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

In this episode of the Fidelity ETF Exchange, host Étienne Joncas-Bouchard welcomes Bobby Barnes to the show. Bobby is Head of Quantitative Index Solutions at Fidelity Investments, based out of Boston.

In this episode, Etienne and Bobby discuss equity markets from a factor perspective. Some of the key topics discussed include a review of where we are in the market and economic cycle, the strength in commodities and which factors to look for to get exposure, and how to use factor ETFs to diversify the equity sleeve of a portfolio.

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[00:01:31]

Étienne Joncas-Bouchard: Good morning, everyone, and welcome to the Fidelity ETF exchange. My name is Étienne Joncas-Bouchard, aka EJB, and I'm your host today, as always. Today I will be running the show solo. My co-hosts, Himesh and Andre are unavailable, but we will be doing a great discussion with a very special guest joining us from Boston. So I guess I could even say this, you know, this is a recurring guest that we have on, Mr. Bobby Barnes. This is the second time that he's joined us on this ETF exchange podcast here that we run. Bobby is head of Quantitative Index Solutions at Fidelity Investments. Prior to joining Fidelity, Bobby was a systems engineer at Motorola and NASA. Yes, you heard that right. He also has an MBA from Harvard and a Masters of Science in Electric Engineering from Stanford. So, all in all, an extremely smart and valuable resource to my team and to advisors across Canada, as well as in the U.S. So, Bobby, just a very warm welcome to you. Thank you for joining us. How are you doing?

[00:02:29]

Bobby Barnes: Good, good. Good to see you. And thanks for having me.

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Étienne Joncas-Bouchard: Great. Yeah, I know it's extremely busy times. There's volatility in markets. There's clients asking questions, so I want to thank you for joining us and taking 20, 25 minutes to talk factors, which is obviously for our ETF lineup here in Canada, the majority of our product shelf and you and your team having worked so intricately to develop those and to monitor them and to provide us with analysis and insights. I think it's a very good time to revisit some of those key themes that you and your team are seeing, kind of maybe even take a step back into last year. But before we do that and go into the factor discussion, for any new listeners that may have never had the chance to hear from you or don't really know exactly what it is our quantitative team exactly does at Fidelity, can you just provide a brief background on what that is and kind of the role that you guys play in the greater scheme of things?

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Bobby Barnes: Yeah, sure. What I usually like to do is to demystify what is quant, because a lot of people view it as being a black box. And so the way I describe it, if I have to tell my kids what it is I do for a living, I say that just like any other investors, I'm just picking what stocks. And now I've gotten more multi asset class. So, I'll maybe generalize and say, just picking securities, what investments to make for a portfolio to make money for our shareholders. That being said, it does get a little bit more sophisticated and complicated and how we get there.

And so, as a quant, we use statistics, computers, all that in order to build models to help predict which stocks are likely to go up versus down. And within the greater context of Fidelity, even though as a shop, we're not known per se for quant, but as a capability that we've had for a very long time, in fact, the first Quant was hired in 1965. I think it's the date. And so, we've been using Quant in the investment process for quite a long time. And the group has grown, and so we do all sorts of cool stuff these days where we're helping our portfolio managers turn over more rocks. And so, I'm borrowing from a term from Peter Lynch, who's I guess our greatest investor. But the way to think about that is that by leveraging quant in computers, we're able to build more scale, we're able to look at more investment opportunities and kind of give it a thumbs up or thumbs down. And that, I think, creates a competitive edge for Fidelity over time.

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Étienne Joncas-Bouchard: Awesome. That's great stuff, and I think it provides a little bit of insight. Sometimes we have to oversimplify things maybe a little bit because we know that it is definitely a lot more complicated than you were mentioning there. But it's great to just see some of the key themes and key things that you guys do on a daily basis.

