Fidelity Connects

Factor Investing: Fall Trends

Bobby Barnes, Head of Quantitative Index Solutions (QIS)

Pamela Ritchie, Host

[voice-over:] Hello and welcome to FidelityConnects – a Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

Bobby Barnes, Head of Quantitative Index Solutions, is here with us today to discuss how factor investing can help investors find calm in the chaos, and which factors fit best in today's market cycle.

As U.S. equity markets are anticipating a 75-basis point rate hike by the Federal Reserve, Bobby notes that allocations to momentum and quality factors should give you participation if the market is rising, but at the same time can offer good downside protection. Bobby also shares how his work has found that the low-vol factor historically performs well in both late cycle and in recessionary environments.

Speaking of late cycle, Bobby reflects on housing affordability, where we are in the market cycle, and touts the benefits of knowing one's investment strategy and risk tolerance to not get caught up reacting to short-term market movements.

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Pamela Ritchie: We speak to you, as we mentioned, on a day when we're seeing markets rally. There's an awful lot in the markets that doesn't really point to that. I might just ask you off the top, what does this feel like, this type of rally, when you see these pieces of the equity/risk story going in this direction right now?

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Bobby Barnes: There are a couple of things here. On any given day it's kind of hard to extrapolate that out and to say anything meaningful that what you're seeing has any bearing on what's going to happen in the future. That's irrespective of whether or not you're bullish or bearish. You're going to get days that support that argument either way. In fact, we had a whole month of this kind of dynamic we're having today back in July where we were, I guess, in Q2 reporting, but it was very much risk-on, low quality, negative earners, I think, did the best in that month and it gave some back in August, but then we're experiencing a day of that. There have been a couple of days thus far in September like that. I don't read too much into that. It's part of the typical ebb and flow. As you alluded, my outlook continues to be the same for this year in that it's going be characterized mostly by economic slowdown and that's what we've been experiencing. With Q2 reporting, the estimates had come down so as is typical, companies, I think, on average beat by about 5% on those lowered estimates. But the real action wasn't in the Q2 reporting. What you really needed to be watching was what was happening to the Q3, Q4 and the 2023 estimates. Those are really starting to come down over the course of this Q2 reporting.

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Pamela Ritchie: That's fascinating and it points to exactly what we'll try and talk about a lot today. I think it's fair to say that we're seeing some high volatility today. Why don't you just tell us, ultimately, a couple of different factors that we might flesh out a bit more in our conversation today. We're definitely watching volatility, right, so if you're looking at a fast factor to kind of deal with that, what might a couple of them be?

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Bobby Barnes: It's going to be a bumpy ride especially as we move forward in the second half of 2022. Naturally, as the name suggests, low vol is one way to smooth out that ride, low-vol factor, that is. That being said, there are others that I like in this current environment as well. Momentum as an example, just to remind everyone what momentum is, it's basically investing in those stocks that have done well over the last 12 months. Because of that, I describe it sometimes it's a chameleon factor, it kind of takes on the characteristics of what has been working. With that being said, momentum kind of has a bit of a low-vol characteristic now, also high quality and then just a little bit of value since at the start of the year, we did have a bit of a value run. You're kind of finding those quality or low vol at a reasonable price is the way to think about what you're getting with momentum.

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Pamela Ritchie: We'll dig into all of those. I want to get straight a little bit for everyone joining us here today, we spoken to you many times, we're lucky to have spoken to you many times, but just describe ... I know actually you're a rocket scientist to begin with, you used to work at NASA, so that's one piece of your story. Ultimately, how do some of the guidance that you give within Fidelity reach the investors that are joining us here today?

