Fidelity Connects

ETF Investing Strategies in 2023

Étienne Joncas-Bouchard, ETF Strategist

Bryan Borzykowski, Host

Announcer: Hello and welcome to Fidelity Connects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

On today's show, ETF strategist Étienne Joncas-Bouchard speaks to host Bryan Borzykowski about the ETF landscape for 2023 and what factors could thrive in the first half of the year and beyond.

Étienne briefly looks back on 2022 noting that this past December encompassed the best month of ETF flows in Canada, wrapping up a pretty solid year.

As 2023 continues to move along, Étienne says there are some things to keep an eye on including international equity markets. This category saw inflows of about 500 million dollars, it's a category that has been underappreciated. He says it will be interesting to see how it continues in 2023.

Other trends to watch for, ESG ETFs. Étienne says there was a lot of resilience in this category last year. Now in 2023, there is some pushback around ESG. Something to keep an eye on and see if investors will continue to have an appetite for this like they did last year.

Étienne also speaks about Fidelity All-In-One ETFs and what factors to consider in this type of investment approach.

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Bryan Borzykowski: Before we move into the new year, how did 2022 finish in terms of ETF flows and just kind of the ETF space in general?

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Étienne Joncas-Bouchard: December was, I believe, and this is something I've picked up, it was the best month for ETF flows in Canada to end the year in December. It actually wrapped up a fairly solid year, just showing the sheer resiliency of the Canadian ETF market in terms of flows, with about 35 billion in net new assets entering the space in 2022. That's actually good for the third best year on record, 2021 being the record year, and then 2020 being, I guess, number two. This is the third best year, I guess, three consecutive really strong years of flows, albeit last year compared to the two previous ones, much more challenging from a performance perspective across the board as much on the fixed income side as on the equity side.

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A few other interesting tidbits that I found from last year was bond ETFs actually outselling equity ETFs, which is quite surprising given it was probably the worst calendar year for bonds in more than 30, 40 years, maybe, so that was quite interesting. Little caveat there, it was actually the emergence of a category that's been around for a while but received a lot of inflows, which is the cash alternative space. It received about 8.9, 9 billion, let's call it 9 billion, of flows last year. Good for about half the total, a bit more than half the total in all fixed income space.

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So, yes, there is buying of bonds but there is also a lot of kind of hedging out and going to safety, no duration exposure, sitting on the sidelines and benefiting from higher interest rates, so earnings north of 3% for the majority of the year in those types of products. As we roll around to 2023, that does seem like it's a flow through vehicle. I don't think anybody's invested in cash for the very long term. So, it's going to be interesting to see how that moves throughout the year, if there's outflows there into something else, but actually to start the year it's continued a little bit, so positive there also. Those are some of the main things that we saw last year.

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Bryan Borzykowski: Just before we move into this year what does it say about the Canadian ETF landscape? After this crazy volatile year, we saw, AUM was above $300 billion for the second time in a row and that December number that you mentioned. Why is the market so resilient and why are people kind of continuing to put money in when you see all of this volatility?

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Étienne Joncas-Bouchard: It's a great question. I think one of the reasons is that there's just so many great alternatives. There's so many different tools that are available out there to investors. Regardless of what you're trying to achieve in your portfolio construction or which exposure you're trying to get, there's likely an ETF for that. I think that's one of the main reasons. The second is, for the most part, if you look at the total assets, about 65% of total assets are in passive strategies which also means lower fees in nature. I think when markets are volatile and performance is tougher, maybe investors say, oh, one way I can mitigate some of this downside is if I can lower my fee. I think that's also driving it. But for the most part, I think it's just the amount of choice that we have there for investors.

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Bryan Borzykowski: Moving into January, the numbers just came out, what are you seeing there? A little bit different than December from what I've looked at.

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Étienne Joncas-Bouchard: Yes. Actually, December was close to 8 billion in flows, which is crazy. January was actually the first negative month since last June, so about 340 million in outflows. I don't think it's a cause for concern but it definitely shows that maybe you're kind of a wait and see approach. I think that's going to be the theme for the rest of the discussion when we're talking about where we are in the cycle and things to consider for this year is that it's fairly tough to have a really high-conviction view right now, I think. I think that's showing up in the flows.

