i want more efficient client investments.
i need complete portfolio transparency.
i like that ETFs give me both.
Adviser guide to ETFs
Exchange Traded Funds (ETFs) are revolutionising the way investors and their advisers manage portfolios. ETFs are efficient, cost-effective, transparent and offer opportunities to reduce risk. These benefits have driven the popularity of ETFs with some of the world’s most demanding investors, from private banks and pension funds to government agencies and professional investment managers. ETFs are now being used by more and more financial advisers.

This guide provides you with the information you need to understand ETFs, the benefits they can deliver and how they can be used in the portfolios you design for your clients.

**USING THIS GUIDE**

This guide is intended to be a reference tool for advisers. It includes general information on ETFs, what you need to look for when selecting ETFs, the background on the tax implications and ‘reasons why’ statements for use with your clients.

Each section has been designed as a standalone reference.
iShares® is the world’s largest ETF provider, with over USD711 billion in assets under management¹. iShares has pioneered making ETFs accessible to all types of investors and is committed to helping advisers get the best from ETFs. With over 607 ETFs listed on exchanges worldwide and over 39% market share globally, iShares has been championing ETFs as a better way of investing for the last 15 years. Today iShares has more than 100 ETFs listed on the London Stock Exchange².

¹ Data as of end of September 2012. Source: BlackRock Investment Institute – ETP Research, Bloomberg.
² Source: BlackRock, September 2012.
What is an ETF?
What is an ETF?

An ETF is an investment fund that is traded on a stock exchange.

The aim of an ETF is to track the performance of a specified index (like the FTSE 100) and to provide investors with the same return as that index, less fees.

To deliver the same return as the index, the ETF provider manages a fund that either replicates the holdings of the index (known as a ‘physically-replicated’ ETF), or alternatively, the fund can replicate the index’s performance by using a synthetic swap structure (known as a ‘derivative-replicating’ ETF. Please refer to section 3 for more details).

Like an investment fund, an ETF investment gives investors access to a portfolio of companies (shares), bonds or other asset types (such as commodities or property). Like a share, an ETF is bought and sold on a stock exchange. Consequently, ETFs offer investors the best of both worlds – the diversification of an investment fund, with the easy tradability of a share.

There are ETFs available that track most major indices for stocks and shares, bonds, commodities and other asset types (like property), providing efficient access to many markets for investors. Sector-based ETFs are also available, offering access to specific industries. As a result, ETFs are fast becoming one of the most important and efficient investment tools used in portfolio asset allocation. ETFs are index-tracking investments that offer real benefits to your clients in an easy-to-access package.

ETFs are index-tracking investments that offer real benefits to your clients in an easy-to-access package.
ETFs have become an essential portfolio building block, offering diversification, transparency and liquidity, all at a lower cost than many traditional mutual funds. Their growing popularity demonstrates the value investors place on the following benefits that ETFs consistently deliver.

The benefits of ETFs for advisers

**Flexibility**
A place for ETFs in both tactical and strategic asset allocation.
Intraday trading: as easy to get in as it is to get out.

**Cost effectiveness**
ETFs offer a cost-effective route to diversified market exposure.

**Liquidity**
ETFs are listed on exchanges and can be traded at any time the market is open.
An ETF is as liquid as its underlying securities.

**Transparency**
Investment objective of the fund.
Daily disclosure of underlying securities.
Explicit Total Expense Ratio (TER).

**Diversification**
At a fund level: holding the entire index in just one trade.
At a portfolio level: ETFs cover a full spectrum of asset classes including equities, bonds, commodities, investment themes etc.
ETFs are noted as one of the investment tools that are suitable retail investment products as they are a ‘cheap and transparent way to access the market’.

The ETF structure does not support commission remuneration, and this was cited as one of the reasons for their slow adoption in the advisory market. In this regard, ETFs are ‘RDR ready’ as they fit into the new ‘adviser charging’ model being proposed by the Financial Services Authority (FSA).

The majority of ETFs registered for sale in the UK are regulated Collective Investment Schemes (CIS) and, as such, fall under the definition of packaged investment products.

In addition, many ETFs pay dividends and carry UK Reporting Fund Status, making them a useful tool to generate income for clients. ETFs that are listed on the London Stock Exchange can be included as an investment option within a range of product tax wrappers, including:

- Individual Savings Accounts (ISAs).
- Self Invested Personal Pensions (SIPPs).
- Offshore bonds.

iShares is not covered by the Irish or UK compensation schemes. The regulatory framework ensures that ETF assets are held as ‘segregated liabilities’ and therefore under third party oversight and custody, held solely for the owners of the ETF shares. This places all assets outside of the control of any other party, for example, the ETF promoter.

