TRANSCRIPT

iShares: Developing a strategy for cash

Sean Murphy: Good afternoon, everyone. Thanks for your time today. My name is Sean Murphy, and I am an iShares product consultant at Blackrock. Today I'm here to talk to you about ways to put cash to work using some of our exchange-traded funds. Now the funds we'll be discussing today are relatively low risk. And I think of these as the next natural step out of your typical cash solutions. So, from a savings account, to a CD, to a money market fund, and perhaps now some low-risk exchange traded funds.

We'll start by looking at the challenges we all face when it comes to finding low-risk investments that are generating some income. Then we'll take a look at how ETFs can help solve some of those challenges. The key to finding the right product, though, is understanding your needs, and your time horizon. So, we'll look at some things to consider before putting your money to work. Finally, we'll take a look at some of our ETF solutions that can help address some of those challenges we'll be discussing.

So why are we talking about this? Well, for investors looking to generate some income without taking on too much risk, the financial landscape is not providing much in terms of solutions. Interest rates have been low for quite some time now, and just when we thought they couldn't get even lower, they did. I've seen some advertisements in print or outside of local bank branches, touting rates on savings accounts that are, and this is a technical term, bupkis. The interest earned on the average savings account is next to nothing. And even if you lock up money for up to a year, the average CD yield isn't much better. Money markets are a little bit better above CDs, but the challenge is that, on average, none of these rates are meeting expected inflation. So, if you're not earning at least the rate of inflation, well you're not losing money, but your money is losing value.

Now I know what some of you are thinking, listen to this guy talking about how we should all be afraid of inflation. I remember when inflation was dramatically higher than where it is right now, and that's a fair point. In relation to where inflation has been historically, we're in a period of relatively low inflation. The inflation rate in 1980, for that year, was just shy of 13 percent. You compare that to last year, 2019's inflation, which was barely above 2 percent. But the compounding effect of year over year inflation, even low inflation, can be meaningful. So, the chart on the right, let's say a basket of items at the grocery store that cost $100 10 years ago in 2009, at the end of 2019, based on last year's inflation rate, it costs roughly $120. So just because inflation is relatively low and has been doesn't mean you should ignore it. You may not, again, be losing money by putting it under your mattress, but your money is losing value.

Inflation, though, is just one consideration for low risk income investors. For fixed income, or bond investors, there are two additional risks to consider. The first is interest rate risk. And I like to think of interest rate risk as sort of a buyer's remorse for savers. Let's say you and a friend are walking by your local bank branch, and you see an advertisement in the window for a CD rate that you like. Let's say it's 1 percent. You and your friend go in, and you sign up for a six-month CD. But your friend gets a slightly higher rate by signing up for a one-year CD.

Fast forward a few weeks, you're both walking by that same bank, except now the rate on both the 6 and 12-month CDs have gone up meaningfully. How would that make you feel? A little bummed out, right? But who will regret that decision more? At least in six months' time, you'll get your money back, and potentially can reinvest those in those higher rates. But your friend has to wait a full year, walking by that bank, seeing the daily reminder of the advertisement out front of the higher rate, kicking the ground as they do.

The friend took on higher interest rate risk by locking their money up for a longer period of time and is therefore more sensitive when interest rates move higher. The financial jargon term for this is duration, which is a measure of interest rate sensitivity. Typically, the longer the amount of time for a security to mature, the more duration it has.

The second risk is credit risk. Credit risk is the risk that the person or company that an investor lends money to might not be good for it. For example, let's say you have two cousins. The first represented here by the letter A is Cousin Alice. She owns her own business, which is pretty successful. She lives well within her means, she drives a modest car, doesn't buy any unnecessary expensive items or go on any extravagant trips. You also have another cousin, Cousin Charlie, represented by the letter C here. Now, Charlie will tell anyone who asks that he's an inventor. He's an inventor in that sometimes he says things like, "Wouldn't it be cool if your microwave was also a television, so that you could watch TV while your dinner is being warmed up?" The problem though is that Charlie really never does anything with these ideas, and for the most part, jumps from job to job.

Now imagine both Alice and Charlie come to you to borrow money to help with their business. One of those cousins, based on the information we have, would be a higher credit risk borrower, Cousin Charlie. Well what about corporate borrowers? Companies that are looking to issue bonds, how do we know the level of credit risk we're taking on? Well there are rating agencies that evaluate bonds and bond issuers based on the strengths of the issuing company. One of these rating agencies is Standard and Poor's, or S&P. They rate bonds using a scoring system that starts at AAA and goes down to D. Companies that have manageable levels of debt, good earnings potential, and a good record of paying back their debts, will have a good credit rating. Those issuers with a BBB rating or higher, represented by that left column here, they're considered investment grade. And the rating agency believes they have a relatively low risk of defaulting on their debt.

