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Voiceover: Hello and welcome to the Fidelity ETF Exchange, powered by Fidelity Connects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

In this episode of the Fidelity ETF Exchange, co-hosts Étienne Joncas Bouchard and Himesh Patel sit down to recap notable trends and headlines in the Canadian ETF Industry for Q1 2022, including the Canadian ETF industry attracting 13.9 billion dollars in net flows through the first three months of the year.

Key topics of discussion for today include the rationale behind strong inflows into Energy sector ETFs, a continued interest in Dividend and Value factor ETFs among investors, a slowdown in ESG-themed ETFs as well as an outlook for the remainder of the year.

Today's podcast was recorded on April 11th, 2022.

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Étienne Joncas Bouchard: Hello, everyone, and welcome to the Fidelity ETF Exchange, I'm your host, Étienne Joncas Bouchard, a.k.a. EJB. And today joining me back on the show, Himesh Patel. Great to have you back, buddy. How's it going?

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Himesh Patel: It's great to be back. I did a little short hiatus over there and it's good to be back on the show co-hosting.

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Étienne Joncas Bouchard: Awesome. Great. And actually, today we're going to be doing an episode which we're both familiar with. We do this every quarter. It's a recap of the ETF industry here in Canada and obviously some comments on the U.S. side also, but definitely more focus on the Canadian aspect. And talking about performance flows from… give a little bit of factor perspectives and just all around just kind of discussion around the ETF industry. So very excited to be doing that.

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Before we get started, just a little reminder for everybody that is listening in today: our last episode that we recorded was about, let's say, one month ago and it was with a great guest, Bobby Barnes, and we had the opportunity to pick his brain on what he's seeing from a style and factor perspective going into 2022. Some of the key topics that we had discussed there were the shift from an early mid-cycle to a mid-to-late cycle and how the leadership from value stocks and more cyclical sectors was starting to maybe give way a little bit towards factors like quality and low volatility, which tend to do better in the late-cycle phase of the market cycle. So very interesting tidbits there. For anybody interested, you can listen to it on Fidelity.ca. You can also catch it on your favorite podcast app or Spotify, Apple or any others. So, yeah, so that's out there.

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So, HP, let's get started. Another great quarter for the Canadian ETF industry. It just seems like, I don't know if this is ever going to happen, where we're going to be like, wow, big net outflows in the Canadian ETF industry. It hasn't happened yet, with total ETF flows coming out to approximately 13.9 billion in net new assets for the quarter. Equities definitely leading the way at about 10.3 billion, with fixed income around 1.8, multi-asset ETFs around one billion. That's a continued trend that we had identified a few quarters ago that seems like it's once again not slowing down too much. That's from an asset-class perspective.

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From a geographic breakdown, no surprise here, I think. We tend to see flows into things that have done well. So Canada is leading the way almost twice as much flows into ETFs that are invested in Canadian equities or bonds relative to about 2.8 in the U.S. And really, the emerging markets side is the one that's been suffering a little bit, with, understandably so, with some of the volatility that we've seen there. Yeah. So, I guess those are just the quick, quick opening remarks. H.P., is there anything that stood out to you?

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Himesh Pate: Yeah, I mean, you kind of mentioned it right there with the fact that Canadian equities were a big winner in terms of flows last quarter. And it was interesting because obviously last year was a big shift to international markets and for Canadian investors into the U.S. markets. And obviously, with the market leadership that we've seen year to date in terms of energy, commodities, materials, financials doing well in terms of sectors doing well, we've seen that money flowing back to Canadian equities to a high degree.

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And other things, I think, we haven't really seen a big shift in sentiment from some of the themes that we talked about last year. One, as you mentioned, was the multi-asset category, which I think is going to be a continuously growing space in the Canadian ETF market. And then on the factors side, similar continuation of some themes from last year where we saw a lot of flows going into value-oriented ETFs to some degree dividend ETFs as well, as well as quality. And performance has, when you look at performance of these different areas, it definitely has favoured those pro-cyclical sectors, the pro-cyclical factors. But, like you mentioned at the outset, one of our expert speakers, Bobby Barnes, is shifting from this early mid-cycle phase to the mid-late cycle phase. And that's when you want to see some defense. And I think you're starting to see some of that in the performance for the last couple of weeks. And flows, I think, will follow as well.

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Étienne Joncas Bouchard: Yeah, no doubt. We definitely can't say that Canadian ETF buyers are contrarian, let's put it that way. What is working is what is being bought. Another interesting stat that I found is about half a billion in net new assets in energy sector ETFs. That's good for about 16% increase in AUMs. So, there's about four billion total in those ETFs. You know, they're up 540 million year to date. That's been a really strong push and I think maybe a little bit underinvested in the last, say, five years, almost.

