Fidelity ETF Podcast

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Announcer: Hello and welcome to the Fidelity ETF exchange, powered by Fidelity connects, the Fidelity Investments Canada podcast.

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 the third quarter of 2021. With the first nine months of the year behind us, the Canadian ETF industry has brought in a record $39 billion in net new assets. That's a new calendar year record.

Key topics of discussion today include the return of positive flows for fixed-income ETFs, continued growth for multi-asset ETFs, as well as a conversation on investment factor performance and an outlook for the end of 2021.

Today's podcast was recorded on October 19, 2021.

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Étienne Joncas-Bouchard: Hello, everyone, and welcome to the Fidelity ETF exchange. I'm your host at Étienne Joncas-Bouchard , a.k.a. EJB. And joining me, as always, is my good friend Himesh Patel. How are you doing today, man?

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Himesh Patel: I'm doing well. I'm doing well. Can't complain.

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Étienne Joncas-Bouchard: Awesome. Well, we're just us two today. Seems like it's been a while. We've had some really great guests recently. I guess our last two guests being Cameron Chamberlain, who is a portfolio strategist at Fidelity.

And then more specifically, and even more recently in our last episode, we had a chance to sit down with Rory Poole. And so Rory is an alternative strategist at Fidelity Investments Canada, and we had the chance to pick his brain on everything around alternative funds and ETFs. We also took the time to break down, I guess, what is an alternative strategy. Some of the different types available to Canadian investors, as well as how to position them in portfolios. Because at the end of the day, that's really what we're here for is yes, we want to provide information to advisors and investors, but we also want to be able to provide information in a context that can be applicable to portfolio management and asset allocation.

So, we also had the chance to get his take on alternative strategies and ETFs more specifically, which obviously given the nature of our podcast, was also great to do, given we like to focus on ETFs here. Albeit we do stray away from that quite often, it feels like, but definitely today for this episode, we're going to be really focusing back on the Canadian ETF industry with our third quarterly recap that we've been doing. Before we get into today, though, I just mentioned if you do want to go back and listen to any of our other episodes, you can always find them on Fidelity.ca or on your favorite podcast app.

So I'll start by maybe pointing out a couple of highlights from a broad perspective, and I'll take numbers as of September 30th. So really the end of the third quarter, it actually marked if we look from a year-to-date perspective, a new calendar year record with a total of 39 billion in net new assets in the Canadian ETF industry. And we still have three months to go. So we surpassed 2020, which was the previous record in terms of broad asset class breakdown. Our fixed income actually made a very strong comeback in September, with 1.9 billion in and net inflows versus a now rare outflow, I'd say over the past two years in the equity component with minus 300 million.

So if we go back from…that was September, obviously and wrapping up the end of the quarter, if we go back to a longer…say year-to-date, we're still seeing a very strong flows in the equity segment, with 21 billion total versus 8.2 billion for fixed-income ETFs. So on the topic of flows, you know, are there any clear trends that you've identified over the past three months or more of the same since the beginning of the year?

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Himesh Patel: Well, the one you skipped over just now is the multi-asset category. And so this is a category that I think is more of the same where we saw continuous flows, strong flows to start off the year and those have continued into Q3 as well. So right through September 30th, we're at about 5 billion inflows year-to-date into the multi-asset category. So that's not something new, but a little bit more of the same.

I would say a couple of things that are different. Obviously, as you mentioned on a fixed-income side, we're seeing a little bit of a reversal where we saw lots of redemptions and outflows earlier this year. But I think that's making a little bit of a comeback, especially with what's ensuing in the fixed-income markets, more recently now with the taper talk and all the Fed news.

But I think another area that is starting to see an uptick, especially from us internally, is value. And that's something that we've talked about a lot this year. We've seen a lot of market news and headlines around value investing year-to-date, but we're starting to see a little bit of a resurgence in terms of flows as well as performance, too. So, I think that's interesting and we'll see how that plays out into the remainder of this quarter.

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Étienne Joncas-Bouchard: Very interesting, and I love your point about value, and actually, I'm going to get back to that in a few moments, but I think one comment I might make on with regards to fixed income is actually quite interesting because when you think about it, the key headlines that you mentioned, whether that be Central Banks tapering their asset purchases or whether that be eventual quicker rate hikes coming in the next year. If we look at the options market, they're definitely ticking up.