So why am I talking about all of this? Well the funds we're going to be discussing today are some of the lowest risk funds at iShares. These funds will have two things in common. First, they will be investing in bonds that have a relatively short amount of time until maturity or will have low duration. And second, they invest in bonds that are all investment grade. All bonds having a score in that left-hand column.

Now before we move on, just a quick point of clarification. I have 19 first cousins, some of whom have Fidelity accounts, and I want to be clear, so as to avoid any awkward interactions once this quarantine is over. Cousin Charlie, not inspired by any of my actual cousins.

Moving on. Understand why we will be discussing short duration funds as a cash solution. Let's take a closer look at interest rate risk, or aka, that buyer's remorse, and the impact it has on the bond market. To do so, we're going to take a closer look at 2018, which was an interesting year, to say the least, for bond investors. In the first nine months of the year, the U.S. Federal Reserve raised interest rates three times. That's sort of like seeing that bank you got that CD at raising that CD rate three times. But the impact for bond investors is a bit different. Bond investors don't have to hold their bond, they can sell it. And when investors sell a lot of something, well the price goes down. And for those investors who owned bonds with longer maturities, that's what they did.

The chart on the right of this slide shows you the price movement for three U.S. Treasury indexes. So, all of the bonds in all of the indexes are from the same issuer but are grouped instead by when they mature. U.S. issuer, U.S. government, AAA rated. So essentially, no credit risk here. But because of the length of time until those bonds mature, depending on where you put your money, your experiences vary. One index, represented by the white line here, consists of Treasuries with at least one year, but no more than three years, until maturity. How do those bonds in that index do during that time period? Well by the end of September, if you had invested $100 in January, you were essentially flat by the end of September.

What about an investor who took on more interest rate risk, investing in an index of bonds with between three and seven years to maturity, represented by the dotted line here? That investor lost a little over 1 percent. Lastly, what if an investor took on way more interest rate risk by investing in Treasuries with at least 10 years to maturity? Well they lost about 4 percent during those nine months -- during that nine-month period. The point being, even though all of the bonds were issued by the same borrower, the AAA-rated U.S. government, investors had varying performance depending upon how much interest rate risk, or how much duration they took on.

Well that was the first nine months of 2018, what happened the last three months helps us better understand credit risk. The U.S. equity market sold off sharply in the fourth quarter of that year. Many investors were concerned about slowing growth, and fear of an escalating trade war. When investors have those types of concerns, they tend to seek out the Cousin Alice's of the world and avoid the Cousin Charlie's. Again, not a real cousin.

As evidence of that, let's take a closer look at the chart on the right. The white line represents a $100 investment in an index that consists of all U.S. Treasury bonds, regardless of how long until they mature. Again, all AAA rated. Well during that selloff, investors looked for safety, and a $100 investment made October 1st was worth about $103 by the end of the year.

The dotted line represents an investment in an all investment grade bond index, but all corporate bonds. Corporate bonds in aggregate, not AAA rated, for the most part. So, you're taking on a little bit more credit risk. Still, all investment grade. That investor would have lost about 20 cents of their $100 by the end of the year.

And that solid black line, that represents an index that invests only in non-investment grade bonds. Those companies, at least in relation to investment grade companies, were deemed riskier by the credit rating agencies. Investors in that index would have lost over 4 percent in those three months.

So, for investors looking to preserve capital, but pick up some yield above that of CDs and money markets, it's important to keep credit quality on the higher end.

We have several ETFs that are commonly used as a step out of cash, because of their low interest rate and credit risk. But before we get into those options, let's first discuss what an ETF is, and why use ETFs in the first place.

ETF stands for exchange traded fund. And they offer many of the same benefits as mutual funds. They're portfolios, managed by investment professionals who have resources at their disposal that the typical investor does not. But unlike a mutual fund, they can be bought or sold any time during the trading day.

When we ask our customers what they like about our iShares ETFs, we typically get one of three responses. First, ETFs provide diversification. Providing access to potentially hundreds of securities in one purchase, giving that much needed diversification. But ETFs provide an additional benefit that mutual funds do not. And that is, daily transparency. Most ETFs track an index. So, you know what is it going to hold. It's a rules-based criteria for investing. Securities that meet those criteria will be within the fund, securities that do not, will not be in the fund.

Knowing what you own allows investors insight into the risks, such as interest rate risk and credit risk, you're taking.

