Institutional Investor

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Liquidity and Speed Prove Key in Market Uncertainty

excerpt from

Managing Market Volatility in 2021

What institutional investors did in 2020 –
and what they learned

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Methodology

In Q3 2020, Institutional Investor's Custom Research Lab surveyed 766 institutional investment decision makers in North America, Europe, the Middle East, Africa, Asia-Pacific, and Latin America, on how they navigated market volatility in 2020. The research process also included interviews of more than a dozen well-qualified sources at insurers, endowments, family offices, foundations, pensions, and asset management firms. Throughout this report, the phrase "asset manager" is used to refer to survey respondents and interview sources who work for asset management firms, serving their clientele of asset-owning institutions.

The demographic highlights of the research cohort are below.

Institution Type (n=766)

Asset management firm	34%
Insurance company	20%
RIA firm/financial advisory firm	10%
Public pension	9%
Endowment	6%
Family office	6%
Private pension	5%
Hedge fund	4%
Foundation	4%
Multiemployer / Taft-Hartley plan	2%

Titles (n=766)

Chief investment officer	18%
VP or director of investment	15%
Equity or fixed income investment analyst	13%
Risk officer	13%
Portfolio manager	11%
Product specialist	11%
Director of research	10%
Equity or fixed income trader	9%

Location (n=766)

North America	36%
Europe, Middle East, and Africa	29%
Asia-Pacific	21%
Latin America	14%

Assets Under Management (n=766)

More than US$50 billion	26%
US$10 billion to US$50 billion	27%
US$5 billion to US$10 billion	9%
US$1 billion to US$5 billion	22%
US$500 million to US$1 billion	8%
Less than US$500 million	8%

INSTITUTIONAL INVESTORS EXPECT CONTINUED MARKET VOLATILITY

As they look to the next 18 months, 68% of institutional investors expect continued heightened volatility (n=766). During that time, they plan on increasing their use of ETFs more than any other investment vehicle.

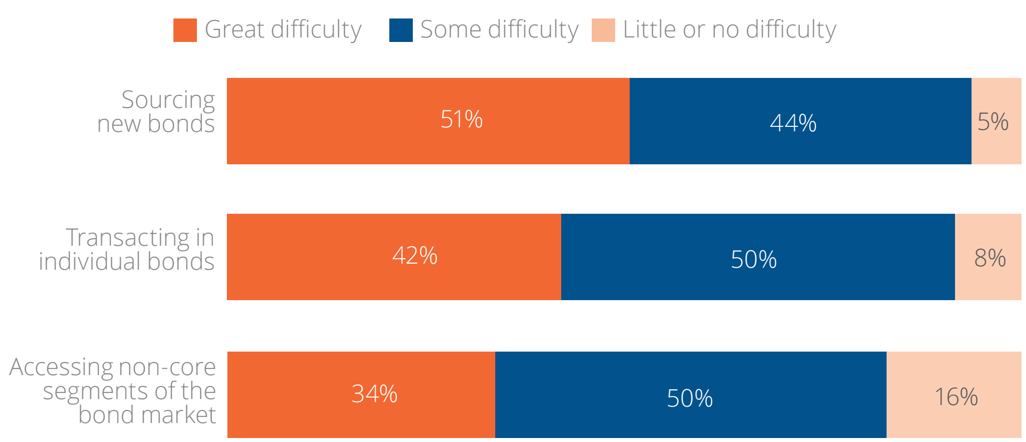
Of particular note during the pandemic was institutional investors' use of fixed income ETFs when liquidity, price discovery, usage, and transaction costs were pressure points across multiple asset classes in the bond markets – including high yield, investment-grade corporate, emerging markets, and, for a short time, U.S. Treasuries.

One reason institutional investors turned to fixed income ETFs during this period was difficulty in bond sourcing and transactions. Survey respondents shared that . . .

- They had difficulty sourcing new bonds (95%) during the early period of pandemic-related market dislocation (see Fig. 1).
- Individual bond transactions were also a pain point (92%).
- During pandemic-related volatility, their organizations increased use of fixed income ETFs as a means to source and price bonds and to execute trades (54%) (n=762).
- When it comes to replacing individual bonds, they appreciate the liquidity of fixed income ETFs (61%), the speed at which they can access the market (55%), and the fact that they don't have to engage in analysis of individual bonds (51%) (see Fig. 2).