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Obviously, when you're buying a Canadian index strategy or Canadian value or dividend-oriented strategy, you are getting energy. But like the real pure play energy sector ETFs really started to pick up some steam and is in line with that kind of theme of what does well in an inflationary environment? What tends to hedge out some of that inflation risk, as well as rising rate risk?

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And that brings me to the other point is that on the fixed income side, flows have slowed down. And I think in our conversations in the meetings that we do with advisors and talking about asset allocation, there's not too much appetite for fixed income, even now when you've seen yields rise substantially. Like the 10-years almost, you know, [indecipherable] once again, maybe off on a few basis points, but like close to double, if not more since the beginning of the year. From a velocity perspective, yes, we're still below say what the peak was in 2018 and 2019 on the US-10 year, but what a move.

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Himesh Patel: Yeah, it's been very interesting to see just because of obviously what's happening in the rate markets and the fixed-income markets, with the central banks now in hiking mode. But I think that's one big theme that we're going to be watching and that we're going to be talking about for the rest of this year is fixed-income funds, ETFs, flows. Performance, I think, is going to be a huge topic of discussion this year. And, I think we're starting to see a little bit of it right now just because of short-term rates being so high. You're seeing some of that demand going to those cash alternative, high-interest savings ETFs, you know, as investors look to still capture a little bit of yield but still trying to take some risk off the table. And I think where you'll see that progress into the next few quarters is probably into the short-term corporate or short-term government bonds space where as of the time of recording, that the yield curve is flat and inverted a couple of weeks ago for a short-time period. But you'll likely see that steepen out as we sort of get into the later stages of the cycle. So I think that's going to be one area where we're going to see a big shift in investor sentiment going back towards fixed income where, like you said earlier, it hasn't been in favor for the past couple of years and now those people have been allocating to that area.

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Étienne Joncas Bouchard: Yeah, that kind of like middle area of the curve, right? Because you look at the 20- and 30-year, it's moved, but it's not like to the extent of where you've seen like the 2-year, 5-year and even the 10-year move. That is really like it's now almost an attractive entry point for fixed income, you know, right? Like, that's kind of the discussion now is that we've kind of avoided it. You'd want to reduce it, add equities, add some alternative-type investment strategies, whatever it may be that has been done over the past couple of years. We're probably going to see a tipping point, I feel like this year in terms of...and, we might see it on flows, on ETFs, it might be on the fund side, it might be on an individual bond side. I've also heard advisors looking to actually just buying a single corporate bond as an individual line because it's easier to explain to investors and say, we're buying this close to par, probably discount right now, actually. And you know, we're going to hold it to maturity and this is the yield we're going to get. It's a more simple math process, potentially,

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But, definitely, just in general, fixed-income ETFs have created this great tool or is a great tool for a lot of investors and advisors to get this very liquid and broad exposure. So, we've seen actually, if you look from a category perspective in the fixed-income ETF space, it really remains what's been the most popular in terms of flows. The Canada Aggregate Type Index product is leading the way once again this year with 814 million in net new assets as of end of March. The other one that you mentioned cash alternatives also 708 million, but that's a big increase, more than 10% increase in the total AUM in those products. And as those rates have gone up, obviously, you could maybe expect like a sub-one percent yield on those products a year ago. Now you can get closer to two, maybe even more than that. That's pretty interesting. I could see that pick up some pace also.

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Himesh Patel: Yeah, absolutely, and I think one way that I've heard advisers shifting their portfolios into more defensive, more fixed income-oriented areas of the market is by using some of these multi-asset ETFs. And I know you've had a lot of conversations on this with a bunch of advisors, and I know you've had some pretty nice wins there too, and some nice stories. So why don't you elaborate on some of the themes that we're seeing there?

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Étienne Joncas Bouchard: Well, the multi-asset ETF, what's really interesting is that it is also a very diversified solution, right? I think there is so much uncertainty going into the year. And then, we've had some very big and important headlines since then, notably a very hawkish tone from the majority of central banks. That creates some volatility on the equity and the bond side. You've also seen a style which had been underinvested, once again kind of like energy, but like value and dividend, you're seeing the flows like you mentioned. So you're trying to get exposure to that. But then at the same time, your growth, quality stuff has been rerated by about 25% looking at, say, the average PE of our quality ETFs. They're down like 25% to start this year. The price isn't down that much. But it's interesting

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Himesh Patel: clarification, not performance, but valuations.