And they do this at a fraction of the cost, with the typical iShare ETF charging about a third that of the same mutual funds. This is especially important for income investors, because income distributions made to investors are after fund fees are taken out. So, all else being equal, lower fund fees means more income for investors.

And lastly, for taxable investors, ETFs are more tax efficient. They're less likely to distribute a capital gain. This is often an overlooked component of the investment selection process. If you're not thinking about tax efficiency, you're missing a major part of the equation.

Bond ETFs have been around since the early 2000s but have historically not been part of the cash conversation, because of a few hurdles investors have had to face. One of these was commissions, or transaction fees. Let's say an individual, after paying rent, car bills, student loans, and the like, has $100 that they can save a month. But the interest they get on their savings account is, again, bupkis. Instead, that individual might want to invest that $100 in a very conservative ETF. Let's say they find a low-risk fund that they think is right for them.

Well historically, for many investors, they couldn't invest that $100 without paying a fee, which for many was $5 a trade. That means only $95 of that $100 actually got invested. If they repeated that process every month, the return that ETF would have had to have generated for the investor to have $1,200 would have to be roughly 11 percent. Now that is not a feasible return for low risk cash-like solutions.

But the industry's moved away from commissions. Fidelity customers can buy any of the funds we'll be discussing for no fee. So that hurdle has now been removed. It's also worth mentioning that all of the funds we'll be discussing have been commission-free in Fidelity for actually quite some time.

The second obstacle which Fidelity recently helped investors overcome is share price. What if that investor found the right fund for them, with the desired level of risk, but it's trading at $110 per share? They obviously don't have enough for that one share, and therefore couldn't purchase it. But Fidelity now offers dollar-based, rather than share-based, investing. Dollar-based investing makes it possible to buy fractional shares and gives you, the investor, control of your savings.

There's one more important consideration that only you know the answer to. And that is your investment time horizon. What is the purpose of the cash you are looking to invest? If it is for a purchase, or liquidity need that is near-term, then the amount of credit or interest rate risk you should take on will be low. Why? Well because the longer your time horizon, the more time you have to recover from potential losses. And therefore, the more risk you can take.

So, to help you find the right ETF for you, we will break down our offerings based on different cash segmentation strategies, so that we can match the appropriate risk levels with the time horizons for your cash. The beauty of iShares is with so many products available, investors can customize the risks they wish to take. In that vein, we'll take a closer look at our iBond ETFs.

Here's a simple roadmap of funds to consider based on your time horizon, starting with very near-term needs, and going out as far as two years. The funds suggested for the most near-term need will be the most conservative. And as the time horizon increases, the funds suggested will be taking on a little bit more risk. To be clear though, all of the funds on this page have two things in common. They are relatively short in duration, or have low interest rate risk, and they're all owning investment grade bonds, so relatively low credit risk.

The first cash segment is money that needs to be available for more immediate needs. Because of the short-term nature of the cash, capital preservation is key. Think of this as an alternative to, let's say, your bank's savings account. For this group, we have two similar funds. Both provide exposure to Treasury bonds with very low interest rate risk. Again, U.S. Treasury, AAA rated. SHV owns Treasuries with less than one year to maturity, with the average bond in the portfolio maturing in roughly five months. The second fund is TFLO, and it also invests in Treasury bonds. But the maturities are a bit longer, on average, let's say 14, 15 months. Even though they're longer in maturity, these funds have nearly identical interest rate sensitivity, or duration. And the reason, TFLO invests in floating rate Treasuries. Remember that CD example from earlier? You open a CD, but then rates go up, and you're left frustrated? Well what if the rate on your CD adjusted to the new rate? That is what the bonds within TFLO do. If rates go up, the coupon on the bonds it owns will go up as well, offsetting that buyer's remorse feeling.

The next segment is less immediate, but still short-term. Think of this as money you might need in a pinch, but you know, knock on wood, that pinch never comes. If you were, for example, to lose your job, and you want to set aside some money to cover a few months of expenses, just in case, we can take on a little bit more risk, but again, we don't want to risk that money not being there when we need it. Our iShares suggestion is ICSH. It's our Ultra Short-term Bond ETF. To be clear though, this isn't the money market, although it does invest in some of the same securities you see in a money market. ICSH does not track an index, it is actively managed by portfolio managers here at Blackrock, but they do a great job of diversification. They will not put all their eggs in one basket on a particular security type, but rather they cast a wide net. They actually own some CDs. But they also own investment grade bonds, and commercial paper. Average maturity of the holdings within the fund is typically a little over half a year and provides a yield a little bit higher than the previous funds discussed. They generate that higher yield by taking on a bit more credit risk, but again, still, all investment grade.