Fig. 1: Pandemic-Related Volatility Created Difficulty in Sourcing New Bonds

To what extent has pandemic-related market volatility affected the following dimensions of your organization's access to the bond market? (n=766)



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At the outset of pandemic-related financial stress, trading in U.S. fixed income ETFs surged to $1.3 trillion in the first quarter of 2020 – half of the $2.6 trillion for all of 2019.[1] In many cases, institutional investors found ETFs provided more liquidity, greater transparency, and lower transaction costs than the underlying bond market.

65%

of institutional investors say they will increase their use of ETFs (n=766).

An additional

29%

say they will likely keep their current allocations to ETFs roughly the same.

ONE-ON-ONE

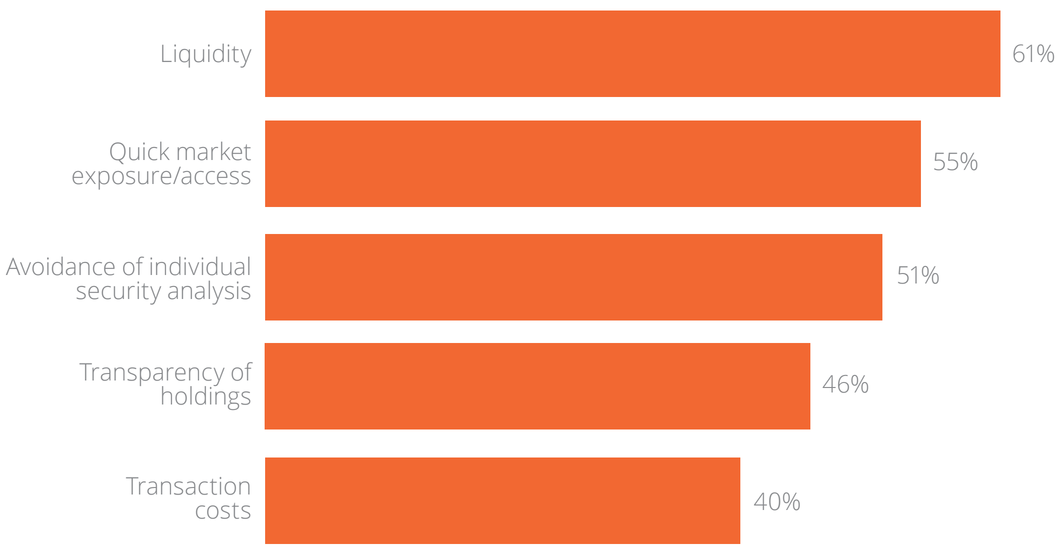
"Our equity positions fell so much in market value, we had to decide whether we wanted to rebalance back into them in the middle of a major market meltdown, and if we could do so at reasonable prices.

"We realized in the moment that ETF markets were functioning extremely well. They offered the best way to rebalance in major asset classes or in asset classes where there might not be as much liquidity for an active manager."

– Senior Analyst, Asset Manager

Fig. 2: Amid Volatility, Institutional Investors Embraced Fixed Income ETFs for Liquidity, Speed, and Analytical Convenience

Which of the following make fixed income ETFs a good replacement for individual bonds? (n=671)



[1] BlackRock, Bloomberg (as of May 31, 2020)

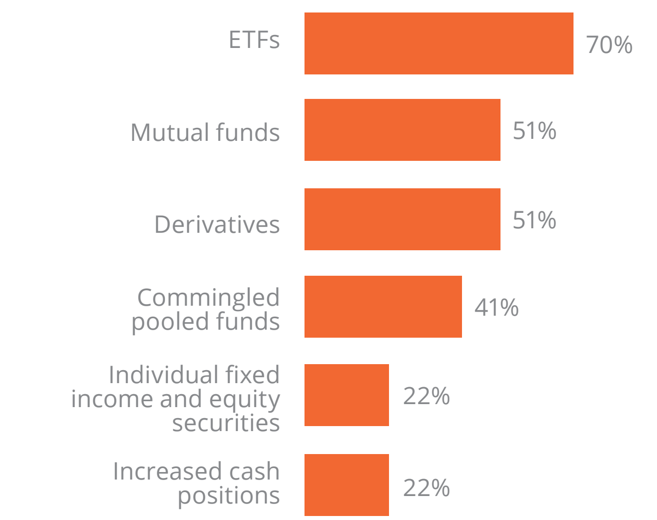
INSTITUTIONAL INVESTORS WANT LIQUIDITY AND SPEED WHEN REBALANCING AND REPOSITIONING DURING VOLATILITY

