

**BUILDING A BETTER
INVESTMENT WORLD.
HOW ETFs ARE SHAPING INVESTMENT TRENDS.**



An introduction to ETFs

iShares® Exchange Traded Funds (ETFs) are some of the fastest-growing investment vehicles in the financial markets today.¹ In 2008, ETFs overall received net inflows of \$75 billion,² as investor demand for cost efficiency and investment transparency increased during volatile markets. This article addresses four essential questions surrounding ETFs:

What exactly are ETFs?

What benefits do they offer investors?

With hundreds to choose from, how should the investor go about choosing the best ones?

What are the essential portfolio strategies that investors can use with ETFs?

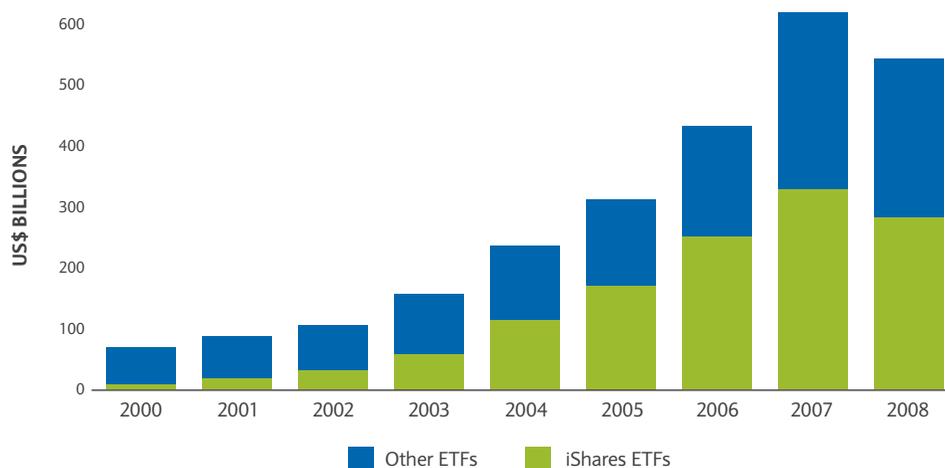
To understand what ETFs are, it is important to think of them as a kind of investment hybrid: they are diversified like index funds, but trade like a stock. They offer efficient, low-cost and transparent design—combined with a wide range, flexibility and access to virtually every major asset class. These qualities have helped fuel enormous growth, as illustrated in Figure 1 below.

While iShares ETFs and mutual funds each hold baskets of securities, some key differences do exist. iShares ETFs trade on exchanges intraday at market price, which may be greater or less than net asset value, and shares of iShares ETFs are not individually redeemed from the fund. Also, transactions in shares of iShares ETFs result in brokerage commissions and generate tax consequences. In addition, iShares ETFs seek to track a market index, before fees and expenses.

In comparison, mutual funds are accessed directly from the fund company or through a select broker, pricing generally occurs once a day, and investors buy or redeem shares at the end-of-day net asset value, less any applicable fees. Some mutual funds may charge sales loads or redemption fees. Mutual funds may be either actively managed or track an index. The structure of both active and index mutual funds is similar, but the management strategy differs. Active mutual funds seek to outperform their benchmark while the goal of index mutual funds is to track their index. Consequently, active funds typically charge more than index-linked products for the increased trading and research expenses that may be incurred.

Similarly, both mutual funds and iShares ETFs are obliged to distribute portfolio gains to shareholders.

FIGURE 1
THE GROWTH IN POPULARITY OF ETFs: TOTAL U.S. ETF ASSETS IN US\$ BILLIONS



Sources: *Strategic Insight*, Bloomberg and National Stock Exchange as of 12/31/08.

1. Source: FactSet and Bloomberg as of 12/31/08; excludes fund of funds and money market funds. 2. Source: *Strategic Insight* as of 12/31/08.

The benefits of ETFs

Diversification

iShares ETFs are designed to closely follow the index or sector they track (from emerging markets to U.S. large-cap to health-care or tech). That means investors instantly achieve access to that sector or asset class—and gain index-like diversification—with a single trade.

