that whole supply chain in companies that are making that technology possible.

This is actually a great point for me to pause and hand it over to Steve. He's going to show how Fidelity makes it easy for you to see the ETFs in these categories that we've just mentioned.

Steven Travali: Thank you. Thank you, Brad. So as we look at doing the research on Fidelity.com, I'm going to run through just a quick ETF screener, I'm going to show you how to build out what you're looking for based on a specific theme or topic, and then I'm also going to show you how to look a little bit under the hood of that. So we would like to all think that if an ETF comes out, and the name of that ETF is, let's say, small cap, for this instance, that automatically that is 100 percent small cap stocks. But that's actually not the case. A lot of ETFs, as they build them out, do deviate from their theme -- their core theme. And I'm going to go, let's see here.

So if I just go by market cap, then I'm going to choose my small cap, the screener's going to pre-load all the small cap theme stocks for me and normally I would think I would stop right here and say, "Okay, well here are my small cap stocks, I'm going to just basically look at who has the net asset value for liquidity where my market price is, and maybe look at expense ratio." So I'm going to put "expense ratio" in here as a factor of something I want to take a look at, but then under search criteria, I'm also going to double-check my market cap. And I want to see what market cap exposure is under the hood here. Now I can see right here, I have two ETFs at the top right here that are telling me I have large cap exposure in them, and I've got 10 of these that have mid cap exposure. That really wasn't what I was going for. So I'm going to check that off and there's a little slide bar right here. Just exclude those ETFs with any exposure of large cap. I already have a large cap ETF, I have that exposure built out in my portfolio, I'm not looking for that exposure to double-up in this small cap.

I'm going to do the same for the mid cap, and I'm going to wipe those out. Now I've taken this list of 14 and now I'm just down to five. So now I can make a better decision based on net expense ratio, or the net asset value, something of that nature, based on these names, that are going to give me a more pure investment objective of what I'm looking for in that particular sector. So this is one example in small cap, but it goes true to all of them. You do need to look a little bit under the hood of the ETFs to see that the investment style within there, that they're behaving the way that they say they are on the name. Just like anything else.

With that, I'm going to turn that back over to Brad to continue.

Brad Zucker: Thanks for that, Steve. So what Steve just went into is a great segue into the last bit of the session, which are some tips for how to choose the right ETF for your unique investment objectives. As that example showed, some

ETFs are going to sound like they're doing the exact same thing on the tin, but you do need to look a little further because they could be more different than you'd expect.

We suggest using a four-prong framework when you're evaluating any fund. First thing you want to ask is "How well do you know the manager?" Are they big? Do they have scale? Do they have proven track records in all different asset classes that you're looking to get exposure to? So companies like Fidelity and BlackRock certainly fit that bill. If it's a newer provider, or let's say a provider that has proven that they're experts in fixed income, but they're moving to equities for the first time, you just need to monitor them a little bit more closely. Make sure that it's performing as delivered.

You want to make sure you understand the investment objective, and that goes into what Steve was showing through his example. Ask yourself, "What is the goal that I'm trying to get out of this part of my portfolio?" Let's stick with that example. If we're talking about adding more exposure to smaller companies to diversify what you already hold, or maybe to add more growth potential into the portfolio, does the ETF track an index that has rules that actually allows you to get those smaller names? And does it allow you to do that without creating overlap or inefficiencies of what you already have elsewhere in your portfolio?

That leads to the most important part of this framework is exposure. Know what you own. ETFs make that easy again, because they disclose their portfolio holdings every single day. And you want to make sure that the rules of the index that the ETF tracks is actually creating an exposure that aligns with that investment objective. As you saw, Steve was able to narrow a list. There was a bunch of them that showed up for small cap, but once he actually started to narrow that down and say, "Am I getting the exposure that's aligned with that objective at only smaller companies?" That list really narrowed quickly.

The last you're going to want to look at is costs. Again, we mentioned that's an important investment hurdle that we'd want to try to lower. And if you have two funds with similar exposures, the one with the lower cost might be the right choice because that could help you cross your finish line faster. Just to make this a little bit more concrete, I'm going to end with a quick case study on exposure, and then we're going to introduce a concept at BlackRock that we call the Total Cost of Ownership.

So again, we're sticking with the idea of adding smaller U.S. companies to a portfolio. Let's say that you listened to my presentation and you heard all the benefits that core ETFs can provide, so you want to get that exposure through an ETF that tracks a small core index. You might think you could just pick any one of them, maybe based on the expense ratio because you might be asking yourself, "Just how different can two U.S. small cap indexes be?" And what the slide is now showing you is it could actually be pretty different.