And, I guess we might as well just get right into it and here at Fidelity Canada, we on the equity side from our ETF lineup, we have five main factors that we've developed as a firm and they are momentum, quality, low vol, high dividend, and value. And all of these factors have shown over a very long period of time that they can add value or they have added value relative to, say, just a broad benchmark for the majority of regions. So that includes Canada, the U.S., as well as international developed markets. So, these factors, albeit they've done very well over the long term, they tend to change leadership throughout the market cycle. So whether, when we came out of the initial COVID-19 drawdown recession, we entered somewhat of an early cycle. I think, 2021, maybe that was already the end of that phase. But nonetheless, I just want your comments, maybe on some factors that surprised last year and some that maybe disappointed.

[00:06:38]

Bobby Barnes: Sure. Yeah. So I'll start by just helping to frame how one should think about what factors will outperform versus others. You know, it harkens back to when I first started my career in this particular industry. One of my first major projects was to figure out what drives stocks as broad as that sounds. And the answer is earnings and earnings revisions. And so, when it comes to factors, although, they each have outperformed over any 30-year back tests or measurement period, what determines when one factor is going to outperform versus another is going to be due to earnings in the earnings revision story.

And so if you go back to 2021, which you just mentioned, if any of your clients that I spoke to... during that time for the duration of the year, I was pro value. And the reason was because we were in an economic recovery. When you're in an economic recovery, you tend to have positive earnings. Revisions in those stocks are the cheapest. Coincidentally, they're also the stocks that got beaten down prior to the recovery. And so, that's where the most opportunity lies. And so when you fast forward to today, you look at what did the best over 2021. It was value and it was when you peel back the layers of the onion, it was specifically due to the rising earnings or the surprising earnings, surprise to the upside that you got with that factor as opposed to, say, other factors. And so that was aligned with my expectations.

Again, I'd been espousing this throughout the duration of the year, but there were a few surprises at the margin, though. One being, in addition to my prescription for value last year, I was also prescribing for investors to be in smaller-cap stocks because they also tend to be pro-cyclical and you see their earnings surprises to the upside during economic recovery. That did play out for a big portion of the year. But if you remember, 2021 did have a lot of fits and starts. The overarching narrative was reopening. But when you go back through the year, we kind of had reopenings. We had reclosings. Everybody started to get the vaccine. But then Delta hit and then when we started to get some relief from that, then Omicron hit. So by the time we got to the end of the year, I think small size did outperform directionally say versus the S&P 500. But the outperformance wasn't nearly as much as value was, which was along the same lines of the prescription that I had been making.

The other surprise at the margin, I would say, was quality. Now quality is, kind of the way you define it is in the eye of the beholder. So, you mentioned our suite, which is proprietary. We leverage ... our quality definition is largely leveraged off of our symbiotic relationship with our fundamental counterparts again, which is, I think, a competitive advantage that we have versus others. And so our quality product actually outperformed in 2021, and that was not what I had been prescribing in the year. You know, when you're going through an economic recovery, typically another way that people talk about that is it's a junk rally. So you would not have expected quality to outperform.

That being said, though, it wasn't consistent across the globe. You mentioned that we've got a global suite, we've got U.S., Canada, develop international. And so our U.S. quality outperformed, which was unusual in 2021 given the recovery. But then when you look across these other regions like Canada and develop international, it was more aligned with my expectation going into the year, which is that you didn't want to be in high quality. You wanted to be in the pro-cyclical factors like value, which was, I think, our best factor in all the regions.

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Étienne Joncas-Bouchard: That's great stuff, and there's a lot of stuff to unpack there, and I had prepared a set list of questions and I'm already throwing those out the window almost just because there's a few interesting comments there. The first being with regards to value, like you mentioned, what's really interesting is the strength in earnings growth in a lot of those names and sectors that were overweight relative to the benchmark did extremely well. We actually saw, if we look at like our U.S. value ETF, albeit, above 30 something percent performance, valuations on the most part actually came down. So you saw like those multiples compressed just by the sheer strength of the earnings growth, which I think was absolutely, definitely a positive and a driver of performance. And the second thing that you mentioned, which is really interesting, is that value and quality both outperform, which generally speaking, you'd correct me if I'm wrong, they tend to have a negative excess return correlation over time. So when one's outperforming, usually the other one's underperforming and vice versa and hence the value in combining them, I think, in the long term.