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Étienne Joncas Bouchard: Yeah, valuations, exactly. The four PEs now. So there's still some decent ratios. But anyways, all that to say that it's just multi-asset ETFs just simplify it. Kind of. It's a turnkey solution. You can use it as a core for any type of investors. You can still achieve a lot of the objectives that you're looking for with a direct ETF. You can still lower your fees on your clients' portfolios and your own portfolio, but you're not sacrificing that diversification aspect. So I think it makes a lot of sense.

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And now you have more and more options, like obviously the products that we've developed here at Fidelity, it's more of a quant/smart beta approach on equities, some active fixed income, versus, I'd say, the 80%, 90% of the flows into that category are in like the pure passive strategies. Some of the key winners there were Vanguard, iShares, but they're very, very similar in the structure that they've built out. We offer something that's a bit more concentrated and gives exposure to factors which have all shown to add strategic alpha over time. So the strategy's done really well. So it's been easier on us to talk about them. But just to say that I think that there's definitely demand for a diversified solution. And you can get that in an all-equity mix, right? Like, it's not because it's like a portfolio of ETFs that you necessarily have bonds in there. We have a 100% equity solution that you don't really know what style is going to lead, what sector or what market cap. Well, this gives you a very good core exposure, strong risk-adjusted return type profile in the long term. So, I think even the more equity growth ones have been more popular. Is that something you've seen as well? Like where the conservative balance, maybe a little bit less?

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Himesh Patel: Yeah, I was just going to tack on to that, that it's definitely we've seen a lot of interest in that. We're all equity or growth. Your asset mix, multi-asset ETFs call it, whether it's 85% equities or 80 or 75% equities, anything more than that, I think has been a favorite area. And it's really because in a market like we're experiencing right now, it's very difficult to pick the winners and avoid the losers. Different factors outperform, different factors underperform and it's not an all-boats-rising scenario like we saw after the COVID correction.

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And in this environment, this is really where, we talk about this a lot, but it's diversification at its finest, where you don't know what's going to go up one day, you don't know what's going to go down the next day. So it's staying diversified across sectors, regions, factors is the prudent approach in this environment just because of all the uncertainty that we have in the markets today. And I think, overall, we're going to see that trend continue. Maybe not flows trending more towards the growthier asset mixes or all equity asset mixes. But I think the multi-asset category, just like we've been watching it very closely over the past couple of years, is going to be a big category this year, again, just because of, as Canadian investors, we're skewed towards balanced funds. We love our balanced funds...

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Étienne Joncas Bouchard: ...and the good old 60/40.

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Himesh Patel: Exactly. And that's a whole other argument altogether. But you know, diversification, 60/40 asset mix, I think is a great solution for Canadian investors.

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Étienne Joncas Bouchard: OK. We got something here, though, you kind of scratched the surface on something. One of the other key themes that we identified in these types of industry recaps, and I'm trying to look forward and say, what's going to be popular? One thing that we had mentioned was crypto ETFs,

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Himesh Patel: ...crypto, alternatives, yeah.

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Étienne Joncas Bouchard: Yeah, how are those doing?

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Himesh Patel: So I think, they came out of the gate really strong when we first saw those number of launches last year, and we've seen a number of launches this year as well. But today we're sitting at about $500 million in flows and it's grown as a category pretty big. So the crypto specifically category in the Canadian ETF industry is about $6 billion. So, it's like less than 2% of the market share. But definitely, I think it has some market appeal to it and you're definitely going to see that continue to grow, I think.

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And to dwell on the point that we're just talking about 60/40, whether that's the perfect asset mix or not. I think that's where you'll see a lot of the interest in these alternative type ETFs, crypto ETFs because it does make some sense to add a little bit of an allocation. We'll see how far that goes in terms of how that diversifies risk in return over the next 5, 10 years when we get more performance data behind these ETFs. But from a from a risk standpoint, it definitely does make sense, and it has made sense to add a sleeve to these alternative ETFs to one lower your duration, sorry, lower your volatility, lower your correlation to the market. And I think that trend will continue as well.

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Étienne Joncas Bouchard: Yeah. And you know, we're also lucky here in Canada to have access to ETFs that invest in spot bitcoin, something that unfortunately, U.S. market participants do not have access to. Actually, I was reading on Twitter – and we were talking about this a little bit before we started the podcast – I was reading a tweet which I spend a bit too much time on Twitter than I'd like to admit. But one person I really like to follow, Eric Balchunas, who works for Bloomberg, was highlighting a case study that a lot of U.S. advisors would be extremely happy to have access to ETF, or they'd be more likely to purchase a Bitcoin or Etherium ETF if it was based on spot crypto instead of futures based. So, I think maybe that's benefited, also, the Canadian ETF industry is that we have a unique vehicle or structure, I should say, and, from a global perspective. So that's interesting. Yeah. And I think the next phase of that, like you said, HP is, do those start to capture flows from multi-asset ETFs and ETF portfolios?