One thing that I did notice, though, which was interesting, is coming off of strong performance in international equity markets last year, you saw inflows, so about 500 or so million dollars in inflows into international equity ETFs, which is a category, I think, that's been underappreciated given it's been tougher from a performance perspective. I'm going to be interested to see if that continues. A bit of selling of the U.S. and Canada maybe to go to international, which also includes emerging markets for the most part. So, that's a category to watch out for.

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The other one that was slightly positive, albeit the aggregate number being negative, was multi-asset ETFs, which we'll have a chance to talk about with the All-in-Ones here at Fidelity, but I think that category, which is basically those kind of turnkey simple solutions, I think there's a lot of advisors and investors looking for those types of solutions where let's not make a big call in the market. Let's get a very diversified basket and kind of go from there.

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Bryan Borzykowski: Anything else within those numbers — we were talking about sort of the inflows, what categories did you see outflows from?

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Étienne Joncas-Bouchard: From a broad perspective, both bonds and equities were in outflows. You saw a little bit of selling of the cash alternatives but depended on which product itself it was actually close to flat, which was interesting. The rest is selling of U.S. and Canadian broad equity ETFs. So, just taking maybe a bit of beta off. It's kind of tough...I think we don't have enough data with one month to really see an actual trend happening. So, a bit of a snooze fest, if you will, for January.

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Bryan Borzykowski: So when we look into 2023, more maybe broadly in different categories, are there trends that you're watching out for to see that could have new products or just interest from investors, what trends might sort of materialize over the next 11 more months?

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Étienne Joncas-Bouchard: That's a great question, actually, Bryan. One of the things that we saw a lot of resiliency in last year was ESG ETFs. Now, you're getting kind of this pushback in certain places around ESG, about the way that it's categorized, should we favour certain companies over another based on their environmental, social and governance impact? I'm not going to get into that debate, but we actually saw positive flows last year, albeit a lot of the strategies are kind of tech-focused or growth-focused, so it lagged last year but flows were positive. I'm interested to see what happens to that category this year and if there's still continued appetite from investors. That's one thing I'm kind of keeping an eye on.

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Also, seeing when we see more of a move away from the cash stuff, which I was mentioning earlier, into maybe longer duration type bond mandates. Yields have already come down quite handily since last October if you look in Canada and the U.S., so you had a good rally in bond markets, but you haven't really seen investors take advantage of that, if you will. Obviously, a lot of people held bonds but you haven't seen a massive rotation back to fixed income securities. So, I'd say that there's two or three that I'm keeping an eye on for now.

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Bryan Borzykowski: Great. My opening talked about a little bit about the economic picture. We've seen rates rising both in Canada and the U.S., job number still pretty positive in both countries, ISM numbers that are coming out that are a bit all over the place. It's very confusing, I will have to say. As someone who's watching this a little bit, I'm sort of waiting for this recession or something to happen and we want to get past that thing. What is your view on kind of what's happening now and how is that affecting, do you think, the ETF landscape?

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Étienne Joncas-Bouchard: I think I'm kind of in the same camp as you, Bryan. There's a lot of mixed signals out there. You saw the ISM manufacturing report in the U.S. for January actually contracting even more than it did in December. But then you saw services come out today and completely blow expectations out of the water. Going back into expansion mode, you're seeing comments around supply chains easing, pricing pressures coming down. You're seeing new orders pick up in certain segments, with one exception maybe being housing, which is continuing to be hindered by higher mortgage rates and things like that. It's kind of tough to get, once again, this very clear picture.

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One thing I think that's fairly obvious, and you're hearing it from central banks, you're hearing it from a lot of our in-house macro people at Fidelity, inflation seems to have peaked which is, I think, probably positive news for most. It's going to be interesting to see what happens next with regards to the economy from a GDP growth perspective and then how that flows through earnings. When we're talking about ETFs, equities, mostly equities especially but then, obviously, that has ramifications on the credit market. Where's earnings growth going? Right now, it seems like the market is pricing in a soft landing. Yes, we're seeing a slowdown already in growth. We're not necessarily going to have a very deep contraction. That's kind of the base case that the market's running on with – I was looking at it earlier before we got on the call – the consensus estimate by analysts surveyed by Bloomberg, they have posted earnings expectations for the S&P 500, they're still expecting high single digit growth for the calendar year, 2023, around 8+%. From our perspective, that seems like it's a little bit optimistic. Maybe we'll take the side of being a little bit more cautious or a little bit more defensive and saying that we feel like we're definitely in that late cycle phase and we could potentially see some type of recessionary environment sometime this year.