But yeah, that was a really interesting one.

The last thing I'll add before we move on from this little segment is you mentioned the differences between regions, and it's actually quite surprising that U.S. quality did better than, say, Canadian or international, simply from the fact that your reopening story was a lot stronger than our reopening stories, right? I imagine much of that is probably due just simply from the investment universe that we start off with is just probably tilted towards value by nature. You know where you got more energy and financial and stuff like that in Canada? I don't know if that that would make sense. Is that a contributor, you think?

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Bobby Barnes: Yeah, that's a very good point. I think the way I would attribute it would be to the composition differences across the regions because if you compare the broad market, you know, say, the S&P 500 vs the TSX, the S&P 500 has a much bigger weight to say tech than Canada does. Same is true for develop international. There's far less tech over there. And, with respect to quality, I think it's probably idiosyncratic to the United States, given that tech makes up so much of our benchmark. Quality is kind of overweight those FAANG names, the quality, the more profitable FAANG names. And so specifically, if you look at stocks like Microsoft, Apple, even Facebook.

And so even though we were in an economic recovery in 2021, there were some interesting growth stories, embedded within some of those mega-cap tech that are high quality, that are unique to the kind of the U.S. market. You know, with Microsoft being a key example of that where there's so much growth runway with their cloud business and the adoption of the cloud. Some of that, I think, was even accelerated with work from home and things going virtual. And so, I think that kind of helped provide a tailwind to U.S. quality, whereas you didn't see similar tailwinds in these other places. I think to your point, a large part of that was just due to a difference in the composition, the sector composition across these regions.

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Étienne Joncas-Bouchard: Absolutely, that seems to make a lot of sense. I mean, obviously we know it. I mean, we're in Canada here. Our index is not the best diversified. It doesn't have the best sector to diversification, let's just put it that way. But thankfully, we have the flexibility to invest globally. And I think a lot of Canadian investors are slowly, gradually reducing that domestic bias, albeit right now, I mean, it seems like a good place to be given the energy component. And I guess I'll take that route for my next question, which is, commodity prices have risen quite substantially, especially in the energy complex. Is this something that you see as sustainable and currently the way that factors are positioned, would value be kind of the factor that would give you the most exposure to commodities?

[00:15:08]

Bobby Barnes: Wow, that's a very fascinating question, and there's a lot to unpack there. Gosh, where to start? I'll start by acknowledging that, yes, commodities have been on a tear and there are pockets of commodities that I think could be sustainable, specifically energy. And the reason I say that is because we've experienced a pretty dramatic underinvestment in the energy and the production capabilities over the last couple of years. And so, where we are right now is there's a supply/demand imbalance. The world reopened and demand came back faster than supply.

And, I'll use the U.S. as an example. The last time I looked, the number of rigs, these machines that they're sucking oil out of the ground, today, there are still 30 percent fewer of these rigs than there were pre-pandemic, right? And so, we're just not able to suck this fuel out of the ground. Meanwhile, the world is reopening. I mean, our mask mandates are going away here pretty soon. I think, hopefully knock on wood, international travel will open back up again. I think I feel like Canada, as well as feel the U.S. is going to start doing more business travel going into 2022. And so all that's going to be incremental demand for oil. So that's the one pocket of commodities I think I'm on constructive on. The reason why I frame it that way is that, we haven't gotten into it, but maybe that's where we're going to head is into my outlook for 2022.

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Étienne Joncas-Bouchard: Oh yeah, we'll get there. But you go ahead, please go ahead. I think it's definitely the right time because like you said, it's going to be that transition from value leadership to what we were discussing prior to the call. That outlook is seemingly changing in 2022 with a bit of a … anyways, give me your top-down perspective because I thought it was really, really interesting.