The majority of ETFs are UCITS III compliant – please see our Global Product Information at www.iShares.co.uk for more information.

ETFs have been cited by the Financial Service Authority’s RDR (June 2009) as one of the packaged products that advisers, wishing to consider themselves independent, should familiarise themselves with and consider in their recommendations to clients.

ETFs and the Retail Distribution Review (RDR)

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Comparing ETFs and mutual funds
## Comparing ETFs and mutual funds

The traditional mutual fund is the investment structure of choice for many advisers. ETFs bring together many of the benefits of mutual funds coupled with the advantages of shares. However, there are some features that differentiate ETFs from mutual funds.

The following table compares ETFs with traditional active mutual funds and index-tracking mutual funds.

<table>
<thead>
<tr>
<th></th>
<th>ETFs</th>
<th>Active Mutual Funds</th>
<th>Index Trackers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Structure</strong></td>
<td>Open-ended fund</td>
<td>Open-ended fund</td>
<td>Open-ended fund</td>
</tr>
<tr>
<td><strong>Investment objective</strong></td>
<td>Replicate an index</td>
<td>Outperform an index</td>
<td>Replicate an index</td>
</tr>
<tr>
<td><strong>Trading</strong></td>
<td>Intraday during LSE market hours</td>
<td>Once a day or less frequent</td>
<td>Once a day or less frequent</td>
</tr>
<tr>
<td><strong>Accessibility</strong></td>
<td>Via a stock broker or wrap platform</td>
<td>Via fund manager or fund supermarkets</td>
<td>Via fund manager or fund supermarkets</td>
</tr>
<tr>
<td><strong>Pricing</strong></td>
<td>Priced at close to Net Asset Value (NAV) and continually in market hours</td>
<td>Priced daily close to fund NAV</td>
<td>Priced daily close to fund NAV</td>
</tr>
<tr>
<td><strong>Expense ratios</strong></td>
<td>TER*</td>
<td>TER*</td>
<td>TER*</td>
</tr>
<tr>
<td><strong>Bid/ask spread</strong></td>
<td>Yes</td>
<td>Yes (unless single priced)</td>
<td>Yes (unless single priced)</td>
</tr>
<tr>
<td><strong>Dividend treatment</strong></td>
<td>Distributing or accumulating</td>
<td>Distributing or accumulating</td>
<td>Distributing or accumulating</td>
</tr>
<tr>
<td><strong>Transparency</strong></td>
<td>High</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td><strong>Minimum investment size</strong></td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Exit/penalty fees</strong></td>
<td>No</td>
<td>Sometimes</td>
<td>Sometimes</td>
</tr>
<tr>
<td><strong>Tracking error</strong></td>
<td>Low</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td><strong>Returns variability</strong></td>
<td>Low</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td><strong>Manager selection risk</strong></td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**Tax Wrapper Inclusion**

<table>
<thead>
<tr>
<th></th>
<th>ETFs</th>
<th>Active Mutual Funds</th>
<th>Index Trackers</th>
</tr>
</thead>
<tbody>
<tr>
<td>ISA /SIPP</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Offshore bond</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

*Total Expense Ratio (TER)
Index-tracking products like ETFs generate consistent benchmark returns.

ETF fees are typically lower than those charged by traditional mutual funds.

Lower fees and consistent market returns, combined with complete transparency, mean ETFs can be a beneficial alternative to traditional mutual funds.

The annual cost of holding an ETF is known as the Total Expense Ratio (TER), which can range from 0.09%-0.79% of funds under management.

ETFs provide a high degree of transparency, as most providers publish holdings daily on their websites.

Actively-managed funds charge higher fees for the possibility – but not the certainty – of outperforming the market.

Source: BlackRock 2012.
Selecting the right ETF
The rapid growth of the ETF market in recent years has made it more important than ever to understand how to differentiate between products that, at first glance, can appear very similar.

Asking the right questions will help you choose the right ETF for your clients. In the following section, we focus on these four key considerations:

- **What is my benchmark?**
- **How do ETFs track their benchmarks?**
- **What costs are involved?**
- **How experienced is the ETF provider?**

By asking the right questions about ETFs, advisers will be well placed to deliver the best portfolio solutions for their clients.

