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The Inside Story On ETF's And iShares

Dan Eggertsen: I'd like to welcome everyone to the call today. This is Dan Eggertsen. I'm here with my father Karl Eggertsen. Hey Karl, Dad, how you doing today?

Karl Eggertsen: Doing good.

Dan Eggertsen: Well good. So we've lately been getting a lot of questions about ETFs and specifically about iShares. I mean some people just ask about ETFs, some people are asking about iShares. So we're going to kind of attack these things at the same time because they're very similar. Basically iShares are a subset of ETFs. So are you ready to answer these questions Dad?

Karl Eggertsen: Yeah Dan, I think I'm ready to go so shoot it.

Dan Eggertsen: All right. Well let's start with the most popular question that we're getting asked and I've just kind of summarized these in the top three most popular questions we get asked. The first one is, "What is so unique and special about ETFs, specifically iShares? It is a term I hear a lot but I'm just not sure what they are exactly."

Karl Eggertsen: Okay but what I'll do is I'll first explain what the relationship is between iShares and ETFs and then I'll get into what they are and go from there. iShares are basically a brand name that Barclay's Global Investors which is a major investment institution named ETFs or exchange-traded funds.

Every exchange-traded fund that they've developed which is well over 150 they have named iShares. So it's iShares something. So they add a name that differentiates the different ETFs by adding for example, iShares S&P 500 or iShares Russell 2000. They basically have labeled or branded all of their exchange-traded funds that they created by starting with the name iShares.

Dan Eggertsen: So it's just a brand name basically.

Karl Eggertsen: Yeah and there're so many Barclay's Global Investors ETFs that iShares predominate out there and I can see how it's become synonymous with exchange-traded fund and the name iShares. Barclay's Global Investors have done a very good job of branding their

product and proliferating it out there so it's almost become like synonymous with ETF or exchange-traded fund. Okay.

Dan Eggertsen: So what are these things?

Karl Eggertsen: Well I'm going to get into that in the next thing here but basically Barclay's Global Investors is the largest issuer of ETFs out there in the United States as well as worldwide. Basically what they are is they're an investment vehicle built similarly to a mutual fund but trades like an individual security; a stock or a bond on the exchanges. They're unique that way because unlike a mutual fund you can trade them at any moment during a normal business trading day on the stock market. When the exchanges are open, you can trade them any time, whereas with a mutual fund you've got to wait a day or two for it to close.

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Dan Eggertsen: Yes you do.

Karl Eggertsen: So you could put your order in but then you got to wait and it's next day or the day after depending on what time of the day on the initial day that you make the trade; before a certain time or after a certain time then it's going to delay or speed it up but it's not until, at the earliest the next day is it going to close and become effective.

Dan Eggertsen: So day traders technically – even though we don't do any day trading – but day traders could theoretically use an ETF but they could not do a mutual fund in day trading.

Karl Eggertsen: Oh yeah. Any type of investor could use any strategy they want with ETFs because they're so flexible. And that gets into some of the benefits and attributes of exchange-traded funds as we get later into this. But exchange-traded funds they hold a basket of stocks or bonds, you know whatever they're holding.

The attempt is to replicate a given benchmark or market index such as the S&P 500 or the Dow Jones Industrial Average and there's many, many, many other indexes and slicing and dicing that can be done to come up with different exchange-traded funds that cover different areas of the market worldwide as well as just in the US.

Dan Eggertsen: Right.

Karl Eggertsen: So the returns of these exchange-traded funds if they're doing their job and most of them do very well is, their returns is very close to the underlying index. So the basket of stocks or bonds that they hold within a particular exchange-traded fund based on the performance of the index that they're replicating, they come very close to it. The major difference is the management cost to run the fund which is typically extremely low for exchange-traded funds. Okay?

Dan Eggertsen: Okay.

Karl Eggertsen: So that's basically what they are and the exchange-traded funds, there're hundreds of them out there. Not just by Barclay's Global Investors iShares but there's others that have many funds out there, exchange-traded funds that, some are in competition for the same index that an iShare might be. But there's many that are unique that iShare has that are unique and some other companies have that are unique that iShares doesn't have. So there's a whole variety to pick from out there. Okay?

Dan Eggertsen: Okay great. Now just a sidebar question here. So everything else being equal, let's say you have a mutual fund like an S&P 500 mutual fund, it just mirrors the S&P index and you've got an ETF that does the same thing, it mirrors the S&P 5 – usually, in most cases everything else being equal you'd want to go with the ETF right because you've got more flexibility, you can buy and sell any time you want and the management fees will be a little less. Is that usually the case?