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Bryan Borzykowski: From your job looking at the ETF landscape, what does that impact ETFs? We've seen last year it's all over the place and ETF inflows still did well. So how does that affect maybe where people are going to invest?

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Étienne Joncas-Bouchard: So, this is not so much to say how the ETF industry flows are going to go, but more how certain styles are likely to perform in the current environment. If you look at the late cycle in recessionary periods, the more defensive factors like quality and low volatility tend to be the better performers and momentum also. I'd add an asterisk, if you will, to momentum because, say, low-volatility stocks in sectors like consumer staples and utilities and things like that start to work, momentum starts to transform itself into that type of factor or style. You've already started to see that happening with the performances we saw last year. So, it's like a combination of value and low vol right now. Those factors tend to do well.

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Historically the excess returns that we find in various ISM scenarios really concord with that chart which is fairly theoretical. If you look at, for example, value, when things are getting better and they're expanding, that's usually when value does really well. If you take 2020 and 2021, for example, you either started in 2020 with an ISM below 50 and rising, and then you moved into 2021 with above 50 and rising. So, basically things were contracting and then contracting at a slower and slower pace until a point where they were expanding and then starting to expand at a faster pace. But what we saw last year was above 50. We were still expanding but at a slowing pace. As of December, for both services and manufacturing, we were actually below 50 and falling and then services just completely messed up our thesis and bounced back for January. But manufacturing still is in that falling trend below 50. You can see that momentum, quality and low vol are the factors that tend to have the highest annualized excess returns over a benchmark during those periods.

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Those are some of the factors that we're keeping an eye out for. It emphasizes defense a little bit, trying to find stocks that have lower variability of their earnings, if that makes sense. You don't want stocks that are necessarily as dependent on the macro environment, so taking away a bit of cyclicality which has actually helped in the past year because most of the cyclicals were trading at a discount to the broad market, so less sensitive to higher rates. It's a different story a little bit this year.

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Bryan Borzykowski: Can you just walk us through the factors a bit and just to make sure everyone understands, what are the factors and why is this investing approach? Why are you interested, in fact?

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Étienne Joncas-Bouchard: I think it's quite fascinating. Call me biased, that's my job. I'm prescribed to know these factors and these models. A factor, in a simple ways, is just trying to pick stocks based on fundamental characteristics but doing in a systematic way. So, instead of having a portfolio manager that's doing this on an active basis every day, looking at stocks, running through financial statements, running their own fundamental models on cash flows and things like that, we rely on more simple ratios to transact and to purchase stocks or to sell stocks. There's various different factors that have shown over time that if we select stocks based on certain characteristics, it actually helps or allows us to add value relative to a market cap-weighted index.

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If you take value, for example, it's a very fairly straightforward example, I think, and fairly easy to understand so let's go with that one. We're picking stocks based on the price-to-tangible book. We're picking stocks based on the forward P/E, EV to EBITDA, free cash flow yield. Those are four metrics that have different iterations of value for a given stock. Then we want the best ones. So, we look at a large investment universe, create a concentrated portfolio systematically, and offer you exposure to cheap companies. It applies for all these other factors like low volatility, which is basically picking stocks that display low volatility in price, in earnings and things like that. It's kind of a hybrid between full-on active management and passive management where you're not doing anything and active, you're doing a heck of a lot of stuff. We're doing some stuff but we're not going as granular as meeting the management teams, for example.

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Bryan Borzykowski: How would maybe advisors use these different kinds of ETFs? We'll talk about the All-in-Ones, but you can pick and choose different factors. As you said, some will outperform in different environments, so how should advisors maybe approach these different factors?

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Étienne Joncas-Bouchard: It's a great question. I think there's multiple use cases — I don't want to get this wrong, let's say three. I'll try to knock the three there and at least make it the three. The first is definitely from a tactical standpoint. You want to express a view that you have on markets by focusing on a given type of companies. For example, you want to reduce the average valuation in your portfolio, so take away maybe a bit of the growth exposure, you add in from a tactical perspective to get some, ideally, strategic alpha. Trying, not necessarily, to time the market but to get exposure to a given type of stock that is likely to benefit in the current phase of the market cycle. So, basically doing what we were just talking about with regards to, okay, maybe it's time to add a bit of quality or low volatility to the portfolio. That's the tactical trade.