Transparency

Most iShares ETFs publicly disclose which securities they are holding every day (some funds release that information monthly due to licensing restrictions). Most mutual funds disclose that information just once every three months. This matters because mutual fund managers may change holdings frequently, and expose the investor unknowingly to a particular security or asset class.

Tracking a benchmark

Index investments like iShares ETFs seek to deliver performance that tracks a market or asset class benchmark. While good active managers exist, the challenge is identifying them in advance, and not simply chasing returns. Only the very skilled (or very lucky) active managers can be right most of the time. As shown in Figure 2, following a year of outperformance, the number of S&P large-cap blend managers who continued to beat the index declined in each of the following two years. Due to this inconsistent performance, the median S&P large-cap blend manager underperformed the index by 0.96% over the 10 years ending 12/08.³

Lower fees

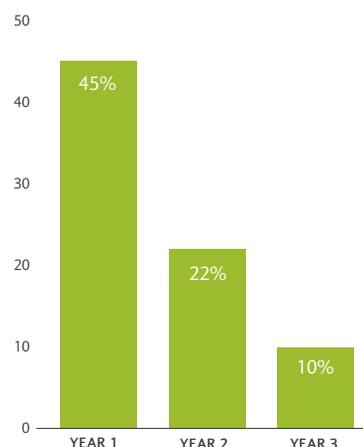
iShares ETFs are a low-cost alternative to traditional mutual funds, with expense ratios that are typically well below those of both active and index mutual funds. The average expense ratio of an iShares ETF is 0.41%, versus the average active mutual fund expense ratio of 1.50%—a 1.09% difference that can result in significant savings over the life of an investment.⁴

Tax efficiency

In the world of investing, some funds are more tax efficient than others, delivering higher after-tax returns for similar amounts of risk. In addition to having the relatively low portfolio turnover rates associated with index funds, iShares ETFs can be even more tax efficient than their traditional index fund brethren. If traditional mutual fund managers need cash to meet investors' redemptions, they may have to liquidate holdings in the portfolio, possibly generating a capital gain that may be passed along to all other shareholders. Of course, when investors sell an ETF at a gain, normal tax rules apply.

FIGURE 2

S&P LARGE-CAP BLEND MANAGERS OUTPERFORMING THE MARKET IN CONSECUTIVE YEARS



Sources: Morningstar and Barclays Global Investors, as of 12/31/08.

Averages for time period 1994 to 2008. Data is based on the oldest share class of active open-end mutual funds to avoid double-counting of multiple share classes. **Past performance does not guarantee future results.**

Trading in difficult-to-access asset classes

Due to an ETF's unique creation and redemption process, by which new shares are issued or redeemed, an iShares ETF that is based on an index in an illiquid asset class can still facilitate good executions. This can be especially valuable to investors when the underlying securities become difficult to price or trade, as occurred in some segments of the fixed income market throughout 2008.

Managing risk

All of the above features translate into one critically important benefit: managing risk in a portfolio. By tracking specific asset classes closely, knowing what you own, keeping fees and taxes low, and being able to trade in and out of illiquid asset classes, the investor can help prevent unpleasant surprises in a portfolio—in other words, manage risk.

3. Morningstar and Barclays Global Investors, as of 2/09. 4. Source: *Strategic Insight*, 2/09.

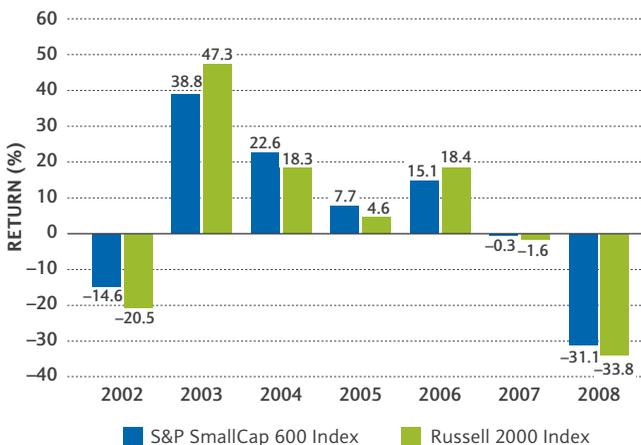
Navigating the ETF landscape

Today, there are literally hundreds of ETFs out there, and more are joining the crowd all the time. Choice is good, but having to pick from several funds that all seem to cover the same asset class—that can be confusing. Here, at a glance, investors will learn the qualities that could help isolate the one ETF that best fits their needs.