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Karl Eggertsen: It's usually the case. It usually is the case. So they're a big competition for the existing index mutual funds is because – and I'll get into the variety of benefits of the exchange-traded fund along with a couple of cautions or tips to watch out for. But we'll cover that in subsequent questions you have.

Dan Eggertsen: Okay. So the next question then that I've got here is, "How do I know if I should invest in ETFs or iShares? I just don't know if they would be right for me."

Karl Eggertsen: Okay, well first of all getting into the iShares and specifically for a moment here is Barclay's Global Investor Institution that created and developed the first ETFs and have since developed close to 200 of them. I don't know what the exact count is but it's somewhere I think between 150 and 200. They're proliferating quickly. So they have two trillion dollars in assets so their financial strength is extremely strong. They're one of the largest and financially strong investment institutions in the world.

Dan Eggertsen: Right.

Karl Eggertsen: They have thousands of individual investors as well as institutional investors, you know, taking care of institutions being like companies that are taking care of their retirement savings for their workers. There are millions and millions of people, individuals as well as institutions that utilize ETFs for retirement funds and other types of purposes.

So from that standpoint, when you talk iShares you're on solid ground with a very well healed company with a lot of assets and their proven quantities and they know what they're doing with exchange-traded funds because they are the creators of the original ones. So your question is, "Why – "

Dan Eggertsen: "When do I know if they'd be right for me? Are they right for me?"

Karl Eggertsen: Okay let's go through some of the advantages. Number one is low expenses; lower than most mutual funds by far. Tax efficiency, they don't do a lot of selling. They get a

basket of stocks or bonds in an exchange-traded fund and they're mirroring the index out there so there's not a lot of selling going on so their capital gains are few and far between and they often try to balance any trading they do, any additions or sales, they try to balance it out so they keep the tax efficiency near zero.

It's not much impact on your taxes. They're very transparent; you know exactly what you're holding. There's no secret strategies, no secret assets in there, you know exactly what you're holding. They support most any asset allocation plan. You got so many to choose from you basically can configure whatever kind of portfolio you want to configure for whatever purpose you have. They provide tremendous diversification.

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With one trade you can be in a market index just like that. If you have a variety of diversified exchange-traded funds covering different areas of the market, some classes go down some will go up. You basically have a low risk factor there from that standpoint. The trading flexibility, you can trade at any time during the trading day and sell at any time during the, you know, buy or sell during the trading day.

So there are tremendous advantages to it, to these. They beat most mutual funds, you know, performance-wise over time because they are so cheap, because the tax ramifications are near zero. It's really hard for a mutual fund with higher costs and many of them actively traded so there can be a lot of trading going on trying to beat the market. You're going to be doing a lot better by far than most of the mutual funds out there.

They really can be right for most anyone, for any purpose. An exchange-traded fund for most any asset class is out there. You can configure in a modular way. I kind of look at ETFs like they're modules; they each have different attributes to them and you can pick and choose and configure a portfolio very quickly and you're in full control of it because you know exactly what you have. You know that these [beep] exchange-traded funds are not going to be changing.

They're going to be staying the same in representing the area of the market you want to represent and you can have whatever weighting you want. [beep] The different modular pieces of ETFs that you're putting into your portfolio. So there're a lot of advantages. Now they mentioned a couple of cautions or tips.

These are not the best tools – exchange-traded funds are not the best tools for regular dollar cost averaging like every month or every two weeks putting in a little bit of money. When somebody's putting in like maybe 100 or 200 bucks every couple of weeks or every month, what you're doing is like a stock, is you trigger a trading commission.

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Dan Eggertsen: Now so let's reiterate what the notes of caution are here for ETFs and iShares, just to make sure everyone understands.

Karl Eggertsen: Okay. Just some cautions or tips. When it comes to investing on a regular basis into exchange-traded funds, they're not built to be the best tool to do that because, since they trade like a stock, you have a lot of trading flexibility; you also pay commissions like you do with stocks. So they are not the best tool unless you're investing less frequently or investing larger amounts or the commissions are going to be a much smaller part of the amount that you're contributing to your investment account or into your retirement account.

So unless you're investing in more of a lump sum basis periodically or a onetime lump sum thing or investing a significant of money more than the cost of the commission then it doesn't make sense to do that with an exchange-traded fund.

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For that purpose it's best to go with a discount broker like Scotts Trade where they charge a lot less than most other brokers and you could try to use a exchange-traded fund that way or you could use for example, Vanguard or Schwab. They have very low cost mutual fund index funds where they will not charge you anything to contribute to their mutual funds. But it's important to be in the company that provides the mutual fund.

You can get really good index mutual funds at Vanguard and at Schwab, Charles Schwab for only like 0.09% which are like an index fund except they're mutual funds. Okay? Index mutual funds, so that's something to think about. You wouldn't pay anything to contribute every month. It's zero cost for you to contribute to those accounts.

