Revised and Extended Remarks at the U.S. Securities and Exchange Commission Investor Advisory Committee Meeting

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May 21, 2020

Good morning and thank you for inviting me here today. In my remarks I will provide a brief overview of the index investing landscape, then share some thoughts on how we can help increase transparency to benefit investors.

The growth of index funds

Index funds have experienced tremendous growth over the past decade. According to data from the Investment Company Institute, U.S. index funds, including index mutual funds and index exchange-traded funds, had $8.5 trillion in net assets at the end of 2009.[1] At the end of 2019, that number had increased to $22 trillion.[2] Exchange-traded funds, or ETFs, represent approximately 50% of these indexed assets.[3]

While this growth is significant, it's important to keep the size of index funds in perspective relative to the overall market. Index equity mutual funds and ETFs represent just 15% of the US equity market.[4] They are an even smaller percentage of the US fixed income market.[5]

We believe the rising popularity of ETFs reflects the benefits that ETFs provide to investors. Scaled asset management has reduced costs and created a virtuous cycle of improved outcomes, as more investors, both individual and institutional, come to the market. By bringing low-cost access to a diverse range of markets and asset classes, index products have helped people allocate capital more conveniently than ever before.

Index investing is not "passive" investing

In her paper, *Passive in Name Only: Delegated Management and 'Index' Investing*, Adriana Robertson asserts that there is nothing "passive" about index investing.[6]

At BlackRock, we agree. In fact, all investment decisions are active decisions.

[1] "Investment Company Factbook", Investment Company Institute, pg. 39, available at https://www.ici.org/pdf/2020_factbook.pdf.

[2] See Footnote 1.

[3] See Footnote 1.

[4] "Investment Company Factbook", Investment Company Institute, pg. 40, available at https://www.ici.org/pdf/2020_factbook.pdf.

[5] See Footnote 4.

[6] See Adriana Robertson, "Passive in Name Only: Delegated Management and 'Index' Investing", 36 *Yale Journal on Regulation 795,* (June 2019), available at SSRN: https://ssrn.com/abstract=3244991.

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Investors actively choose to invest in an index fund to help meet their investment objectives, starting with a broad range of indexes, and index fund managers actively work to help deliver the desired outcome with low tracking error to the chosen index.

Much of the current market dialogue pitches active and index investment strategies against each other as opposites, but in practice, the landscape is more nuanced. It may seem binary—active vs. "passive"—but we think it is better to view investment strategies as a continuum, ranging from the most actively managed to the most index-oriented.

The term "passive" investing can give the false impression of a fully automated approach to investment management. While these index-based strategies do seek to track the composition and performance of an index, they require specialized portfolio management expertise to do so.

During index rebalances and reconstitutions—when securities are added to, removed from, or reweighted in an index—index fund managers rebalance or reconstitute their portfolios. When trading around index events, index fund managers have control and exercise discretion in seeking to track the index and maximize shareholder value.

For example, when bonds are downgraded from investment grade to high yield, the index fund manager has discretion over how long to hold those bonds (subject to disclosure in their offering documents), whereas some other investors may be immediate forced sellers of these fallen angels.

Index fund managers must review information about upcoming index changes and have an implementation plan in place to buy or sell securities to align their portfolio with the index in a way that balances risk, return, and cost.

Other responsibilities may include tracking corporate actions that can impact the composition of an index, reinvesting dividend or interest payments received from a fund's portfolio holdings, and monitoring risk in their portfolios and in the market.

In instances where a portfolio holds a sample of an index's securities, portfolio managers have discretion over security selection and can choose which securities to add or remove from the portfolio in order to continue tracking the index while aiming to minimize transaction costs and taxes.

The roles of index fund managers and index providers are often conflated, so it's important to draw a distinction between the two.

While index fund managers oversee portfolios, it is the index providers that mange the underlying indexes.

Index providers, like MSCI and S&P Dow Jones Indices, are responsible for constructing and monitoring a wide variety of indexes. It is the index provider that sets the methodology that defines the scope of the index. It is also the index provider that determines when the makeup of an index will change, and at what frequency these changes will occur.