The two most popular small cap indexes here in the U.S. are the Russell 2000 and S&P's SmallCap 600. Now as the names indicate, there's about 1,400 unique stocks between them. When you consider the portfolio weights of those companies, you see the holdings overlap is only 36 percent. That means even though they're labeled to do the same thing -- give passive exposure to smaller companies in the U.S. -- they're actually more different than they are alike. And you might be asking, "Well, how important is that from, like, an ultimate performance perspective?" The chart on the right shows that year over year, the performance differences can be pretty dramatic.

So the next question usually is, "Well, which index is better?" And of course that depends on what you already hold elsewhere in your portfolio. A lot of investors use the S&P 500 as their way to either benchmark or get exposure to large companies here in the U.S., and those investors should use ETFs to track S&P mid and small cap indexes to complete that allocation without creating an overlap, any gaps, any inefficiencies. There are also many investors that use the Russell 1000 as the way to get exposure to larger companies here in the U.S., and they would want to use an ETF that tracks the Russell 2000 for the very same reason. So exposure matters. It's what drives our ultimate risk and return and we want to understand what we own, and make sure it aligns nicely with what we hold in the rest of our portfolio.

Moving onto cost. The major cost that we all see and think about when it comes to investment vehicles is the expense ratio. But a lot of due diligence processes just stop there. That is similar to going to buy a car and only thinking about the sticker price that you see. We know that's not the only thing we do in practice, right? If we have two cars that we're deciding between, looks like they have a similar price tag, we're also going to ask things like, "What's the relative fuel efficiency?" "How many miles am I getting per gallon?" That helps us understand how much am I likely to pay at the gas pump? Which also might think about things like, "Well, what's the relative cost I'm going to spend on maintenance a year?" We sum those components up so that we can figure out which one gives me the better deal, which one is actually a better value. And you have got to do the same thing when it comes to your investment products. Look beyond the expense ratio. There are other important costs, such as transaction costs. Fidelity and others helped us to worry less about things like commissions, but other transaction costs that are very meaningful, manifest through what's called a bid-ask spread. Less liquid ETFs trade with wider bid-ask spreads, which means a higher cost every time you go on to buy and sell.

Your Fidelity account also makes it easy for you to see the bid-ask spreads. Any time you type in a quote, you're going to be able to see the bid and the ask of a stock or a fund. In addition to that, you want to consider what we call tracking difference. That is when you compare the performance of the ETF to the index that it is designed to track. You want to make sure they're very close. That's a cost because it can represent an opportunity cost. What you don't want to have happen is that you've selected the right index to meet your asset allocation and investment needs, but then the ETF does a poor job tracking it, which means you might have left some potential returns on the table.

The last thing again, taxes matter. If we could lower our tax bill, we'd keep of what we earn. ETFs that historically have been more tax-efficient tend to remain more tax-efficient, so look at the historical capital gains distributions of funds. When you sum all these different components together, you get a total cost of ownership, and assuming that two funds have a similar exposure, you'd want the one with the lower cost because it's a lower hurdle to success.

I spoke about a lot in a short period of time, so let me just quickly summarize. Diversification has been called "the one free lunch in finance." ETFs make diversification easy, and they do it at an extremely low cost and a tax-efficient manner. ETFs can do a lot of things. Some people think ETFs only exist to track or mirror a market. We saw other things they do, like they could help seek enhanced performance or get ahead of a trend that you might want to invest in. Once you've determined the right type of ETF that makes sense for your unique goals, consider our framework.

END OF AUDIO FILE

Diversification and asset allocation do not ensure a profit or guarantee against loss.

ETFs are subject to market fluctuation and the risks of their underlying investments. ETFs are subject to management fees and other expenses. Unlike mutual funds, ETF shares are bought and sold at market price, which may be higher or lower than their NAV, and are not individually redeemed from the fund.

Exchange-traded products (ETPs) are subject to market volatility and the risks of their underlying securities, which may include the risks associated with investing in smaller companies, foreign securities, commodities, and fixed income investments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets. ETPs that target a small universe of securities, such as a specific region or market sector, are generally subject to greater market volatility, as well as to the specific risks associated with that sector, region, or other focus. ETPs that use derivatives, leverage, or complex investment strategies are subject to additional risks. The return of an index ETP is usually different from that of the index it tracks because of fees, expenses, and tracking error. An ETP may trade at a premium or discount to its net asset value (NAV) (or indicative value in the case of exchange-traded notes). The degree of liquidity can vary significantly from one ETP to another and losses may be magnified if no liquid market exists for the

ETP's shares when attempting to sell them. Each ETP has a unique risk profile, detailed in its prospectus, offering circular, or similar material, which should be considered carefully when making investment decisions.

Keep in mind that investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

Beta is a measure of risk. It represents how a security has responded in the past to movements of the securities market. Smart beta represents an alternative investment methodology to typical cap-weighted benchmark investing, and there is no guarantee that a smart beta or factor-based investing strategy will enhance performance or reduce risk.

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