For the other areas of your investments you could use exchange-traded funds but if you have a regular contribution you want to stick with lump sums or trading larger amounts less frequently into exchange-traded funds using a discount broker like Scotts Trade which is bare bones cost compared to a lot of brokers or you want to use a mutual fund if you're doing it regularly with smaller amounts.

Dan Eggertsen: Okay. Quick question. If somebody has mutual funds, they have a bunch of mutual funds already. They've already been investing. They've already been doing their due diligence. Now ETFs come into play. Should they consider moving all of their mutual funds to comparable ETFs or would that not be worth it?

Karl Eggertsen: Well it depends on how long you've had them. You want to evaluate what the – it's a good question – you want to evaluate what the, you know, how much capital gains you, you know, what the capital gains tax would be to sell because every time you sell you're going to potentially trigger either a loss that can help you on your taxes because you're accruing a loss, you're harvesting losses. Or you're, depending on how long you've held it, you know, you could have some capital gains where you're going to owe some taxes.

Dan Eggertsen: Then of course the transaction fees and all that for selling it.

Karl Eggertsen: Yeah, yeah. But the thing is, that's the advantage of the kind of market that we're in, that we've been in is...

Dan Eggertsen: Gives you a chance to restructure.

Karl Eggertsen: This is a good chance for a lot of people to restructure into lower cost vehicles and for the long run and position yourself in ways – you know a lot of these exchange-traded funds were not even available a number of years ago so there's a lot of things that have changed; lower costs, new and different ways of packaging investment vehicles like exchange-traded funds so in bad times like this like – you know, one of the old sayings is, "Look for the good in any bad situation you're bound to find it."

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This would be an advantage to a lot of people if they'd just open their eyes and think about it that there would be some advantages because you could make some changes in your portfolio right now that you would even be accruing losses so when the next bear market comes along – in fact we're seem to be moving more and more these days, the way the stock market's been going up – it would be a very good thing to make whatever changes in your portfolio structure. If you wanted to add some exchange-traded funds where you had mutual funds right now, now would be a good time to do it as long as you're replacing like with like.

Dan Eggertsen: Yeah. Like with like. Okay. And then the final question is just kind of about you personally. "Do you have any ETFs and iShares in your portfolio and if so, which ones and why?"

Karl Eggertsen: Yeah what I have in my portfolio, I basically have ETFs and – remember I've been investing for quite a while so exchange-traded funds were not even around when I started investing. They're a relatively new vehicle that's really started to come in around in the mid, late 90s and have proliferated ever since.

So I have four iShares that I use to cover major broad indexes and these include the S&P 500 index which the ticker symbol is IVV. It's very low cost, only 0.09% management fee. It's basically the blue chip index. It's the 500 major big blue chip companies in the United States. So I've got that covered with a very low cost exchange-traded fund.

Then I have an S&P, Standard & Poor's 400 which is ticker symbol is IJH. Its cost fee is a low 0.2%, 2%. It focuses on 400 of the most healthy, profitable, liquid companies. And when I say liquid, I'm talking about they have high volume. Over 100 thousand daily trading volume every day; they're well over that. They're into the millions actually. In fact all my ETFs have very high volumes so they're easy to trade. You're not going to get stuck with them.

Then I have the Standard & Poor's 600 which ticker's IJR. It's a 0.2%. It focuses on the most healthy small companies. Again with profitable, liquid, high volume, and again they focus on

the more healthy companies of the small companies. And then I have one that's a little bit more risky. It's the Russell 2000 which is 2000 of the small companies. It has 2000 small companies in this index. Ticker's IWN, its cost is 2.5. It's a mix of lower priced small companies.

It focuses on value. Companies that have low price based on what is construed to be their real value. For whatever reason they're priced low, they're bargains and they have the potential to increase in value when the economy gets better and/or the companies profits begin to increase. A lot of small companies are startups, they're just starting up and profitability's not that great.

So it's a little bit more risk in this but there's more potential for growth too. So I've got those four and the thing I wanted to emphasize about the ETFs is there're some things to always think about. Realize that they're pure. They're transparent. You know exactly what you have in each one. You have full control once you put it in your portfolio because it's going to cover what you want to cover. It's going to do for you what you want it to do for you in your portfolio.

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They're very low cost so there're tremendous advantages in using exchange-traded funds if not in every part of your portfolio at least in many. Okay?

Dan Eggertsen: Yeah. All right Dad. Well thanks so much for your time. I want to thank everyone else for being on the call and your time is valuable to us and thanks so much Dad. We'll talk to you next time.

Karl Eggertsen: Okay Dan, bye.

Dan Eggertsen: Bye. All right Dad. Excellent.