I was just looking earlier using the overnight index swaps that can be found on Bloomberg. We went from expecting 0.8 hikes in until next July in Canada to now close to 3 being priced in in July. That should be a pretty, pretty bad headwind for fixed income, right? But you saw an increase in flows, which leads me to think it's also probably due to the volatility we saw in equity markets at the beginning of the end of September and then even going into October. So maybe it's just taking a little bit of gains away from equities and rotating back to a more conservative asset class. But nonetheless, and I wanted to highlight that because it was quite interesting that we saw those movements and that was literally over the past month. So that's as of October 18th relative to September 1st. So quite a drastic change on that front.

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Himesh Patel: Yeah, very interesting stat. The market, again, as we've seen before, leading the Fed and it looks like investors are looking for juicier yields than what we've seen in the fixed-income markets recently.

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Étienne Joncas-Bouchard: Yeah, absolutely. I'm going to go back to that value point you made because from a business cycle perspective, I think it was fairly easy to say back when we were in Q1, and we were doing either this wrap up or even our predictions at the end of 2020, saying that value seemed to be primed for a comeback from a relative valuation standpoint. So you know, the size of the discount relative to the broad market. The fact that we were in an accelerating economic growth environment, do you think we still find ourselves in that phase or you know, or are we getting closer to the mid-cycle? Or how will that play out from a style standpoint?

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Himesh Patel: That's I think one of the big questions on a lot of people's minds right now is where are we in the cycle? Obviously, it's very hard to tell, but I really do think that we're coming into this mid-cycle transition phase and we're seeing a little bit of dynamics on both sides of the spectrum where some metrics you look at or some stats you look at put us in the early cycle. Other things like the slowing earnings growth that we're seeing put us into that mid-cycle phase.

So, we're definitely seeing sort of this in-between market right now where we're seeing characteristics of two cycle environments. And, you know, couple on top of that that the global economy isn't fully reopen yet. So, there's still a little bit of headway there. But in terms of where we are in the cycle, I think we're definitely nearing that mid-cycle transition phase. We're definitely seeing, for example, in Q1 and Q2, earnings growth were really strong and substantially outperformed every other quarter that we've seen in the last 24 to 36 months. But we're seeing that earnings growth kind of slowly dwindle down and still positive, obviously, but much more muted versus the first two quarters this year.

So, we'll see how Q3 earnings season played out. I think that just started over the past week or so. So, you know, the jury will still be out in terms of how slow earnings will grow. But then on the other hand, the aspect of it is we have a little bit of multiple compression that's happening. So, in a matter of like a month, we saw the PE go down about three times. So the S&P 500 was trading around 26 to 25 times, now are trading close to 21, 22 times. So this really does look like we're transitioning into that mid-cycle phase. But then again, you know, like I said, we're still seeing some of that early cycle characteristics as well.

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Étienne Joncas-Bouchard: Yeah, that's all great points, and I really think you know that that multiples compression that you were talking about where on it, like the reality is, it's kind of the denominator now that's squeezing this back down with earnings just continuing to come in strong. What's really interesting about the mid-cycle phase anyways in the way that's theoretically categorized as strong, positive but moderating growth in the sense that it is not accelerating or getting going at a faster pace of expansion from quarter to another quarter. And I think that's what really we're seeing as much from a macro standpoint, too, like you were saying from a fundamental standpoint with earnings, for example, and profit like business profits and things like that.

So I was looking at once again, you know, maybe I spent a bit too much time on our beautiful little Bloomberg, but I was looking at consensus GDP estimates globally. And what's really interesting is obviously we're in what's expected as a peak in 2021. But then until 2023, we're still expected to see above a decade average economic growth for the majority of regions, especially in the developed world. So whether if I look back even on a 10-year average, it was telling us between 1.6 to 1.8% for most of the G7. But right now we're averaging around 2.3% up until 2023. So once again, it's very positive backdrop is probably not going as fast as it was over the past year, given we were coming off such a low base.

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Himesh Patel: Yeah, and I think the implication of that is a very strong and positive backdrop. But we saw prices lead all of these fundamentals that we just mentioned over the past 12 months or so to a very high degree, where now we're getting into the arena where prices won't move higher as fast as we have seen in the past 12 months.

So it's going to be real focus on how this cycle scenario plays out, how sort of the GDP numbers play out and the fundamentals of the stock level play out as well. So, it's an interesting dynamic, I think one that we haven't seen in a long time. So, it's going to be interesting from an investment standpoint as well.