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The second is a strategic exposure. For example, and this is, I think, specifically true for a factor like momentum which is very hard to tactically time because it's continually changing, but you believe and you've seen over time that these models have added value. You're saying, yes, it's likely going to underperform in certain periods. It's going to outperform in others but, if I invest with this factor for the very long term, I'm likely to capture some type of annualized alpha. This goes back to academia, right? There's a lot of academic research done on this. We're doing our own research here at Fidelity and, basically, saying, I'm buying this and I'm holding it for the long term.

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The third — I made it, I got to the third — portfolio construction which is I'm literally using this as a counterweight to something else. The way that maybe from an advisor perspective that I've seen this a lot is, let's say you're a discretionary advisor and you're picking your own dividend stocks. You go in and pick a basket, 5, 10, 15, 20, 25 stocks in the Canadian market that are paying above average dividend and that's kind of your strategy, you want to generate some income, well, that's going to put you into a certain basket, right? So, to counter that exposure you buy something like a quality which doesn't really look at payout but looks more at earnings and profitability. So, you're going to get different sector exposures, you're going to get different single stock exposure and really using that as a diversifier, if you will. Those are the three main ones, but it really depends on the way that you manage your portfolios. I think there's a way to approach it for everyone.

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Bryan Borzykowski: If you didn't want to do this all yourself, there are other options. You mentioned the multi-asset ETFs are doing well and have done well over the years. Fidelity has All-in-One ETF portfolios. Maybe talk about the All-in-Ones: what are they and how do they work and then we can talk about how advisors can use them.

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Étienne Joncas-Bouchard: This is kind of the culmination of four-years work by our team. I know I repeat that often but there's a lot of product launches that went into this for us to have enough tools to create these fully diversified solutions and strategies that give you broad market exposure, they're strategically diversified, so from a geographic perspective, from a sector perspective, from a market-cap perspective, asset class, you name it. We're trying to build an all-weather portfolio at a low cost, which is also something that's important to us given we're in the ETF landscape and we're competing against full-on passive management. These are not passive. This is something that, yes, you're getting very broad exposure, but you've got about 2,000 to 2,500 total holdings compared to, say, a 20,000 holding portfolio for most competitors in the passive space, whether it's Vanguard iShares, BMO, you name it, their strategies tend to have a lot of very, very, very, very broad exposure and not giving you an opportunity to add value.

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That's really what we're trying to do with these is combine our various equity factors which, once again, like you mentioned, Bryan, if you don't want to be picking these individual factors and changing them depending on where we are in the cycle and all that stuff, here you're getting an equal weight approach. You get low vol, quality, momentum, value. You want to capture that strategic alpha over time which is, on average for the U.S. market, for example, at around 1.8% when you combine them all together. If you can capture that, you combine that with active fixed income in our Global Multisector Bond ETF and our Canadian Bond ETF, as well as a sleeve of cryptocurrencies, which is an addition that we made a year ago, all that together, I think you get a very solid simplified automatically rebalanced solution. I think this is a great tool for those RSP contributions or RESPs, TFSAs that you're kind of dealing with right now and you're not too sure where to put it, this is a very good, simple, diversified solution.

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Bryan Borzykowski: On the factor component there, are you actively changing the factors as we move through different cycles in those ETFs?

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Étienne Joncas-Bouchard: We don't. There's a few reasons for that. First of all is cost. That's something that is costly to do and it's also fairly challenging. Albeit, I was talking about defence earlier, if we do see a soft landing maybe value picks up. It's fairly tough to do. Ideally, we would have liked to have an algorithm that tells us, okay, when you see this signal you buy this — that doesn't exist, unfortunately.

So, from that, you take on a portfolio construction perspective and you're saying, I want to get the best risk-adjusted return and if you look at an equal-weighted factor portfolio, the volatility of that, given the diversification effect, gives you actually a lower standard deviation than if you buy the low vol as a standalone, which is the lowest volatility factor out there. That's what it's designed to do. The diversification effect of having all four really creates a strong Sharpe ratio. That's the idea there.