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Bobby Barnes: And so in normal scenarios, the commodities rise at the same time value outperforms, and all of that is due to rising economic activity. Like I said, you always got to tie this back to the economic activity and how that impacts earnings. And so you take everything that I just said with oil just a minute ago, my outlook for 2022, actually, is that we're going to be in a global slowdown. And so given that backdrop, I'm actually less constructive on value. Value typically doesn't do well when earnings are slowing and revisions are being revised downward. Typically, you need to go into more defensive factors like high quality and low volatility and even momentum. And so, for those reasons, I think that we'll be in a unique scenario where we could be at the end of this year, 2022, with oil being up because of the fundamental supply/demand characteristics I just mentioned but against the backdrop of slowing economic growth on a global level. And so that's going to be a headwind to other commodities: steel, aluminum, and other base metals.

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Étienne Joncas-Bouchard: Base metals and stuff like that.

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Bobby Barnes: Base metals and then same thing on the factor side, it's going to be more of a headwind for value.

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Étienne Joncas-Bouchard: Interesting. Interesting. So this is one thing and also why obviously I'm biased, but why I'm fascinated about factors is simply the fact that they're also extremely dynamic. And, when you're mentioning, so high quality as we enter somewhat that transition from the mid to late cycles, we've seen some of that peak acceleration in economic growth as we head into that gradual slow down not to say contraction per se or the R word like you told me the other day, but just to say, we've somewhat peaked. Energy, which traditionally has not been in the value or in, excuse me, in the quality screen or framework, that can change also like if these companies because there's this long-term supply/demand imbalance that's been created due to, like you said, under investment from a capex perspective, and usually you said from a U.S. perspective, it's the same in Canada. We've seen capex come down drastically, like we just had our rebalancing period for our Canadian high-quality ETF. It's now overweight energy. How does that happen?

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Bobby Barnes: Yeah, it's a good question. And it's a fascinating time. So you know, one thing I'll share about energy companies that your viewers might not realize or appreciate is that with oil now, I think this morning I look at Venus clock??? coming in at 110 dollars a barrel. These oil companies are because they have limited their capex, they really, I use the analogy of you sending your kid off to camp, they kind of get in shape and they come back bigger and stronger. That's kind of what you have here. I mean, in order to survive the pandemic. Let's not forget, in 2020, the price of oil. I think the oil futures went negative.

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Étienne Joncas-Bouchard: Oh yeah, minus thirty something dollars, you're getting paid to take on barrels home. Need a bigger backyard.

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Bobby Barnes: Yeah, they pay you to take their barrels. And, in that kind of backdrop, these companies make a lot of cuts, right, in order to survive and they get much leaner and more efficient. And so now, this idea that with $110 oil, these companies are printing money, I mean, one of our strategists the other day said, you know, some of these integrated oil companies have like seven to eight percent free cash flow, which is like an unheard of number. Companies don't trade in that kind of multiple or print that kind of money, but that's the situation we are in now where they're not investing for growth. They're really just harvesting the returns from this unique opportunity. And so as such, quality as we define it, we define it a couple of different ways.

Generically, you can think of all of our expressions or definitions of quality as being some expression of profitability. And so that's things like RWE. I mentioned free cash flow, free cash flow margin. These energy companies, as it stands today, are starting to profile well in some of those definitions. That being said, we do take some longer-term expressions of quality as well that energy does not profile as well on, like we look at the five-year stability of cash flows and so on. On a measure like that is looking back that far, obviously they're still not going to be looked at well, but on a last 12 months, you know, free cash flow margin or RWE, you know,

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Étienne Joncas-Bouchard: Yeah, those are looking good,

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Bobby Barnes: They're starting to look quite good.

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Étienne Joncas-Bouchard: Yeah, that's really interesting. And that's like you said, for example, the stability of cash flows, like that is not the way you would generally define the energy industry as a whole, right? So maybe this could be a short-term thing, but I thought that was interesting when I saw our recent rebalancing and it's something that I always mention to advisors that we work with and the fact that investment thesis you're buying into, whether that's quality, value, momentum, whatever, we are going to follow that thesis based on what the market gives us, right? We will react to the fundamental characteristics and allow it to adapt over time. So you might not necessarily be owning the same thing six months out than you are now. So these are active, right? Like these move quite a bit.