Holdings

Indexes serve as the foundation for nearly all ETFs on the market today—however, not all indexes are the same. Two benchmarks, even those with similar names or based on similar areas of the market, can differ from each other, resulting in divergent risk and return characteristics (see Figure 3). Index holdings and their weightings are determined by each index provider's methodology. Knowing these differences helps ensure that the right ETF is selected for the right needs.

FIGURE 3
SMALL-CAP INDEX PERFORMANCE COMPARISON



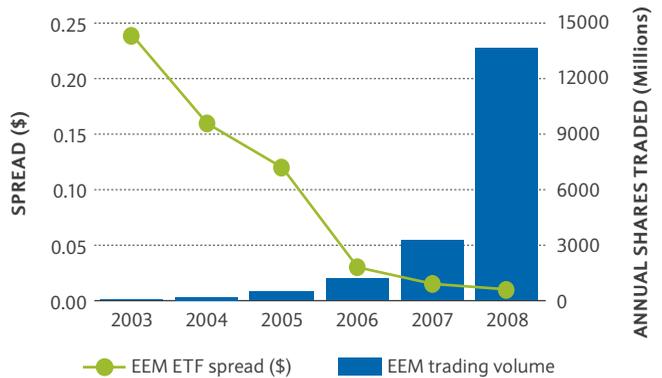
Source: BGI.

Index returns are for illustrative purposes only and do not represent actual iShares Fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged, and one cannot invest directly in an index. Past performance does not guarantee future results. For actual iShares Fund performance, please visit www.iShares.com or request a prospectus by calling 1-800-iShares.

Liquidity

ETFs offer two levels of liquidity—traditional liquidity on the secondary market and the liquidity provided by the creation/redemption mechanism.⁵ Most investors trade on the secondary market. Liquidity impacts investor trading costs and can be a significant piece of total costs. Two ETFs offering similar market exposure can trade quite differently. Those with greater trading volume generally have lower spreads, ultimately lowering the cost for investors to enter and exit their positions (see Figure 4).

FIGURE 4
TRADING VOLUME AND AVERAGE SPREAD
iShares MSCI Emerging Markets Index Fund (EEM)



Sources: NYSE Arca,SM Stock Facts Pro, 12/08.

Total costs

Expense ratios are only one part of the cost picture. Together with implicit costs, they form the total cost of owning an ETF. Implicit costs include the investor's trading and market impact costs, the cost to rebalance back to a target allocation and the ETF's tracking error relative to the benchmark. Implicit costs are not equal across ETFs and can overwhelm any expense advantage of one ETF over another (see Figure 5).

Structure

Innovations in product structure have allowed exchange traded products to expand beyond the traditional open-end fund structure associated with ETFs. Each structure has unique exposure, risk and tax implications. These nuances may make some structures and products more appropriate for some investors than others (see Figure 6).

Provider

Size, scale, expertise and commitment vary across ETF providers. Look for a provider's:

- Scalable operations to cross trades and minimize costs and market impact.
- Track record managing ETFs, including low tracking error and high tax efficiency.
- Dedication to providing support and resources to investors, intermediaries and market participants.
- Deep knowledge of index construction and methodology.

FIGURE 5
TOTAL COST COMPARISON FOR LARGE-CAP ETFs

	Explicit Costs		Implicit Costs			Total Cost
	EXPENSE RATIO	COMMISSION	TRADING COST	REBALANCE COST	TRACKING ERROR	
ETF 1	0.20%	0.01%	0.04%	0.01%	0.21%	0.47%
ETF 2	0.10%	0.01%	0.28%	0.01%	0.47%	0.87%

Source: BGI.