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Bobby Barnes: There are multiple ways. I think the first way is through my team's partnership with the Fidelity Canada product team. I like to say I'm kind of the fixer, if you will, people like to approach me with their tough problems and say, "Hey, Bobby, we want to curate a particular investment solution, can you help us build it?" One example of that would be the metaverse, the total metaverse index, an ETF that we launched just this summer. That's an example where the Fidelity Canada product team approached me and my team with ideas of what type of exposures we wanted to offer our clients, the risk-return properties that we were aiming for and then, as I like to say, my team and I go in our little engine room and then create a process that helps identify those stocks that meet those characteristics.

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In this example, we were looking for companies that are emblematic of Web 3.0 and also digital payments, both traditional digital payments, but then the emerging ones that kind of get into some of the crypto stuff. As a quant, there's the security selection that we have expertise in but then also, and just as importantly, portfolio construction and how do you put all those pieces together in a way that offers our shareholders a superior investment experience.

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Pamela Ritchie: You and your team, I think there's other rocket scientists too, go into the engine room ... this is fascinating to me ... and do some of this. Just while we're on the metaverse, I wouldn't mind asking you just to bring us up to date on crypto, actually, because it's something we've spoken to you about in the past. It's, obviously, at the moment behaving like risk assets. It's not always meant to, but what's your take? How do you look at that?

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Bobby Barnes: You know, crypto is interesting. I'm glad you asked me that because it's something that I've been thinking deeply about for a while now, mostly just trying to answer the question in my own mind of what is it exactly? What I have arrived at after mulling over this for some time is actually it reminds me a lot of my time back when I was an engineer working at tech companies and, particularly, start-up companies. Back in those days the way that a new company that may not have revenue, as an example, the way that they would compensate their employees would be to give you stock options. At that time, it's like those options, if you think about it, they basically offered you exposure to the upside in the company. If and when they launched a product and that product was adopted, you would benefit economically from that.

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Crypto's kind of the same way. It's not really necessarily being used in a ubiquitous way yet, but if you're owning the tokens now, it's in the same way that I would have had stock options in the start-up company and if it were successful, that would be a very successful economic outcome. Crypto is kind of similar, if and when these digital assets get used in a pervasive way in our everyday lives, that's where the economic benefit will accrue.

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Pamela Ritchie: And then it could change the way it behaves, ultimately, within the markets. Going back to sort of what you said about the macro environment, I do want to kind of get a handle on how you see things broadly because it fits into, obviously, the question of low vol, the question, ultimately, of looking at momentum, which direction it's going to go in. How do you see the markets? Here we are awaiting, we think, a monster hike from the Fed. We don't know, but certainly enough of the market believes that at the moment. How does this end?

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Bobby Barnes: There's a lot to unpack there. There's the story here in North America, but then we can have similar conversations about Europe, emerging markets. Let me just start with the U.S. and we'll see where we go from there. Yes, the market is, I think, anticipating another 75 basis point hike. Some people like to split hairs, is it 50 or is it 75? I echo back to things I've said before, which is that the magnitude doesn't matter as much as really is it going up or is it going down? That's the way to think about it. What you're really after is the cost of money going to be more expensive than it was before or less? That's going to have economic implications. That being said, if I kind of set the context because it really became part of our conversation mostly in the last six months but even prior to that, if your listeners might have heard me before, the cost of money had been rising already if you're looking at the 10-year Treasury. Those moves have an impact on earnings and economic activity but with an 18-month lag. I say that, emphasize that to make the following point, which is that there's a lot of back and forth about whether or not there's going to be a Fed pivot.

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Pamela Ritchie: Yes, there is and the market really seems to be, I mean, there seem to be very confident voices in both directions, actually.

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Bobby Barnes: Sure. I won't get into that fray but what I will highlight, which may be illuminating, is that even if the Fed did pivot today, they said we're not going to do the 75-basis point hike, the benefits of that won't happen until 18 months later. We basically already have to pay the piper for the increases in costs, or money, that we've already experienced. That's where we are today and that's what feeds into my outlook for this year and into 2023 continuing to be one of a more defensive posture.