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Bobby Barnes: Yeah, that's the right way to think about it. I'd say to our clients, these products are active by design, passive by implementation. I spent the bulk of my career on active side, and that's where I came up with these models, my team and I working alongside of our fundamental portfolio managers and analysts. And so we've basically baked those insights into these ETFs. And they are passively doing active management.

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Étienne Joncas-Bouchard: Yeah, that's a great way to put it. Absolutely. Bobby, I have to ask you your thoughts on, I guess, the impact of the ongoing humanitarian crisis that we're seeing in Ukraine, with Russia obviously entering the country to ... exactly what their objective is, I'm not going to go into the geopolitical aspect of it, but just from a humanitarian aspect, obviously extremely terrible. Has that changed your outlook for 2022 in any way? I mean, we've seen, for example, bond yields fall quite drastically. We've seen rate hike expectations come down a little bit, albeit not that much. I know we had, for example, the swaps market was pricing in a 50 bips hike a week ago for the next meeting. It is now back down to about .24. I think it's even a little bit less than one hike. Has that impacted the way you're approaching this year or is it more of a short-term maybe readjustment?

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Bobby Barnes: It's a good question, and it has impacted the way that I'm thinking about this year. But it's done so in a way that it has exacerbated a lot of the moves I was expecting already.

So, before any of this started out, my prescription, as it is now at the beginning of the year, was for an economic slowdown based off of a lot of the analyzes and stuff I had been doing up to that point. Similarly, if you had talked to me in January, I would have said the same thing I said to you just now about energy and oil. And so, with respect to both of those two things, I think that what we're seeing over in Ukraine is exacerbating.

And so just to walk you through the globe and how that works: Russia is one of the major oil providers. The world, I think correctly and rightly, has shunned them for what they've done invading a sovereign country in Ukraine. And as a result, there are a ton of sanctions which my team is actually reacting to real time right now. And so the punch line here is that this supply/demand imbalance that I mentioned for oil is going to be exacerbated. It's going to be worse than my prior expectation even before any of this started. And that's why I mentioned there's another reason why I'm constructive on oil as a commodity, but not necessarily, you know, all commodities, because the same is not necessarily true for things like aluminum and such.

Similarly, I mentioned my prescription for a global economic slowdown, so slowing economic activity. This situation is not going to help that especially over in Europe, where I'm trying to remember which country it is. There was some country. Maybe it was Turkey where … I think it was. Maybe it was Turkey where tourism is a big part of their economy. And on financial news, a few days ago, I saw the stat of how many of their tours actually come from Ukraine. It was like a big number. And I think it's, there's one thing you can bet on, there aren't going to be as many vacationers from Ukraine over the next 12 months. So that's going to be a negative impact to the Turkish economy, and they're probably bank shots from there right across Europe. And so it's just going to further exacerbate some of that slowing growth that we'll experience in those areas in 2022.

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Étienne Joncas-Bouchard: Interesting. I think that's really, once again, from a financial perspective, putting aside the humanitarian side, I think that's what's scaring maybe market participants a little bit is that this will lead to maybe even a quicker slowdown from an economic growth standpoint, but won't necessarily bring inflation down. And, because you're talking about energy prices, for example, like if you live in Germany or you live in any country that's supplied oil from Russia, and all of a sudden your energy costs just to warm your house has gone up. That's inflationary. And I think that the worry now is that we enter in this environment where there's little growth but high inflation, which is really not a good scenario for any asset or for the majority of asset classes.

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Bobby Barnes: That's right. Yeah, I think I've been toying with this idea in my head. I I'm going to say it, describe it as we have a date with the inevitable. And the reason why I say that is that, federal reserves across the globe, they have the mandate of managing inflation. And so, the time to raise rates is usually when … you want to do it when the economy is accelerating, not decelerating. But we're kind of in this environment where it's a catch 22, where some would argue the Fed is behind the curve. They should have raised them in 2021.