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**Understand the index**

ETFs are designed to track indices, so understanding the index that the chosen ETF tracks is vitally important.

There are a wide array of indices that can differ significantly in terms of investment type and strategy. This means that it is essential to be able to assess the composition, objectives, performance and risks of each index.

**WHAT IS MY BENCHMARK?**

Here are some examples of key asset class indices across equity and fixed income markets:

<table>
<thead>
<tr>
<th><strong>EQUITY INDEX TYPES</strong></th>
<th><strong>FIXED INCOME INDEX TYPES</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total market indices</strong></td>
<td>Aggregate indices</td>
</tr>
<tr>
<td>e.g. MSCI World</td>
<td>e.g. Barclays Capital Euro Aggregate</td>
</tr>
<tr>
<td><strong>Sector specific indices</strong></td>
<td>Government bond indices</td>
</tr>
<tr>
<td>e.g. EURO STOXX Banks</td>
<td>e.g. FTSE UK Gilts All Stock</td>
</tr>
<tr>
<td><strong>Region/Country specific indices</strong></td>
<td>Corporate bond indices</td>
</tr>
<tr>
<td>e.g. MSCI Europe, FTSE 100</td>
<td>e.g. Markit iBoxx £ Liquid Corporates</td>
</tr>
<tr>
<td><strong>Size indices</strong></td>
<td>Asset-backed indices</td>
</tr>
<tr>
<td>e.g. FTSE 250, EURO STOXX Small</td>
<td>e.g. Markit iBoxx Euro Covered Bond</td>
</tr>
<tr>
<td><strong>Strategy indices</strong></td>
<td>Inflation-linked indices</td>
</tr>
<tr>
<td>e.g. EURO STOXX Total Market Value/Growth Large</td>
<td>e.g. Barclays Capital UK Government Inflation-Linked Bond Index</td>
</tr>
</tbody>
</table>

Source: BlackRock.
Knowing your index – case study

MSCI AC World and MSCI World are two very well-known international equity indices. According to MSCI index methodology, AC stands for ‘all countries’.

The MSCI AC World covers developed and emerging countries, while MSCI World covers only the developed regions in MSCI AC World.

MSCI AC World is probably the most global equity index that currently exists. It measures approximately 85% of the world’s equity market capitalisation and contains more than 2,500 securities in 48 countries. MSCI World, on the other hand, covers only 23 developed countries and contains approximately 1,700 securities.

Given that MSCI AC World includes emerging markets as well, it represents a more diversified index when compared to MSCI World and it is widely used by investment professionals as the measure of global equity markets.

Investors looking for truly global exposure can gain exposure to the vast majority of the world’s equity market capitalisation by combining iShares MSCI World and iShares MSCI Emerging Markets. MSCI World can also be replicated using a greater suite of iShares as shown in the figure below.

MSCI AC World is probably the most global equity index that currently exists.

Source: BlackRock.
ETF providers can use a range of techniques to track indices – by taking a practical approach, iShares ETFs make use of the most appropriate way to deliver accurate market returns.

There are broadly three techniques that ETF managers use to deliver index returns. iShares ETFs use all three approaches, depending on the technique we believe is most efficient for that fund.

Both physically-replicated and derivative-replicated techniques have strengths and weaknesses in delivering index returns. The next section provides an overview of the different structures.

**PHYSICALLY-REPLICATED ETFS**

Replicating index performance using the ‘cash’ markets to buy all, or a sample of, the securities within the underlying benchmark is known as physical replication. There are two forms of physical replication: ‘full index replication’ and ‘sampling replication’.

**HOW DOES THE ETF REPLICATE ITS INDEX?**

<table>
<thead>
<tr>
<th>PHYSICAL ETF</th>
<th>DERIVATIVE-REPLICATING ETF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full index replication</td>
<td>Single counterparty, uncollateralised exposure</td>
</tr>
<tr>
<td>Sampling replication</td>
<td>Multiple counterparty, uncollateralised exposure</td>
</tr>
<tr>
<td></td>
<td>Single counterparty, over collateralised* exposure</td>
</tr>
<tr>
<td></td>
<td>Multiple counterparty, over collateralised* exposure</td>
</tr>
</tbody>
</table>

* In this context, ‘over collateralisation’ means that the aggregate market value of collateral taken will exceed the overall counterparty exposure.