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Étienne Joncas-Bouchard: We were talking briefly about value in, you know, typically we say that value does well in the early cycle, but an environment like this, it seems like it could be poised to continue to do well in the sense that a lot of the sectors that find themselves at a relative discount to the broad market, their fundamentals are getting much, much better. So, whether that be in the material space, whether that be in the energy space or even, you know, in financials, if we can expect somehow for rates to lift off, that generally will be good for financials. But just looking at materials and energy, their margins are expanding fairly rapidly with a better commodity complex. And those are the three sectors that tend to be overweight in value. Strategies are value-oriented managers portfolios. So I'd argue that, you know, we were talking about value earlier. I think it's still got some legs in this mid-cycle phase.

So, I guess I can move the conversation, HP, to some of the volatility that we saw near the end of the quarter and how that might have impacted just index investing in general. Because whether we like it or not, index type ETFs, or passively managed. ETFs, remain, I'd say, the largest component by far in the Canadian ETF industry.

And given some of the volatility that we saw recently, notably coming out, for example, out of the Chinese market with the issues they're facing in the real estate sector with companies like Evergrande and Fantasia, how can that be put into perspective when buying a passive equity strategy or even a bond strategy for a region like emerging markets? And maybe I'm focusing in on emerging markets here, but it could be applied to the broad spectrum. Is there any risks when facing those volatility scenarios of passive investing? And have you seen anything show up basically that could raise a red flag?

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Himesh Patel: So I think emerging markets specifically, and this is my personal opinion, you definitely want to be either active or semi-active and 100% positive, just not passive, just because, you know, there's so many idiosyncratic risks in the EM market, with corporate governance obviously being at the forefront of the major issues across EM like, you mentioned some of the volatility that we've seen around China.

So whether it's that's due, it's sort of a quality screen or even fundamentally from an active bottom-up stock selection perspective or bond-selection perspective, I definitely think passive indexing on the EM side has its drawbacks. But, you know, I think to the point we were making earlier as we transition into this mid-cycle phase where prices won't lead earnings and fundamentals, as we've seen over the previous 12 months, this is really a time when index investing won't shine as bright as we have seen recently.

And the reason for that really is because the focus from a market perspective will be on the fundamentals. So, whether it's value outgrowing or outearning its growth counterparts or whether it's developed markets outearning emerging markets, the numbers will play out in the fashion that we've seen in previous cycles where the market will reward these companies and these areas in the market that are fundamentally getting better versus all boats rising, as we saw in 2020. But there's no potential red flags that I see in terms of passive investing. I think, like you said, it's still a big chunk of the Canadian ETF industry. It's a huge chunk of the US ETF industry, even the mutual fund side as well, too. So it's definitely sort of a convenience factor. But I know you have some take on passive and indexing strategies.

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Étienne Joncas-Bouchard: Not particularly more than what you've mentioned, I think it just reminded me that, you know, understanding the composition of each index that is owned in a portfolio, not all of them are built equally. There's inclusion criteria as in certain indices; there are some that are not at all considered in others. So it was just in discussions that I had with advisers over the past three months is realizing, maybe choosing certain indices should be done with more care.

And actually, it was quite interesting on the emerging market front because for some reason, I hadthought that there was quite a bit of flows that had gone into that space based on what the conversations we've had with our mutual fund counterparts, either here at Fidelity or some industry notes that we've seen. But in reality, there's been very little flows into emerging market ETFs this year, almost flat on the year, which tends to be surprising because we would have expected that as the early cycle came around, maybe some flows would have gone there in terms of maybe shifting a little bit to performance and because this is a more of a geographic take.

But from a factor perspective, we talked about value. But what also did really well in Q3 and that we had obviously discussed a lot about in 2020 was high-quality names. Those in July and August were the two best performing factors pretty much for any specific geographic region. Do you think there is a reason for that? Or it was just kind of a cool down in the more cyclical trade in factors like dividend and value taking a seat and taking a step back, if you will, and then snapping right back in September and October already?

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Himesh Patel: Yeah, definitely. So we've definitely seen them going head-to-head and back and forth over the past three-to-four months. Whereas the first four-to-six months of the year, we saw value significantly outperforming growth and quality. I think the heels of that is really related to inflation expectations, expectations around the Fed-hiking cycle like you, the expectations on interest rate hikes being drastically different, even just in a one-month period. And I think it's just also some of that knock-on effects of the volatility we're seeing in the emerging markets that potentially could make it through to developed markets. Who knows, that's kind of remain to be seen.