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Pamela Ritchie: Fascinating. We've spoken about this before a little bit, again, from a factor perspective, the place we are in a market cycle if it is some version of a slowdown or, in fact, something closer to a recession, and we don't really know, the positioning is pretty much the same that you would suggest. Is that right?

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Bobby Barnes: Yes. That's also right. I don't concern myself that much with making the distinction between an economic slowdown or a recession because the prescription from a factor performance is the same either way. As it stands today, our asset allocation team, who I subscribe to very strongly, they suggest that we're solidly in late cycle right now, which is characterized by slowing growth. So positive growth but a slower rate. When you look historically at the factors that tend to do well in such an environment, it is momentum and quality in particular. They are more neutral, they found more neutral benefits from low vol but from my work, I actually would extend the prescription to include low vol because it kind of does well in both late cycle and in recession.

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Pamela Ritchie: Interesting. Just flesh out a little bit sort of the, as you say, the asset allocation call. What else do we need to be ready for? We spoke about the cost of capital, does that necessarily translate into defaults? Again, what types of things does this positioning sort of help ballast against?

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Bobby Barnes: Yes, that is correct. We'll start with your defaults comment. It does help inoculate you against those. The other thing to keep in mind about slowing growth and/or recession is that where we are right now, we're at a place where … and it may not feel this way… but we're at a place where things are as good as they get. If you look at things like, say, corporate defaults where they're at lows. We look at unemployment, we are at or near lows. That's always the case before we go into recession, every cycle. Go look at all of them and look 12 months before, things were as good as they get and then started to unwind. Because of that, that's why you want to have defensive positioning because there's this concept of downside capture, which is something that I speak with our portfolio managers a lot. The way to think about downside capture is you want to minimize the probability or amount that you will lose money.

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The reason that that is, if you indulge me I'll share with you this following thought exercise. If you have an investment and it goes down 50% and it goes up 50%, many lay people or laypersons might think that you're back to even. But trust me, I'm the rocket scientist, if you do the math, you're actually still down and still down by a lot, which means that downside capture is worth more than upside capture. Having that balance in your portfolio helps you maintain what we call dry powder so that when you get to the part of the economic cycle where you should take more risk, you've got the capital available to deploy that.

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Pamela Ritchie: I'd love you to comment, again, within the macro discussion of signals, of what you see and what ultimately leads you to work with the types of factors that you're pointing out. It really is the unemployment situation because it seems like a positively but weird situation. How do you read unemployment at the moment and, ultimately, how it fits into sort of the macro discussion?

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Bobby Barnes: Unemployment, there are a couple of things there. One data point doesn't make a trend, but this most recent reading on unemployment, it actually did tick up by a little bit but not necessarily for ... well, it ticked up for a good reason, which is that more people came into the workforce looking for a job. All things being equal that's actually a good thing. But I do anticipate unemployment will rise for the more negative reason, which is that companies are laying employees off. Some of that is really what the Fed is after. The employment market is very tight right now. Increasing the cost of money via Fed rate hikes, they're trying to slow the economy down and so one of the by-products of that would be a higher unemployment from where it is today.

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Pamela Ritchie: It seems that a lot of people sort of talk about that. What's the discussion of the hero? These markers that we're looking at today might be almost a good illustration. It's the way, partly, you've mentioned this before, that you guide your team, looking for different pieces of the story. There's a heroic discussion here. Can you bring that to light for us?

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Bobby Barnes: To set the context there, throughout the duration of my career at Fidelity when supporting our portfolio managers, one of the thought exercises that I always would go through in working with our portfolio managers is find the heroic assumption. Every investment has some thesis behind it and the premise behind this heroic assumption is if your thesis for free investment is predicated on something heroic happening, something that's never happened before, something that has an extremely low probability, then that's an area where you really want to spend more time digging into your thesis and ensuring that you're confident that that's going to actually happen. One of the areas in this exercise that I see today, I see commentary about, call it, bottom fishing, buying the stuff that's really beaten down over the summer, and there's a lot of that right now. A lot of these nascent thematic strategies, for example, are down a lot. It's seducive to want to buy those things now.