Source: BlackRock.
Full index replication

Full index replication is achieved by buying all of the underlying securities that make up the index. For example, the iShares FTSE 100 ETF holds all 103 stocks listed in the FTSE 100 Index in accordance with their weighting in the index. There are three main advantages of using full replication for physically-replicated ETFs:

- Full transparency of the underlying holdings.
- Low tracking difference (the difference in performance between the index and the index-tracking fund).
- Low counterparty risk (the risk that the other party in an agreement will fail to honour the obligation, or ‘default’).

Sampling replication

The easiest way to explain sampling replication is to use a very broad index such as the MSCI World Index, which comprises more than 1,700 stocks from 23 countries. The time, effort and expense involved in carrying out the necessary transactions for complete replication could be disadvantageous to the portfolio.

As a result, ETF portfolio managers will sometimes use ‘sampling’ or optimisation replication techniques. These ETFs only purchase a sub-set of index components, which has the advantage of reducing administrative and transaction costs. However, these benefits come with the possibility of slightly higher tracking error, as the ETF does not hold all the securities in its benchmark.

As with all physical ETFs, whether using full replication or sampling, they offer full transparency of the underlying holdings and low counterparty risk.

As the screenshot below from www.iShares.co.uk shows, investors can see the underlying holdings of each iShares ETF on a daily basis using the fund search tool, or the fund’s holdings page. Clients and advisers can also use the key facts page for each fund at www.iShares.co.uk to find important benchmark information and product details on pricing, performance and dividends.

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**iShares FTSE 100 (ISF)**

<table>
<thead>
<tr>
<th>Key Facts</th>
<th>Pricing &amp; Exchange</th>
<th>Performance Holdings</th>
<th>Securities Lending</th>
<th>Distributions &amp; Yields</th>
<th>Documents</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Domicile</strong></td>
<td>Irish</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>UCITS Compliant</strong></td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Ticker</strong></td>
<td>ISF</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Asset Class</strong></td>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Currency Hedged</strong></td>
<td>No</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Expense Ratio (TER) %</strong></td>
<td>0.4%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em><em>Securities Lending Return</em> (30/09/12)</em>*</td>
<td>0.03%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Base Currency</strong></td>
<td>GBP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Inception Date</strong></td>
<td>27/04/00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Rebalance Frequency</strong></td>
<td>Quarterly</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Product Structure</strong></td>
<td>Physical</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Product Methodology</strong></td>
<td>Replicated</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Distribution Frequency</strong></td>
<td>Quarterly</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Use of Income</strong></td>
<td>Distributing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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**Net Asset Value Information**

- **NAV**: 5,777,497
- **Daily NAV Change**: -0.02
- **Daily NAV Change (%)**: -0.27%
- **Total Return NAV**: 13,576,572
- **Total Net Assets (000)**: 3,495,500
- **Shares in Issue**: 605,019,707
- **Benchmark Level**: 4,044.95 GBP

**View History**

These values are individually rounded.
DERIVATIVE-REPLICATING ETFS

In addition to physically-replicated methods of ETF construction, a further approach has evolved in recent years. This method is usually referred to as ‘derivative replication’ and relies on using a swap agreement between an investment bank and the fund provider. The following example illustrates how a derivative-replicating ETF aims to replicate its benchmark.

The ETF holds a basket of equities prescribed by the swap counterparty and enters into an agreement to exchange the performance of this basket for the performance of the relevant index. It is important to note the equity basket itself will not contain all of the securities of the index. Rather, it will hold a selection of liquid stocks, while the swap provides the performance of the index.

In derivative-replicating ETFs, index tracking is effectively outsourced to the investment bank with which the ETF provider has the swap agreement.

The following diagram shows how index performance can be matched using a total return swap.

In the example, the fund itself holds a basket of equities, the value of which increases from £100 to £105 over a given period. The corresponding total return index increases from £100 to £107. The resulting payments of £5 (swap leg I) and £7 (swap leg II) from the ETF and the swap counterparty respectively are netted. The ETF receives a net £2 so that its Net Asset Value (NAV) is £107. The swap counterparty is responsible for paying the £2 difference, which it typically generates by investing in securities or derivatives which track the index performance and by hedging any open positions from the swap.

Being able to structure a fund that aims to replicate the return of the benchmark index without owning the underlying securities enables certain ETFs to comply with UCITS III regulations on diversification and asset type.