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Himesh Patel: ...or even mutual funds.

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Étienne Joncas Bouchard: Or even mutual funds. Now that and institutional investors also, the ETF vehicle being a liquid as it is makes it a useful tool for any type of portfolio manager, not only advisors or direct investors. I think this is going to be used also by some of those institutional-type investors as the best tool for them to get exposure to bitcoin crypto.

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Himesh Patel: Yeah, absolutely. I think, for the most part, we've seen a lot of those flows recently have been retail-oriented or direct investor-oriented. I think the jury's still out if you'll see a tide of asset allocators allocating to the crypto space in their multi-asset portfolios. But that, I think, is a trend that we're going to be experiencing later in the year, and we might see some more interest there, but definitely some interesting, interesting things that are happening in that area.

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Étienne Joncas Bouchard: So that might be like the next leg of growth for that space, right? Because I think, not to say it's saturated, but the pace of growth has slowed a little bit relative to like when it came out of the gates. Everybody just kind of jumped on the trend. And you know what, maybe like we're saying about earlier about how flows tend to go with what's working. Well, there was some volatility in crypto markets.

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Himesh Patel: I was just gonna say, that was when crypto, that was when bitcoin was about 60,000 dollars Canadian or something. Right now, it's down to like 40.

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Étienne Joncas Bouchard: Yeah, I'm sure a lot of investors would like that to go back to 60,000 and soon. But we're not really in the crypto price targeting game, so I guess we can go on to another subject. And another theme that we had explored also was ESG investing. I feel like in 2020, everybody was talking about ESG because once again, what is it? Is that a commonality? It was working? Everything that was E-focused seemed to be getting a lot of love, solar, a lot of the technology names looking at renewables. We were just talking about how there's been a ton of flows to energy. Has that slowed down the investing, I guess, attractiveness of ESG in the short-to-medium term? I know in the long term, look, I don't think anybody would argue that this is going away. But in the short to medium term, have we seen flows slow down? Do you have any stats on that?

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Himesh Patel: Yeah, they've absolutely slowed down. And I think this isn't as a result of the fact that ESG as sort of a theme doesn't have any merits behind it. Like you said, long term, I think there's definitely merits behind ESG investing from a shareholder perspective, just from a public-good perspective. But we have seen flows slow down. I think last year was one of the biggest years in terms of ESG flows. And this year we've seen them slow down where last year you're probably getting around $6 billion of flows into the Canadian ESG-oriented ETFs. This year, that's way down, and you're seeing a lot more outflows from ESG-oriented ETFs versus inflows.

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And I think part of that is related to the fact that we've seen a lot of these cyclical areas of the market really rally on the heels of commodity prices increasing and materials prices increasing as well that a lot of asset allocators' portfolios were underweight this area and really got hurt from a performance standpoint. So, what we're seeing is a lot of inflows, like we said earlier, moving towards the cyclicals like energy and maybe ESG taking a little bit of a backseat from now. But I don't think that's ... there's definitely a place for ESG in a portfolio long term. I think the market is kind of figuring out where that might be and what's sort of the right mix from an ESG perspective.

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Étienne Joncas Bouchard: ..and kind of the way to go about it, right? Like should we be using an ETF that screen for ESG characteristics based on certain data? Or should we give this to an active manager who's maybe doing a bit of impact investing or is meeting with these companies and trying to understand how their sustainability will improve over time? And I think, like you mentioned, like ESG as a fundamental research practice, if you will, like incorporating ESG characteristics into the whole investment process, that's not going away. I think maybe right now the market is trying to figure out like, how is this the best way to invest in it? Whereas seemed like it was just kind of a little bit trying to chase performance a little bit in 2020 where I think that was some of it. But, once again, this is going to keep developing over time. But yeah, so interesting, interesting stuff.

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HP, we are already at about, say, 23 minutes here. Before we wrap this up, maybe just a quick outlook of some things that you're keeping an eye on for say the next couple of quarters. It can be anything really. And I'll chime in with a few things I'm keeping an eye on.