Nearly all – 90% – of the 766 institutional investors in this survey rebalanced their portfolios within six months of the onset of pandemic-related volatility. That in itself isn't especially unexpected – there's nothing like a severe shock to reveal where a portfolio has strayed from its intentions, perhaps having taken on more risk or excess correlation[2] than realized.

In attempting to get their asset mix back in line with their investment guidelines, institutions expressed a clear preference for ETFs, with 70% indicating they turned to ETFs while rebalancing (see Fig. 3).

Fig. 3: Vast Majority of Institutional Investors Rebalanced Within Six Months of the Pandemic Outbreak

Which methods have you used to rebalance your portfolio since the start of the Covid-19 market volatility? (n=692)



ONE-ON-ONE

"Toward the end of 2019, using ETFs to implement our credit strategy in investment-grade and conservative duration[3] and risk positions became a more viable option for us. I spent a lot of time getting comfortable with the risks and liquidity of ETFs.

"The early months of the pandemic presented some case studies in how they reacted in a less than ideal liquidity environment. Coming out of that, we have significant balances to invest in that bucket of the portfolio – cash and, in the medium term, fixed income. That's where we see the most opportunity to expand our ETF usage going forward."

– Portfolio Manager, Insurance Company

KEY TAKEAWAYS

- Most institutional portfolios were rebalanced within six months of the outbreak of the pandemic, with ETFs as the most-used instrument.
- Institutional investors expect elevated market volatility to continue, and 65% say they will increase their use of ETFs. A further 29% say their use of ETFs will remain at its current level.
- Sourcing individual bonds was a major challenge during pandemic-related market volatility. More than half (54%) of institutional investors increased their use of fixed income ETFs as a result (n=762).

[2] Correlation measures how two securities move in relation to each other. A higher correlation indicates that securities tend to move together.

[3] Duration is a measure of a bond fund's sensitivity to interest rates. For every year of duration, a 1% change in interest rates will lead to a 1% change in the opposite direction of a bond fund's value.

Carefully consider the Funds' investment objectives, risk factors, and charges and expenses before investing. This and other information can be found in the Funds' prospectuses or, if available, the summary prospectuses which may be obtained by visiting www.iShares.com or www.blackrock.com. Read the prospectus carefully before investing.

Investing involves risk, including possible loss of principal.

Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments. Non-investment-grade debt securities (high-yield/junk bonds) may be subject to greater market fluctuations, risk of default or loss of income and principal than higher-rated securities.

International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. These risks often are heightened for investments in emerging/developing markets and in concentrations of single countries.

There can be no assurance that performance will be enhanced or risk will be reduced for funds that seek to provide exposure to certain quantitative investment characteristics ("factors"). Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods. In such circumstances, a fund may seek to maintain exposure to the targeted investment factors and not adjust to target different factors, which could result in losses.

A fund's use of derivatives may reduce a fund's returns and/or increase volatility and subject the fund to counterparty risk, which is the risk that the other party in the transaction will not fulfill its contractual obligation. A fund could suffer losses related to its derivative positions because of a possible lack of liquidity in the secondary market and as a result of unanticipated market movements, which losses are potentially unlimited. There can be no assurance that any fund's hedging transactions will be effective.

There can be no assurance that an active trading market for shares of an ETF will develop or be maintained. Transactions in shares of ETFs may result in brokerage commissions and will generate tax consequences. All regulated investment companies are obliged to distribute portfolio gains to shareholders.

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Shares of iShares ETFs may be bought and sold throughout the day on the exchange through any brokerage account. Shares are not individually redeemable from the ETF, however, shares may be redeemed directly from an ETF by Authorized Participants, in very large creation/redemption units. There can be no assurance that an active trading market for shares of an ETF will develop or be maintained.

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1120 Avenue of the Americas, 6th Floor, New York, NY 10036
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