Derivative-replicating ETFs offer a range of advantages, including precise tracking of the benchmark before fees and access to a number of markets and exposures that are difficult to reproduce through the physically-replicated approach.
These areas can include commodity, specific emerging market countries and money market indices. It is worth noting that counterparty risk can be a feature of derivative-replicating ETFs; however, UCITS III rules limit this risk to 10% per counterparty.

iShares has a strategy of offering physically-replicated ETFs where the assets underlying the index can be traded and held efficiently in the fund. As iShares looks to expand its asset class coverage and provide access to difficult-to-trade markets, its derivative-replicating ETF platform has been designed to offer transparency, combined with the minimisation of counterparty risk.

For derivative-replicating iShares ETFs launched in 2007, the maximum swap counterparty risk is currently limited to 5%, which is below UCITS III requirements. The iShares Dublin-domiciled derivative-replicating ETFs deliver the access and flexibility of swaps, while maintaining a commitment to transparency, service and risk management.

Some of the main features of the iShares new derivative-replicating platform are:

- Multiple authorised participants and swap counterparties ensure best execution for the client.
- The quality of collateral and over collateralisation* protect against counterparty default risk at all times.
- The ability to see collateral and index holdings, swap counterparties and aggregate swap exposure on the iShares website ensures transparency in line with physically-replicated ETFs.

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What are swaps?

A swap is an agreement between two parties (one usually being an investment bank) to swap one stream of payments for another. Swaps are individually tailored contracts (sometimes referred to as ‘Over-The-Counter’ or ‘OTC’) and can be based on any terms agreed by the two parties.

Swaps based upon interest rates and currencies have existed for over 30 years. An ever-growing list of instruments is now being included such as inflation, credit, equity market returns and commodities.

Swaps generally involve an exchange of a fixed set of cashflows known in advance for a variable (‘floating’) set of cashflows that depends on the future path of a variable, such as the performance of a stock market.

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* In this context, ‘over collateralisation’ means that the aggregate market value of collateral taken will exceed the overall counterparty exposure.
The following table compares physical and swap-based ETFs.

<table>
<thead>
<tr>
<th></th>
<th>Physical ETFs</th>
<th>Swap-Based ETFs (Single Counterparty)</th>
<th>Swap-Based ETFs (Multiple Counterparties)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange listed</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Hold underlying index securities</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Swap counterparty risk</td>
<td>No</td>
<td>Yes</td>
<td>Yes, diversified among multiple counterparties</td>
</tr>
<tr>
<td>Fees</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>
Consider total costs

When evaluating the cost efficiency of an ETF, investors should aim to understand the ‘Total Cost of Ownership’ (TCO).

This approach will take account of explicit and implicit charges, as well as additional sources of return, such as securities lending revenue for ETFs.

The TCO is calculated by adding all the costs of an ETF and subtracting all the revenues generated over the same time period. It considers both internal and external costs (see figure below).

**TCO: INTERNAL AND EXTERNAL FACTORS**

Internal factors include both costs to the fund and revenues received by the fund for the same time period. These internal factors include TER, rebalancing costs and any securities lending revenue generated.

The Total Expense Ratio (TER) represents the total cost to you of holding your ETF investment for one year. The TER covers all annual costs relating to fund management.

External factors are costs to the investor, deducted at the time of purchase and sale of an ETF, and include trading or creation/redemption costs along with brokerage fees and taxes. Trading costs are reflected in the bid/ask spread when buying an ETF in the secondary market (i.e. on-exchange or OTC).

In any investment decision, understanding the total cost of ownership is just as important as considering the risk and expected return.
EXPLICIT COSTS
Total Expense Ratio (TER)
The TER includes all operational and management costs of the ETF and includes costs such as prescribed documentation, legal and auditing fees as well as management and licensing fees. The TER can range from 0.09%–0.79% of funds under management.

IMPLICIT COSTS
Trading costs – buying and selling costs
The trading cost of an ETF is typically reflected in the bid/ask spread. These spreads tend to be lower for larger funds with higher assets under management and those with higher daily trading volumes. In addition, the more liquid the underlying securities of the index, the lower the spreads will be.

As ETFs are bought and sold like ordinary stocks through wrap platforms and brokers, brokerage commissions will apply. Both these costs (bid/ask spreads and broker commissions) become more important as the investor’s investment horizon shortens.

Rebalancing of the underlying index
Index providers such as FTSE, Standard & Poor’s, MSCI and Dow Jones rebalance their benchmarks on either a monthly, quarterly or semi-annual basis. These changes may reflect an index provider’s security selection criteria, corporate actions and other events. If an index is rebalanced, the ETF manager should immediately make the corresponding changes to their portfolio and the resulting inflow and outflow of securities will generate transaction costs.