But I think quality as a factor has done well recently just because, well, not in September, but in the summer months, really because of inflation in yields. And when you think about as we go forward from here on out inflation, I think everybody can now agree is not transitory and it's going to be here to stay. So, we're starting to see some of those supply chain issues or starting to see some of those cost pressures come in to a lot of these companies' earnings calls and companies putting on profit warnings. So, this is definitely playing a factor into why quality is doing better and the reason for that really is because in an environment where we're seeing these cost pressures and supply chain issues, quality tends to have the best position to be able to either, one, pass on those costs to consumers without experiencing a demand shock, or ramp up production so that they can meet demand in a very short order.

So, they're kind of the best position. And I think that's one of the reasons why we're seeing quality outperform the cyclicals in July and August. Now, September was a different month because obviously we saw lots of volatility in EM and we saw rates rising a little bit as well. So on the heels of that, again, that's all related to the hiking cycle. Quality really did underperform in that month relative to value and cyclicals. But I think that's sort of another month where we saw the reopening story kind of play out again and resurge itself as we enter Q3, Q4 season of 2021

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Étienne Joncas-Bouchard: Group points, and from a flows perspective, it hasn't really made it budge though. We haven't seen smart beta ETFs in the quality space receive a drastic amount of flows from an industry perspective. But we're, like you mentioned at the offset of the conversation, value and dividend, all of a sudden outperformance you're getting close to like one year of strong performance seems like investors, advisors, even institutions are kind of maybe now believing it's possible for value to actually do well for more than a couple of months showing the fact that it hadn't really done that in close to three or four years. So, you know, if there's one thing I'd keep an eye out for and from now to the end of the year is how that dynamic evolves.

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Himesh Patel: Yeah, and you make a good point. Flows really haven't followed through with what we've seen in terms of performance. What are you seeing from a valuation perspective? Have valuations changed pretty drastically, even though we've since November of last year, really, we saw value outperform growth even through September on a cumulative basis by about 15%, which is pretty significant. What are you seeing from a valuation perspective in terms of some of these factors, broader trading?

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Étienne Joncas-Bouchard: Yeah, absolutely, that's a great question. I mean, we can look at it and break it down, and once again, for everybody listening in to our podcast, yes, we're a little bit always tilte from a discussion standpoint towards investment factors, and that is the reality based off of what our expertise is here at Fidelity Canada, we have a wide array of factor-based ETFs or smart beta ETFs for all geographies. So it's I think we definitely keep an eye on and it's something that we also don't necessarily consider enough when we're doing portfolio construction because we tend to look at it from a sector and geographic standpoint. But we hope that with these conversations, we can open some eyes on to factor risk contribution like we talked about with Cameron Chamberlain.

And also just, you know, some key topic or ideas to exploit given the business cycle. But anyway, that was a little paragraph, just so everybody knows why we talk about this stuff so much. But I think that's a great question on valuations because what's really interesting is albeit value's done really, really well from a performance standpoint, it's still super cheap relative to the broad market because the fundamentals are getting better. So you're getting multiples like compression, like you said, HP, but even to a greater extent or that's really what's compressing it is that, you know, earnings are coming back to the energy space. You know, I was looking at a stat earlier. The MSCI ACWI energy sector saw more than a 100% increase or margin expansion over the past year. That is very interesting. It's actually now brought it up to now ... I don't want to state the wrong number, but it's well above 15%. I think it's closer to 17%.

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Himesh Patel: Something we haven't seen in a long time.

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Étienne Joncas-Bouchard: Exactly the last time we saw that for the sector as a whole was pre-2008. So, the commodity complex has changed drastically. I think it's made these companies attractive, not only from an asset price standpoint, so like a price-to-book, but now from a free cash flow perspective. So now obviously, I was focusing on energy there, but there's other sectors that are cheap as well, like materials, like financials to a certain extent. You could also find some value in real estate in certain geographies. So these are sectors that are getting much better and are trading a big discount. To that point, also with performance that has followed there and the positive momentum from an earnings standpoint. Well, you know, momentum factors are now looking a lot like value factors just because of what's been in favour over the past year. So if you look at like historically momentum will trade at a premium to the broad market. But most momentum factor indices now are trading at a discount to the broad market. So that's something that's quite interesting right now.