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In my mind when I do this exercise of finding the heroic assumption, in order to buy those today, you must believe, and it must be true, that you're going to get some reacceleration in economic activity because that's what these sorts of investments need on a go-forward basis in order to do well. Anything's possible but not everything is probable and that's where I would describe that as being a heroic assumption that I see today.

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Pamela Ritchie: Again, pieces of this story that lead and funnel into how you're looking at factors that work, there are many people who will say housing is the economy. People will disagree with that or agree with that, but it's not unimportant. What do you see in the housing story right now? This would be more in the U.S. Canadians, it's all we talk about at cocktail parties, when we're allowed to, is housing prices. From your perspective, looking broadly across the U.S., there have been some real changes in the housing market.

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Bobby Barnes: Housing is another place where I've seen some, what I would describe as heroic assumptions, especially if you're bullish right now. I mean, it's very clear if you look at what has transpired, prices went up very quickly and they're quite high and then in conjunction with that the financing costs also went up quite substantially. Where we stand today with housing is actually pretty mind boggling. When you look at the affordability, the affordability needs to take into account both pieces, what's the price of the house but then also what's the financing cost. We are at a point today in the U.S. of affordability that's well beyond where we were at the financial crisis back in the 2008, 2009 era.

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That being said, I do want to make this other point, which is that even though affordability is very low based off that metric, I don't necessarily see as much risk with respect to housing as we had back then because back in those days we did have a lot of what we call poor borrowers where they had bad credit scores. I don't even know if the banks were even taking credit scores for some of these borrowers back then. We're not in that kind of environment and don't expect your house to depreciate by 25% or whatever the case may be. I do think there's going to need to be some normalization and that's going to probably come from a decline in house prices. It's likely to be something more moderate than what we experienced but a decline, none the less.

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Pamela Ritchie: We know the link to that, the increased costs, the affordability question on housing from those two different perspectives, it goes to the consumer's ability to spend, ultimately. I think the last time we spoke you were looking at one of the proverbial canary in the coal mine of inventories going back to the consumer, the discussion there. They've built up the goods, services divide and discussion of where the economy is going. We know well. Is there any update that you would share on that? Is there still some way to go on that particular story for consumer stocks?

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Bobby Barnes: Yes, there's still a ways to go. What strikes me as fascinating about that whole thing is that in my mind ... often times you hear people say, okay, well, is it priced in? I feel like it's pretty well known that inventories are bloated now. Despite that, you and I were talking about this months ago, and despite that companies are still finding a way to disappoint on earnings, particularly the retailers because they have way too much stuff. Now is a great time ... if you haven't bought an air fryer or a big screen TV yet, now's a great time to get the deals, they've got way too much of that stuff. That continues to be an ongoing theme. Actually, if you indulge me to share one more story, I had my family in town a few weeks ago and speaking of retail inventories, we had a nice dinner and there was an Old Navy across the street. My niece and nephew went in, came back out, grinning ear to ear. I said, well, why are you guys so happy? They said that they had just bought t-shirts for 14 cents. Oh my gosh, that's how bad the inventory problem is where it's near free. You're giving stuff near free just to get it out the door.

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Pamela Ritchie: Wow. That is something, actually. That is something. Again, that is the picture that you're getting. Wasn't there sort of an interesting story that you might tell us also about just the consumer's ability to buy. I think this was a cars example, actually, that I wanted to ask you about. How many cars, ultimately, globally are bought and sold and you would learn this lesson, it goes counter to the TV story, the t-shirt story. I think years ago, right?