SECURITIES LENDING
Securities lending is an established practice in the investment management industry. It is a low-risk way for funds to generate additional returns by ‘lending’ assets for a period of time to third parties. These third parties pay a fee to borrow the securities and provide collateral of value greater than the loans.

ETF managers and many index fund managers earn additional income by engaging in the securities lending market and pass the returns through to the fund.

The securities lending industry is a very large, well-established, Over-The-Counter (OTC) market with over $13 trillion available for lending globally and over $1.9 trillion on loan on a daily basis.

iShares ETFs benefit from an industry-leading securities lending programme that is underpinned by a strong risk management framework.

$13 trillion available for lending globally and over $1.9 trillion on loan on a daily basis.

Securities lending for iShares ETFs adopts a quantitative approach to revenue generation and risk management, both of which benefit from our skill, experience, advanced technology, scale and position as part of one of the largest asset managers in the world.

4 Source: Data Explorers as at March 2012.
iShares actively manages risk by:

- Selecting well-capitalised borrowers.
- Always taking collateral greater than the value of the loan.
- Always receiving collateral before releasing a loan.
- Valuing loans and collateral daily on a marked-to-market basis.
- Investing in proprietary systems that enable straight-through processing and the automation of loan and collateral transactions.
- Dedicating legal and tax professionals to support all aspects of the lending programme.
- Indemnification against losses from borrower default.

The example below illustrates the impact of implicit costs and additional sources of revenue on the overall cost structure of ETFs.

At first glance, ETF 2 would seem to be the less expensive option, as it has a TER of 0.15%, compared to a TER of 0.25% for ETF 1. However, once trading costs, rebalancing costs and additional revenues are taken into account, the total cost of holding both ETFs becomes equal.

The additional costs of owning ETFs can vary considerably across different funds. Furthermore, opportunities for additional revenue generation (for example from securities lending) can vary greatly between funds. The impact of costs and additional revenues is most obvious when looking at the performance difference between the ETF and the index it tracks.

Informed investors and their advisers should therefore take a holistic view and consider the total cost of ownership, including costs extending beyond the TER and incorporating the impact of possible revenue generation capabilities into the decision-making framework.

### For further information on securities lending, please visit our website and refer to our dedicated brochure, ‘Securities Lending at BlackRock: Overview, Benefit and Risks’.

<table>
<thead>
<tr>
<th></th>
<th>TER</th>
<th>Trading Costs</th>
<th>Rebalance Costs</th>
<th>Additional Revenues</th>
<th>Total Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>ETF 1</td>
<td>0.25%</td>
<td>0.04%</td>
<td>0.01%</td>
<td>-0.20%</td>
<td>0.10%</td>
</tr>
<tr>
<td>ETF 2</td>
<td>0.15%</td>
<td>0.07%</td>
<td>0.01%</td>
<td>-0.13%</td>
<td>0.10%</td>
</tr>
</tbody>
</table>

Source: BlackRock.

5 BlackRock’s indemnity currently provides for the satisfaction of borrower’s obligations under a lending agreement. The indemnification does not cover the risks associated with the reinvestment of cash collateral. The indemnification arrangement is subject to change, and in some cases without notice.
Evaluate the provider

Experience matters. Size, scale, expertise and commitment can vary significantly between ETF providers and these differences can impact performance across several areas.

Advisers should evaluate an ETF provider’s:

- Scale of operations to minimise costs and manage market impact.
- Track record in index portfolio management, minimising tracking error and trading costs.
- Knowledge of index construction and methodology.
- Dedication to providing servicing support and resources to investors, intermediaries and market participants.
- Commitment to product development.

Providers should have extensive experience of managing index investments, proven portfolio management skills and dedicated research teams.

iShares is the world’s largest provider of ETFs by assets under management⁶

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Tax and iShares ETFs
Tax and iShares ETFs

Many clients have questions about the tax implications of investing in iShares ETFs – the following provides a brief overview for the iShares ETFs most commonly bought by UK investors.

**DUBLIN RANGE**
All of our London Stock Exchange listed iShares ETFs are structured as Dublin-domiciled mutual funds. We use the Investment Company with Variable Capital (ICVC) (corporate form) fund structure and all ETFs in this range have UCITS regulatory status.