But now we're in 2022 and everything that you and I are just discussing right now, I mean, inflation is rising and there are some pockets, particularly energy that are going to continue to be a headwind or they will further propel inflation. And so the Fed has to ... their hand is forced. They're going to have to raise rates to help slow the economy down and battle that. But that activity is going to be a double headwind because the economy is on pace to start to slow down anyway, just kind of given the way that it typically ebbs and flows and oscillates throughout the years. And so in the U.S., I don't yet have a concern about a hard landing or actual ... you said it earlier ... a contraction.. I'm still specifically talking about slowing growth, not negative growth. That being said, Europe, they're not on as strong of a footing as the U.S. And so, I think there could be a potential that by the end of 2022, with these dynamics we're talking about, they actually could at that point get into negative growth. But you know, it's still early innings. So some of that needs to kind of further come into visibility over the coming months.

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Étienne Joncas-Bouchard: Yeah. Interesting to see how central banks are going to kind of play this out to say, yeah, realize maybe they're a little bit late, but at the same time, like you mentioned, maybe being there, getting their hands forced a little bit to try and combat inflation. But definitely, you don't want to be doing that necessarily when you see the pace of growth already slowing down, straining financial conditions just a little bit more, just increasing the cost of borrowing just a little bit more. You know, incremental changes can lead to big impacts over time, I think. So, that's one of the things that we're definitely keeping an eye out for, especially here in Canada with regards to our housing market. That's one of the big drivers of the economy, and there's been a lot of calls about trying to find a way to get that under control because we've seen house prices go absolutely bananas over the past year and a half. But you know, it would be tough to see that be the kind of the nail. You will have to slow down the economy as a whole because we're taking that cookie jar way.

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Bobby Barnes: Yeah, I mean, and just to touch on one thing you mentioned before about the number, I would actually advise people not to anchor on the number of hikes, but the direction. And when you simplify the problem that way... where we stand today, the direction's up. I'm not going to split hairs about, is it 5 or is it 7? The answer, as it sits today, is up. Now that can get revised later on in the year, we're going to go up. But you know, with regard to whether it's 3or 5 or 7, some of that will depend on how dynamics play out through the rest of the year. But what I can guarantee you is that the number isn't 0. And so, you have to think, accordingly. So, the Fed, what they do is one dimensional. They are either slowing the economy or they're trying to speed it up. They've got a gas pedal and a brake.

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Étienne Joncas-Bouchard: I was going to say it's a switch that goes either on or off or up or down.

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Bobby Barnes: Yeah. And so the answer is to slow it, but you need to, there is a delicate needle they need to thread where they need to slow it, but not in a way that creates a hard landing.

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Étienne Joncas-Bouchard: OK. Bobby, I mean, look, we're already at 31 minutes or so. This always flies by when we're chatting. I think our advisors have a ton to gain from these conversations. I have a ton to gain. I always love these, so I just want to thank you very much for your time. Do you have any little final comments, words of wisdom or should we just shut it down?

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Bobby Barnes: No, thank you. I mean, I will, I guess, as a parting comment, I feel like we know we did a lot of the dialog was maybe, perhaps somber. But the anecdote that I'll share in parting is that we did an analysis on our Fidelity accounts. Fidelity has been around since the 60s. And so we looked at what were the most successful accounts over all those decades. And what we found was that the accounts that did the best were the ones where the people forgot they had an account. And you know, you're kind of like a husband/wife combo. The husband did the investing and maybe the husband passed away and the wife ... those were the ones that did the best. So, I encourage our clients to not be too reactive to all that's going on and kind of stay the course.

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Étienne Joncas-Bouchard: Great advice, Bobby. Thank you so much once again for joining us. Thank you, everybody for listening in. Hope you enjoyed this episode! See you next time.

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