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Bobby Barnes: Yes, yes. This is kind of another heroic assumption exercise as well. This was a conversation that I was having with one of my colleagues last summer. When I started in this business 14 years ago, one of the things we did with our analysts at the time was that every quarter we got one-on-one sessions with Peter Lynch, who's one of the greatest investors of all time. I was fresh out of Harvard Business School and I think it was literally my first meeting with him. We were talking consumer and we got to talking about autos. He said to me very simply, he said, Bobby, all you need to know about autos, there is a set number of cars that gets purchased on a yearly basis.

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Pamela Ritchie: This is globally or just in the U.S.?

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Bobby Barnes: I think our conversation was revolving around the U.S., but I think it extends to global as well. It's a number and there's some small variation around that number, but it doesn't really change materially. I think the rough numbers, again, this is 14 years ago, but I think the rough numbers he walked me through at the time was that you're looking at about ... when you're in mid-cycle, it's about 15 million vehicles per year. Then you go into recession and it goes down to maybe 12 and you come out in recovery and it's 18. But really, for all intents and purposes, 15 is your number. Where this gets to the heroic assumption exercise of last summer was if you looked at that time at the aggregate market cap of all autos, the debt market cap had tripled. So for that to be a fair price in aggregate, you needed to assume that the total addressable market for cars, it had also tripled, had gone from 15 million to 45 but no one was assuming that. Clearly, then, there was an oddity in the market that needed to correct for itself. You had many electric vehicle companies that were IPOing and had market caps bigger than Ford or GM but hadn't sold any cars. That's corrected for itself now, but it's one of many good nuggets that I've gotten from Peter Lynch over the years.

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Pamela Ritchie: That's fascinating. Of course, Peter Lynch wouldn't have known of the massive amounts of stimulus that had to be maybe at the time, arguably, put into the market to help us come out of the pandemic ultimately, but to have that kind of money sloshing around and what it did to valuations, it's still relevant. It's so fascinating to apply it to what was going on last year. Your thoughts on energy, particularly over the winter, and what it might mean for certain factors.

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Bobby Barnes: Energy is a good discussion. One of the things I look at very closely is estimate revisions because that, in my work, predicts what stocks, industries, factors will outperform, all the like. Year-to-date, energy's estimate revisions have been spectacular and is consistent. I mean, every month the EPS revisions for those energy companies continue to rise. I've got a couple of thoughts here with energy. First, our asset allocation team, as I mentioned, declared that we're in late cycle, which I agree with. Historically, late cycle is a tailwind for energy. For similar reasons, inflation, which is very topical, one of the ways to hedge, particularly if you're a consumer, your purchasing power is to invest in energy stocks. That continues to be a tailwind as well. As we look into the fall, which is the crux of the question, I continue to think that energy will continue to do well. But that being said, what most concerns me, if any, about energy is if and when we do get into a recession, at that point you will get lower demand. From my work, usually when you've got demand destruction, be it economic activity or the like, energy doesn't do as well. But for now, I think energy's in a good place.

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Pamela Ritchie: What do you want to leave people with? This is a moment, we're watching markets do what they're doing right now. I think you said things look really good, which what then? How do you position when things look really good at this point in the cycle?

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Bobby Barnes: I'll leave our audience with something I say a lot. The best strategy is to pick an approach and to stick with it. There's a lot of inclination to follow the market gyrations and try to react to it on a micro basis. That doesn't typically end well for anybody. As we've talked about in our discussion allocation to momentum, low vol and quality, that's going to give you participation if the market is rising but at the same time offer up some of that downside capture or that downside mitigation. That's going to be a prescription that will allow you to avoid the behavioural bias of wanting to try to time the market of when I'm going to sell out and raise cash or get back in. That's a very tough game and very few people are able to do that well.

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Pamela Ritchie: It is a pleasure to speak with you. Have fun at the Bruno Mars concert tonight, by the way.

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Bobby Barnes: Will do. I look forward to it.

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Pamela Ritchie: Have a fantastic time. Bobby Barnes, all the best. Thank you for joining us.

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Bobby Barnes: Thank you.

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