**THREE LEVELS OF TAX TO CONSIDER**
As with other mutual fund investments, tax has to be considered at three levels:

1. **Investment level**: Portfolio level withholding tax is an important consideration when investing in some asset classes (US or Eurozone equities, for example). The rate of withholding tax depends in part on the double tax treaty status of the holder. Where the holder is an Irish mutual fund, withholding tax is in some cases beneficially reduced by the double tax treaty that Ireland has with the investee country, but not in others.

2. **Fund level**: Offshore mutual funds typically pay no tax at fund level, either on their portfolio income or by way of withholding. Likewise, our Irish funds pay no taxes in Ireland. Some onshore fund types do pay taxes at this level.

3. **Investor level**: Each investor also has their own tax position to consider, and of course this can be affected by the choice of investment vehicle. (A full study of the tax efficiency of an investment strategy should consider whether any withholding tax suffered at portfolio or fund level can be offset against the investor’s domestic tax).

**DISTRIBUTIONS – DUBLIN-DOMICILED RANGE**
For UK resident individual investors, distributions from equity index funds are taxed as dividends. However, distributions from fixed income index funds (with >60% fixed income portfolio content, 60% of assets in bonds, cash, or cash equivalents), are taxed in the UK as interest.

UK resident corporate investors are taxed on distributions from fixed income ETFs under the loan relationships regime. Distributions from equity ETFs are taxed under the foreign profits regime.
**TAX RATE ON iSHARES DISTRIBUTIONS**

**Dividends: equity funds**
Where distributions are taxed as dividends, UK individual investors are generally taxed at 10% (basic rate taxpayers), 32.5% (higher rate taxpayers), or 42.5% (additional rate taxpayers).

**10% Tax credit on dividend distributions**
The 10% tax credit applies for UK individual investors holding less than 10% in offshore funds that are not bond funds. The dividend tax rate on iShares ETF distributions is 36.1% for additional rate taxpayers, 25% for higher rate taxpayers, and 0% for basic rate taxpayers.

The 10% UK tax credit is not available to offshore bond funds; bond funds are funds that broadly hold over 60% of assets in bonds, cash, or cash equivalents (i.e. iShares fixed income ETFs).

**INTEREST: FIXED INCOME FUNDS**
Where distributions are treated as interest, normal marginal rates apply (20%, 40% and 50% respectively). These distributions are received gross by investors, (i.e. there is no Irish or UK withholding tax deducted at the time of payment).

**WITHHOLDING TAX**
Distributions from the Dublin-domiciled iShares range are exempt from Irish withholding tax by virtue of the shares issued being settled via a recognised clearing system (CREST). This applies to all iShares ETFs listed on the London Stock Exchange.

**STAMP DUTY**
iShares ETFs are not subject to UK stamp duty when purchased on-exchange.

**ISAs AND SIPPs**
iShares ETFs listed on the London Stock Exchange are eligible investments within Self Invested Personal Pensions (SIPPs), Individual Savings Accounts (ISAs) and Child Trust Funds (CTFs).

<table>
<thead>
<tr>
<th>Tax Treatment</th>
<th>Tax Rate</th>
<th>Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity funds</td>
<td>Dividends distribution</td>
<td>10.0%</td>
</tr>
<tr>
<td>Fixed income funds</td>
<td>Interest</td>
<td>20.0%</td>
</tr>
</tbody>
</table>
REMITTANCE BASIS
This is now only relevant to UK residents but non-domiciled individuals who have elected under Finance Act (FA) 2008 for the remittance basis of UK taxation to continue to apply; that is, those paying the £30,000 ‘tariff charge’ (£50,000 for non-domiciled individuals who have been resident in the UK for 12 years or more and who wish to retain the remittance basis of taxation). Further, in effect from 6 April 2012, there is no tax on any income or gains remitted to the UK by a non-domiciled individual for the purposes of a qualifying business investment in the UK.

Irish funds were once unsuitable for investors on the ‘remittance basis’ as, for historical reasons, dividends from Irish companies and funds were deemed to be UK sourced for this purpose. However this anomaly was removed by the 2008 UK Finance Act, so distributions from Ireland will be treated the same as those from any other overseas country. Therefore, provided there is no ‘remittance’ of the dividends or proceeds to the UK, such individuals will be exempt from UK tax thereon.