Moving further out on the time horizon, think of this bucket as money to use for a future purchase, like a vacation. Again, you're willing to take on a bit more risk, but you really need that vacation. You don't want to jeopardize your ability to take the trip, but you're hoping that maybe you can upgrade to an ocean view room.

We have three options here. The first is FLOT. FLOT invests in all investment grade corporate bonds, not Treasury bonds, that have less than five years to maturity. But the sensitivity of those bonds to interest rate risk is slim. The reason? The coupons are floating rate. So, if rates go up, the bonds will pay more, much like TFLO that we just talked about. But unlike TFLO, which essentially has no credit or interest rate risk, FLOT has credit risk, because it does not have Treasury exposure, it doesn't have AAA, a large AAA exposure, it has all investment grade corporate bond exposure.

FLOT tracks an index, but the other two funds here are actively managed, just like ICSH. N-E-A-R, or NEAR, is our Short Maturity Bond ETF, where ICSH was ultra-short. So, we're taking on a bit more interest rate and credit risk but yielding a little bit higher as a result. M-E-A-R, MEAR, is our municipal bond version of NEAR, which will be investing in municipal bonds whose income is not subject to federal taxation, and depending upon the bonds within, and where you live, might not be subject to some state level taxes, as well. Much like ICSH and NEAR, the portfolio managers are casting a wide net, investing in bonds issued by states and municipalities around the country. All of the bonds are investment grade, so little credit risk, and the average maturity of those bonds is typically less than one year.

The last segmentation bucket is your longer-term savings. So, money you don't envision needing to touch for the foreseeable future. These two funds will therefore own longer dated bonds than the ones we've previously discussed, therefore taking on a bit more interest rate risk. The first is SHY. And SHY invests in bonds issued by the Treasury, with between one and three years until maturity. IGSB invests in similar maturities, a little longer, one to five years, but is all corporate bonds. So comparable levels of interest rate risk, but they're adding some credit risk into the mix.

We've bucketed funds up to this point based on time horizon. But the interesting thing about time is it passes. What was two years ago, or two years away, I should say, eventually is just around the corner. As that liquidity needs gets closer and closer, investors should consider adjusting the credit and rate risk they first took on. Now for some who want those risk levels to essentially adjust as time goes by, we have our iBonds ETFs. These are term maturity ETFs. What does that mean? Well unlike the previous funds we've discussed, which are designed to exist forever, essentially, these iBonds have maturity dates, just like a bond. But because they are an ETF, they are much easier to trade. You can buy an iBond the same way you would buy a stock. But they're also diversified, owning potentially hundreds of bonds from different companies, or in the case of municipals, different states or municipalities.

iBonds are designed to mature in a particular year, usually in December of that year. Let's say you have some money you've saved for a down payment on a home that you hope to purchase in the spring of 2023. Consider setting aside that down payment in a 2022 corporate iBond. The iBond will mature in December, you'll get your money back, but have collected some interest along the way. Or if you have a child or a grandchild who will be starting college in 2025… if you have some money that you'd like to set aside for those tuition payments, you could set aside money in each year, from 2025 through 2029, and make those payments. Essentially allowing you to offset future liabilities with your current assets.

We currently have three all investment grade iBond suites. The corporate series, a municipal series, and although it doesn't appear here, we recently launched a Treasury series. With iBonds, you can pinpoint essentially how much interest rate risk you want to take on. The longer until the iBond matures, the more interest rate risk. But as the bonds within the fund get closer to their maturity, the sensitivity of the fund to interest rate trends lower and lower, until all the bonds within the fund mature, and therefore the fund itself will mature. The result is a slow de-risking of the investment to coincide with your investment time horizon.

So, to recap, income generation is harder than ever. But iShares ETFs can help. Before choosing an income solution though, figure out the level of risk you are comfortable with, both in terms of interest rate and credit risk. Higher levels of income often mean you're taking on higher levels of risk. So, know what risks you're exposed to. ETFs can help in that regard by providing transparency that allows investors to know what they own.

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Free commission offer applies to online purchases of iShares ETFs in a Fidelity retail account. The sale of ETFs is subject to an activity assessment fee (from $0.01 to $0.03 per $1,000 of principal).

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.

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

In general, fixed income ETPs carry risks similar to those of bonds, including interest rate risk (as interest rates rise, bond prices usually fall, and vice versa), issuer or counterparty default risk, issuer credit risk, inflation risk, and call risk. Unlike individual bonds, many fixed income ETPs do not have a maturity date, so holding a fixed income security until maturity to try to avoid losses associated with bond price volatility is not possible with these types of ETPs. Certain fixed income ETPs may invest in lower-quality debt securities, which involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

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