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Himesh Patel: Yeah, I mean, I think it's where the market is, and all the conversations that we have with clients and advisors, it's really a difficult market to really call one way or the other. Obviously, we're not trying to time markets or do any of that because that's very difficult to do. But I think the approach that we'll see for the next couple of quarters and into the end of the year is more of a risk-off approach in terms of investing. And the things that I think everybody is looking out for is what is going to be transpiring on the central bank front. You know, the market has pretty aggressively priced in nine hikes up until the end of the year from both the Fed and the Bank of Canada. So we're kind of on our toes right now in terms of will they actually get to that point or will they have to stop before that? And I think once we get a little bit more into this cycle, we've only got one hike so far, once we get a little bit more deeper into this hiking cycle, that's when you start to see a little bit more clarity in terms of how things should play out.

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But just from a sort of a fundamental perspective, earnings have been great, although they've come down quite a bit, obviously over the last 12 months. We're still seeing positive earnings growth. I think the telltale sign of things really slowing down from the fundamental perspective is downward revisions into negative territory and we haven't seen that yet. Historically, we've seen that towards the end of the late cycle, in previous scenarios. So those are the kind of the two main things that I'm looking for is one: how the central bank policy kind of plays out, and then two: when will we start seeing sort of those negative downward earnings revisions?

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Étienne Joncas Bouchard: Two absolutely great points. I think central bank policies, probably, at the top or near the top of the list for a lot of investors and advisors. And like you said, it seems like a fairly hawkish scenario is already implanted into the curve with, like you said, about 8.5 hikes or something close to that, changing every day, obviously. But let's say between eight and nine hikes priced between now and the end of the year for both the Bank of Canada and the Fed.

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I think one point where, similar to what you're mentioning with regards to earnings and earnings revisions and just earnings growth in general, right, like we were expecting to start the year to get some high single digit earnings growth for the U.S. market and, you know, say something very fairly similar in Canada. I think as soon as we see a kind of like Q2, it's probably going to be a better indicator than Q1. The further we go or as time moves, we're less and less getting some of the pops off the base effects of reopening the economy and comparing a more open economy to an open economy. And that also comes back down to where our headline inflation number's coming from, because you're already starting to see signs of... not erosion but say... slowdown in economic activity, whether that's a little bit higher inventories here and there, a little bit less orders. There's some things that are starting to show signs of a slowing down. Not to say that inflation necessarily slows down, but definitely economic activity. So I think that would be a scenario that would be extremely challenging for investors is if inflation remains high and growth slows or stops. I think that's where you said the risk off is there's going to be a rush to risk off.

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Himesh Patel: Stagflation, yup.

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Étienne Joncas Bouchard: I didn't want to. Yeah, there you go. I don't want to say it. Not a friendly word. Exactly, that's a bad, bad word.

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But you know, that's going to take some time to figure out if we're actually in that environment, but what happens in that phase is usually we see margins start to fall. Ah right? So if we see the average margin just on the market as a whole, obviously, you can pinpoint to certain sectors. But just looking at the average, the margin, for example, in the trailing 12 months on the S&P 500 and the S&P TSX, if that starts to shrink just because of all the inflation we've already seen and producer prices being so high, that's like one of the pillars, right? Like if monetary policy is getting worse because we're tightening and quantitative tightening is coming also. We take that you got slow earnings growth. The one thing that's holding everything up right now, I think, is like, valuations aren't that bad. If you look at.. there's some areas that are still very, very attractive. I was looking at our value ETF prior to the call for a client call. Our U.S. Value ETF is still trading at around 11.5 times next year's earnings. That's by no mean... We can't say the entire market is overpriced, I think. So I think that's one key...

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Himesh Patel: We went through a pretty rerating, pretty significant rerating over the past...

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Étienne Joncas Bouchard: Exactly. So I think that's one positive that we got going for ourselves. So I guess we sound a little bit bearish, but I think those are good things to keep an eye on and definitely have a big impact on the entirety of the portfolio. So, like you said, I think it's important to stay diversified. There's no easy pitch coming down where you can just almost guarantee a home run or something. It's not like 2020, where there seemed to be like some very clear-cut opportunities lining themselves up. Like, for example, like we saw in high yield or value and things like that, it's just now it's remaining diversified and all that. I think that we're going to wrap it up here, HP. Any final comments or all good?

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Himesh Patel: I think that's a pretty good overview of the market. Just to kind of end off on a positive point. The Canadian ETF industry continues to grow at a record amount with no signs of slowing down. So, we'll definitely keep our listeners up to speed on what's happening in the markets and looking forward to the rest of this year and see how the markets play out.

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Étienne Joncas Bouchard: Awesome. Thank you, Himesh. Thank you, everybody for tuning in. This has been great. We appreciate all the support. Until next time. Thank you.

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