CAPITAL GAINS TAX
UK individuals disposing of iShares funds will normally be liable to Capital Gains Tax at 18% (basic rate taxpayers) or 28% (higher or additional rate taxpayers), subject to the usual exemptions and reliefs. This does not however apply where the funds do not have UK Reporting Fund Status, and in that case gains on disposal would be an ‘Offshore Income Gain’, subject to full marginal income tax rates. Most Dublin-domiciled iShares listed on the London Stock Exchange have this status. UK individuals should purchase funds without UK Reporting Fund Status with great caution, and based on a very thorough understanding of the tax consequences.

For further information on tax and iShares, please visit our website and refer to our dedicated brochure, ‘Tax Implications of iShares – Frequently Asked Questions’.

Please refer to the fund prospectus or the fund facts page at www.iShares.co.uk to confirm whether a fund has UK Reporting Fund Status.
5 Reasons why statements
WHY ETFs?
ETFs offer transparent, low-cost and liquid access to a variety of markets and asset classes. An ETF is a mutual fund that trades on-exchange, tracking a variety of indices across a wide range of asset classes, markets and sectors.

The fund element means an ETF is an open-ended collective vehicle, pooling money to invest in the underlying assets of the index to be tracked. Meanwhile, the exchange-traded features mean ETFs can be bought and sold as easily and efficiently as any blue-chip stock on the stock market.

For most major indices, there is an iShares ETF available to facilitate simple, accurate and cost-effective exposure.

ETFs are eligible for inclusion in ISAs, SIPPs and offshore bonds.

WHY iSHARES?
iShares has pioneered making ETFs accessible to all types of investors.

With over 607 ETFs listed on exchanges worldwide and over 39% market share globally, iShares has been championing ETFs as a better way of investing for the last 15 years.

In the UK, iShares has over 120 funds listed on the London Stock Exchange and consistently dominates the top 10 most traded funds in the equity and fixed income asset classes.

iShares is dedicated to providing excellent service and education for advisers on ETFs.

WHY INDEXING?
An index fund is designed to track the market and is therefore not actively managed, resulting in generally lower costs.

Indexing offers superior diversification and cheaper access to the market and can therefore help to manage cost and risk on an ongoing basis.

WHY COMBINE INDEXING AND ACTIVE?
Active funds offer the opportunity, but not the guarantee, of returns beyond the benchmark. While some do outperform their benchmark, long-term consistency of returns can be difficult to find.

Maintaining the core of your investment in indexing will ensure market returns, giving you more time to select the best active managers to generate outperformance.

Combining active funds and index management provides an optimal approach to maximising returns, while managing risk and cost.

CASE STUDY: BLENDBING ACTIVE AND INDEX INVESTMENTS
Blending index and active investments has a clear goal: to offer investors the potential to generate benchmark-beating performance with actively-managed investments, while creating an opportunity for enhanced risk management and greater cost and tax efficiency through index investments.

The choice between index and active is not based solely on performance, but also on the risk tolerance of the investor. Index funds are designed to track an index and can offer the potential to track an asset allocation model closely. Active funds introduce a risk relative to asset allocation by the very fact that they strive to outperform.

In order for active managers to beat their benchmark indices, they must own a set of securities that differs from the benchmark, and this difference results in increased risk to the portfolio.

7 Source: BlackRock, September 2012.
The diagram below highlights the advantages and disadvantages of using purely active, purely index or blended strategies.

Maintaining the core of your investment in indexing will ensure market returns, giving you more time to select the best active managers to generate outperformance.

Combining active funds and index management provides an optimal approach to maximising returns, while managing risk and cost.

### HELPFUL TOOLS

There are a range of online tools available at our website www.iShares.co.uk to help you make informed investment decisions:

- **Performance chart** – this enables you to measure the historical performance of all iShares ETFs and how closely they have tracked their chosen index over time.

- **Index returns chart** – this compares the index returns for over 150 indices spanning various asset classes around the world, from their performance over the past day back to their performance over five years.

- **Product search tool** – this dynamic search tool enables you to filter the iShares range of ETFs by a wide range of criteria, including asset class type and trading currency. It also enables you to compare different iShares ETFs, so you can choose the right fund for your clients’ investment needs.
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For investors in the UK
Most of the protections provided by the UK regulatory system do not apply to the operation of the Companies, and compensation will not be available under the UK Financial Services Compensation Scheme on its default. The Companies are recognised schemes for the purposes of the Financial Services and Markets Act 2000. Any decision to invest must be based solely on the information contained in the Company’s Prospectus, Key Investor Information Document and the latest half-yearly report and unaudited accounts and/or annual report and audited accounts. Investors should read the fund specific risks in the Key Investor Information Document and the Company’s Prospectus.

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