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What we do, we start the year a quarter each and we let them drift throughout the year unless, from an asset class perspective, so, let's say you start with the balanced, FBAL, which is a 60/40, you get to 65/35 from an equity fixed income perspective, then we'll rebalance to make sure we're respecting your clients' risk profiles and things like that but we're not necessarily going to play around with the factors. There is momentum that builds over a period of time.

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Bryan Borzykowski: You mentioned RSP season. I can't believe it's already February. If an advisor maybe has built an ETF portfolio with separate ETFs, is interested in an All-in-One, how do you then maybe transition from the portfolio that you've built into an All-in-One ETF?

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Étienne Joncas-Bouchard: That's a good question, actually. I guess I'll bring it to different use cases that I've seen in working with advisors across the country – which is one of the great privileges of my job is I get to meet with advisors in B.C. and Newfoundland and Quebec, Ontario. The way that these are implemented are actually fairly similar across the board, but you do see a few differences. The first one is you see these being used as a standalone core exposure. Literally, this is the one holding in a portfolio. At the end of the day, yes, it shows up as one ticker, or code, because these are available in Series B and Series F, so for any MFDA advisors online these are available to you also, but you have 13 to 15 underlying ETFs in there. So, it's fully diversified.

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You can use it as a single standalone. In that case, in your example, you could literally sell all the different lines and buy one single line and simplify your job and make it a smooth ride also for your investor because they see the return of the total package instead of all the individual line, where you might have one or two that are not doing well and one or two that are doing exceptional and then asking, oh, can I get more of the one that's doing well and can I get less of the one that's not doing well? You're exposing yourself to a bit of that, which is twofold because sometimes you want to have multiple lines to kind of show this is what we're doing with the portfolio, we're adding various pieces and things like that, which is the second way that we've seen them used and it's kind of like a core and then you build satellite positions around it. You get extra little exposures. Maybe I add a little 5% of an EM ETF, maybe I add 10 stocks for Canadian market to overweight Canada a little bit. So, things like that. But either as a core and then satellite or full-on, that's the only solution.

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Bryan Borzykowski: What are your thoughts on sector investing?

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Étienne Joncas-Bouchard: There's a similar way to think about sector investing then/than there is with factor investing. Certain sectors are going to do well in certain phases of the market cycle, but it's going to give you a bit more concentration, if I can be fairly blunt. If you're buying an energy ETF, for example, that's one sector exposure. We know, for example, that's maybe not the best example because it's fairly cyclical and fairly high beta. But it can work in the same three ways that I mentioned factors, as a tactical play, you can use it as a strategic exposure. You think, for example, technology is not here to go away and we're going to benefit from changes in technology for the long term, maybe you buy a small sleeve of a technology sector ETF. It's kind of the same thought process, it's just a bit more direct, whereas a factor, you're still getting some sector diversification also but you're focusing on certain types of stocks. I think it has a place in portfolios. We don't have sector ETFs here at Fidelity but it is something I think that's fairly widely used and can be interesting to do, for sure.

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Bryan Borzykowski: Final thoughts on the ETF space. We have seen the ETF market do really well over the last few years. Do you expect that to continue? Could we see another record-breaking month of inflows or another record-breaking year? How optimistic are you on the space going forward?

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Étienne Joncas-Bouchard: If we look at what's happened in the U.S., and we tend to always kind of lag what's happened in the U.S., right? We're innovative in certain ways, we have a spot Bitcoin ETF; they don't. In a sense, from a trend perspective, we've got some catching up to do on certain things. I think those themes might materialize more this year. One of them is more active and more thematic so, high active share, going away from — and this is from a product launch perspective, from an inflows perspective — I think we're going to see more going into these satellite position-type ETFs because there's so much assets already in those core, broad ETFs. That's not to say that they're not going to continue to garner assets because if you have a client and your main ETF that you use, say, a core S&P 500 ETF and they give you some new money to invest, well, they're still going to go into that. From a new innovation perspective, I think it's going to be a year for active and I definitely think the ETF industry as a whole is going to be fine. I don't think January is a sign of things to come.

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Bryan Borzykowski: Great. Étienne, we'll leave it there. Thank you so much for this. Looking forward to see where the year goes and I'm sure we'll chat again soon.

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Étienne Joncas-Bouchard: Absolutely. Thank you, Bryan. Thank you, everyone.

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