Index portfolios are designed to track the performance of a specified index.

Index funds have democratized investing

Index mutual funds and ETFs have been transformational for investors. They have democratized access to the world's investment markets, allowing individual investors to enjoy the benefits of diversified portfolios that institutional investors have recognized for decades.[7]

Not only do ETFs help investors access hard-to-reach markets in a cost-efficient way, but they also serve as vehicles for risk transfer. When market volatility spiked in the first quarter of this year, investors increasingly turned to ETFs to allocate capital, adjust positions and manage risk.[8]

The need for clearer classifications

Across asset classes, indexation has made investing more accessible. However, index investing and ETFs have also broken down the barrier between investors and more complex strategies and exposures.

Recent market events have underscored the need for clearer exchange-traded product (ETP) classifications to better inform investors' decisions.

It's worth noting that earlier this week, the Financial Industry Regulatory Authority (FINRA) issued a notice on sales practice obligations with respect to oil-linked exchange-traded products, suggesting that some investors—as well as the investment professionals recommending these products—may not understand oil-linked ETPs' investment objectives or how the different product structures can impact their performance and the investor experience.[9]

"ETF" has become a blanket term to describe a wide range of products that offer exchange-tradability, and while regulators have worked to promote transparency around these products, there is no standard taxonomy.

On May 13, BlackRock, in partnership with Charles Schwab Investment Management, Fidelity Investments, Invesco Ltd., State Street Global Advisors and The Vanguard Group, Inc., submitted a letter to the U.S. stock exchanges asking for their help in implementing an ETP categorization framework that further classifies exchange-traded products as exchange-traded funds ("ETFs"), exchange-traded notes ("ETNs"), exchange-traded commodities ("ETCs") or exchange-traded instruments ("ETIs").[10]

A clear distinction between different types of ETPs will add transparency to the market; making this distinction with a shared language will help minimize investor confusion.

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[7] Diversification does not guarantee a profit or eliminate the potential for loss.

[8] From Feb. 24 through March 23, as market volatility accelerated, ETFs accounted for 37% of all U.S. trading activity on exchange compared with an 27% average for 2019. BlackRock; Bloomberg (data as of March 24, 2020)

[9] See FINRA Regulatory Notice 20-14, "Sales Practice Obligations With Respect to Oil-Linked Exchange-Traded Products", issued May 15, 2020, available at https://www.finra.org/rules-guidance/notices/20-14.

[10] More information on this initiative available at https://www.blackrock.com/corporate/literature/publication/letters-to-exchanges-regarding-etp-classification-051320.pdf and https://www.ishares.com/us/education/etp-classification.

The system we proposed is not designed to label products as "good" or "bad". Instead, it should serve as an indicator that additional due diligence may be required.

While some are portraying this effort as 'big firms versus small firms', note that three of the firms that signed the letter have products that qualify for the ETC or ETI bucket. Of the more than 900 funds offered in the US by the group of signatories, 887 of them would be ETFs under the proposed scheme, while 18 would be ETCs and 7 would be ETIs.[11]

This is about clearly labeling products to help investors better understand what they are buying, and publicly submitting this letter was the first step in a constructive dialogue where everyone is invited to contribute their thoughts.

We welcome input on this proposal from all parts of the market.

Conclusion

It's clear that the growth of index investing has benefitted investors. As of March 31, nearly 19 million households are accessing the markets via U.S.-listed iShares ETFs alone.[12]

Despite their popularity, the relative scale of index funds is small. This means there is significant room for continued growth in index strategies, particularly ETFs, as investors with varying investment horizons, risk profiles and portfolio goals discover their potential benefits.

In summary, index funds and ETFs are becoming essential tools in all shapes and sizes of investment strategies, but to support further growth, we must continue to educate investors and, critically, make it easier for them to know what they own.

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[11] BlackRock, Charles Schwab Investment Management, Fidelity Investments, Invesco, Ltd., State Street Global Advisors, The Vanguard Group, Inc., Markit, Bloomberg as of March 31, 2020.

[12] BlackRock, as of March 31, 2020.

Important Notes

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