Trading costs are one-way costs and include estimated average spread and market impact costs from 12/3/08 – 3/3/09. Tracking error is a one-year annualized estimate ending 3/3/09.

FIGURE 6
EXCHANGE TRADED PRODUCT STRUCTURE

	ETFs	UNIT INVESTMENT TRUSTS	GRANTOR TRUSTS	EXCHANGE TRADED NOTES (ETNs)	LIMITED PARTNERSHIPS
REGISTRATION	Investment Company Act of 1940	Investment Company Act of 1940	Securities Act of 1933	Securities Act of 1933	Securities Act of 1933
RECOURSE	Portfolio of securities	Portfolio of securities	Pro rata interest in the trust	Issuer credit	Pro rata interest in the partnership
PRINCIPAL RISK	Market risk	Market risk	Market risk	Market and issuer risk	Market risk
TRACKING ERROR	Low to moderate	Moderate	Moderate	Low	Moderate
TAX ISSUES	Potential exposure to capital gains and losses of portfolio, although creation/redemption mechanism works to minimize this. Dividends and interest income passed through to shareholders.	Potential exposure to capital gains and losses of portfolio, although creation/redemption mechanism works to minimize this. Dividends and interest income passed through to shareholders.	Taxed as though investor effectively holds underlying security. Each investor takes a pro rata share of the income and expenses of the trust.	Varies. No dividend distributions. Proceeds may be treated as capital gains or ordinary income upon the sale, redemption or maturity of the ETN.	Each investor takes a pro rata share of the income and expenses of the partnership.

Investment comparisons are for illustrative purposes only and not meant to be all-inclusive. To better understand the similarities and differences between investments, including investment objectives, risks, fees and expenses, it is important to read the products' prospectuses.

Portfolio strategies for iShares ETFs

Financial professionals can use ETFs at virtually every stage of the investment process, from building an asset allocation to tactical strategies such as tax-loss harvesting. Here are some of the ways investors are using iShares ETFs:

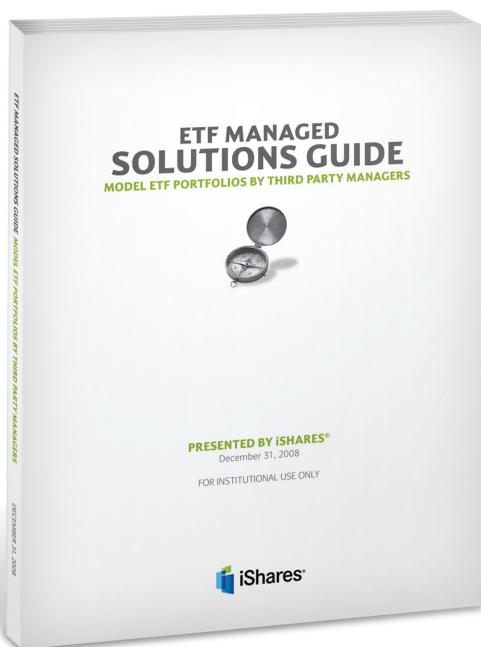
Portfolio Strategy	Objective	Example
Portfolio Completion >>	Ensure a portfolio's complete diversification	Use iShares ETFs to gain targeted exposure to sector and style segments and quickly and easily complete an asset allocation.
Tax Management >>	Manage for long-term tax efficiency	Use iShares Funds in place of high turnover or tax-inefficient investment options to limit capital gain distribution risk. Use iShares ETFs during the 30-day wash sale holding period to remain fully invested while harvesting tax losses. ⁶
Risk Management >>	Manage overall portfolio risk by incorporating index investments	Use iShares Funds for a stand-alone 100% index solution or combine with actively managed portfolios, funds or separate accounts to manage total portfolio volatility.
Concentration Risk Reduction >>	Diversify away from single security, asset class or sector concentration	Use a corresponding iShares sector fund to reduce single security risk or a broad market or complementary fund for single sector or asset class concentration.
Fixed Income Investment >>	Precisely construct a customized, well-diversified portfolio	Select from the 24 fully transparent iShares fixed income funds to build a portfolio with specific duration, credit quality and sector exposure in the broad, corporate, TIPS and Treasury markets.
Yield Enhancement >>	Add tax-efficient dividend yield to client portfolios	Enhance a client's well-diversified strategy yields derived from dividends and/or interest from various asset classes.
Select Foreign Investment >>	Tilt global sector, regional and single country markets	Implement a bullish single country call while maintaining a broad-developed or emerging market investment.
Tactical Rotation >>	Actively trade around research, earnings, economic data and sector calls	Use sector, style, or market cap iShares ETFs to establish, underweight or overweight positions according to tactical strategy or technical indicators.
Cash Equitization >>	Maintain a fully invested market position	Use a broad cap or total market iShares Fund to maintain full market investment, or use a style or sector iShares Fund to maintain asset class weights during manager transition or stock selection process.
Market Neutral Investment >>	Ensure equal long and short exposure	Go long on a sector's stocks and short the corresponding iShares Fund. ⁷