And then what remains expensive, I think, is kind of the low-vol, higher quality space, just some of the more stable names. There's always an appetite for those in portfolios. It's just there's periods where it will be even more in demand than right now, where, like we said earlier, there's just a good backdrop for stocks, generally speaking. So I think if you can get more beta with more cyclical factors in sectors and even geographies, I still think you benefit from that right now. But do you have anything else to add there, HP.

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Himesh Patel: Like you said, there's still that premium on low-volatility and quality stocks just because I think a lot of investors are holding that as their core positions. And with what we've seen in terms of volatility in the markets, that's kind of been the safe haven to go to and driving up some of those premiums, but definitely still lots of opportunities in terms of where things are trading from a discount perspective. So I totally agree.

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Étienne Joncas-Bouchard: Good stuff. Maybe we can shift the conversation a little bit to fixed income. And one theme that I've seen develop throughout the course of the year, and I say has continued, especially with this rotation back towards fixed income in September is the continual purchase and entry of new assets into the short-term bond space.

So, mandates that focus on less interest-rate-sensitive bonds given they have lower maturities, whether that be on the corporate or on the government side, it seems like there's a lot of assets going there. National Bank estimates about three billion in net new assets in that category so far this year. Is this because advisors and investors are still trying to lower that interest rate sensitivity? Or it's simply just a way to park cash in the short-term? What do you think? Is it a combination of both, probably? But is there one driving more than the other, you think?

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Himesh Patel: Yeah, I think it's a combination, but I think more so, it's related to the fact that we're seeing a lot of clients take barbell approaches in their fixed income portfolios now, where obviously with yields being so low across basically every fixed-income asset class and the fact that we're trading in percentiles in yield ranges at all-time historic lows, there's not a lot of opportunity to find a yield. And if you are finding that yield, you have to take on some risk in terms of the fact that we're at all-time lows and perhaps we can see some capital losses in the fixed-income market. But with rate hike expectations increasing, we're seeing a little bit of an uptick in yields recently. It makes sense to take on some of those longer duration aggregate bond type exposures, but then we're going to couple that with a shorter term, shorter duration, lower interest rate sensitivities, type of product, which I think is what's really driving that trend to those flows. But it's going to be an interesting story in the fixed-income markets because we've effectively moved past this mini taper tantrum 2.0 phase. And now the market is kind of okay with the fact that we're going to experience two to three rate hikes next year. Who knows if that actually happens?

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Étienne Joncas-Bouchard: It's being priced in, though, that's all we need to know right now.

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Himesh Patel: Exactly. And that's what's being priced in. So in that environment, you don't want to be taking on too many one-sided bets. And I think a barbell approach with having that sort of lower duration income producing asset on the lower duration side makes sense to pair that with what is traditionally your aggregate bond or your core plus or your longer duration exposure.

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Étienne Joncas-Bouchard: Yeah, great points. And I think that's actually an interesting statement that you made on what's transpired over the past couple of quarters where like Q1, what we really saw is just a complete steepening of the curve, where everything on the long end was trying to guesstimate what future inflation expectations are going to be and how strong will they be going like way out, right, five or 10 years out? Yeah. But now you're going to have to balance that out with expectations that the short end of the curve is going to rally eventually, not to flatten the curve, but to somewhat at least decrease the steepness. So, I think that that's a very good point and why, you know, more recently, I think there's been a lot more talk about maybe rotating to short-term corporate bonds relative to short-term government bonds, which yes, spreads are extremely tight, but you likely don't see as much sensitivity when there are interest rate hikes from central banks. So definitely something to keep an eye on.

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Himesh Patel: Yeah, and the fundamental backdrop is pretty positive. We're not expecting a ton of defaults. Balance sheets are generally strong across these corporate investment grade issuers. And so, I think you're seeing a lot of clients put their money to work in terms of the shorter end to try and just to try and really get yield from anywhere they can.

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Étienne Joncas-Bouchard: Where possible, if possible. That's such a good point. And that's why it remains, I think, a difficult environment, though I was maybe so surprised to see such a strong bounce back in September. But the reality is a lot of that fixed income is ther as an insurance policy in portfolios in case of that equity market volatility. Alright, my friend, that wraps it up for today's episode. Thank you everyone for joining us. We hope you enjoyed this. Feel free, once again, to reach out to us, whether it's on LinkedIn or, you know, via email, we like to get your feedback, things you want to hear from or any guests you'd like to have us host. I would definitely be open to some commentary. So thanks again and see you next time.

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