How advisors are using iShares ETFs

Given the range of strategies available for investors with iShares ETFs, how are advisors actually using them? To help answer this question, iShares recently published the industry's first guide to managers who have significant ETF allocations with their model portfolios – the *ETF Managed Solutions Guide*.

The quarterly *Guide* serves as a resource for financial advisors in identifying third-party managers who offer model ETF portfolios, and explores some of the innovative ways in which advisors are using ETFs to help clients meet their investment goals. The *ETF Managed Solutions Guide* includes numerous third-party managers, providing information on each firm's investment philosophy, portfolio management team, portfolio objective, performance history, top holdings, and asset classes.

The role of the financial advisor is more important than ever in helping investors navigate the turbulent investment waters of the last year. The objective of the *Guide* is an attempt to pair advisors looking for managed solutions with those asset managers who are providing them.



» To receive more information on iShares or obtain a copy of the *ETF Managed Solutions Guide*, please call 1-800-iShares (1-800-474-2737).

6. The Internal Revenue Service has not released a definitive opinion regarding the definition of "substantially identical" securities and its application to the wash sale rule and ETFs. The information and examples provided are not intended to be a complete analysis of every material fact respecting tax strategy and are presented for educational and illustrative purposes only. Tax consequences will vary by individual taxpayer and individuals must carefully evaluate their tax position before engaging in any tax strategy. 7. With short sales, you risk paying more for a security than you received from its sale.

For more information:

WWW.ISHARES.COM

1-800-iShares (1-800-474-2737)

Carefully consider the iShares Funds' investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Funds' prospectuses, which may be obtained by calling 1-800-iShares (1-800-474-2737) or by visiting www.iShares.com. Read the prospectus carefully before investing.

Investing involves risk, including possible loss of principal.

In addition to the normal risks associated with investing, narrowly focused investments, investments in smaller companies and investments in single countries typically exhibit higher volatility. International investments may involve risk of capital loss from unfavorable fluctuations in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Bonds and bond funds will decrease in value as interest rates rise. There is no guarantee that a municipal bond fund's income will be exempt from federal or state income taxes. Capital gains, if any, are subject to capital gains tax. Diversification and asset allocation may not protect against market risk.

An investment in the fund(s) is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

Mutual funds and iShares Funds are obliged to distribute portfolio gains to shareholders by year-end. These gains may be generated due to index rebalancing or to meet diversification requirements. Trading shares of the iShares Funds will also generate tax consequences and transaction expenses. Certain traditional mutual funds can be tax efficient as well.

Shares of the iShares Funds may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from a Fund by Authorized Participants, in very large creation/redemption units.

Investment comparisons are for illustrative purposes only and not meant to be all-inclusive. To better understand the similarities and differences between investments, including investment objectives, risks, fees, and expenses, it is important to read the products' prospectuses.

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