ETF_Episode8_FactorsHighQuality.mp3

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Hello and welcome to the Fidelity ETF Exchange powered by Fidelity Connects, connecting you to the world of investing and helping you stay ahead. In this eighth episode of the Fidelity ETF Exchange, cohosts Etienne Joncas Bouchard and Katrina Wilson take a deep dive into high quality factor ETFs. This is the second of a five part series called Factors in Focus. Over the course of the coming weeks, Etienne and Katrina will offer their outlook on various investment factors, describe how they have performed in the past and most importantly, how advisors and investors can incorporate them into their portfolios.

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Hello, everyone, and welcome to the eighth episode of the Fidelity ETF Exchange. I'm your host, Etienne Joncas Bouchard, and as always, I'm joined by my co-host, Katrina Wilson.

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To start off, how are you doing, Kat?

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I'm good. How are you?

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I'm doing very well, staying busy. Obviously it's been another strong past couple of weeks in terms of activity internally, externally. Staying busy, staying on top of the ETF world.

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Yeah, and lots of news and media for us to follow, too.

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Absolutely. Well, we got the elections coming up. That's something that we might… We're working on to find a way to fit it into our ETF podcast. We're trying to find some way to spin the election into a certain way or certain exposure we can get with an ETF to play that now. So Kat, this is the second episode that we're doing together. How did you find your first episode and are you hyped up for part two of our Factors and Focus series?

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I sure am. First episode was good, things were getting into the groove already and I'm looking forward to talking about quality today.

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You stole my punch line. So for all of you who listen to the last episode, you know what we talked about? We focused on the high dividend factor and it was the first part of our five part series. So we took a deep dive into the high dividend factor.

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Quick recap for those of you who haven't had the chance to listen, although I recommend that you go back and do so. We discussed historical performance of dividend stocks, what to expect from them going forward. What are some of the key trends that are impacting dividend stocks, and last but definitely not least, how you can incorporate them into your portfolios, whether you're an advisor and investor. For anyone less familiar with what an investment factor is, investment factors are quantifiable characteristics that can explain differences in stock returns. The objective is not necessarily to outperform the market, but to isolate a certain style and to achieve a specific investment objective or outcome. But enough about what we did last week, this is officially part two. You mentioned it in the start. We're going to look at what we call high quality stocks or the high quality factor. So, yeah, before we get deeper into the subject, I think it's clear that high dividend is relatively straightforward in terms of what type of exposure we're getting. I think high quality is a bit more gray. So before I take a crack at it, Kat, how would you describe high quality factor to somebody who maybe has never heard about it or just in general, what are your perspectives on that factor?

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So I think you said it perfectly, it's one of those factors that the name doesn't really tell us all that much; like if you hear dividend or low vol, you kind of get an idea of what to expect.

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The way I like to think about quality is a way to measure the success of a management team or a board. So if you think about a public company or you think about the dividend factor, we're looking at certain criteria that are associated to the stock, like what's the dividend yield on that stock? What's the status of that stock? The quality actually looks deep into the financials of the company. So I see it as a great way to measure of is the management team running a profitable business and is it a type of business that I want to own. What are your thoughts? How do you like to sort of characterize it or define it?

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Yeah, there's a couple of good points, I think, that you hit the nail on the head with there. First of all, management team, because at the end of the day, what we're looking for here are companies that are, I think, another term that we can use is leaders in their industry. So companies that are able to outperform their peers in terms of how they operate their business, how they're able to reinvest one dollar of cash flow into future profits and revenues. So we often refer to high quality companies as compounders, so companies that are able once again to reinvest strong free cash flows into a higher margin businesses or products and services.

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But it's definitely a bit more complicated to describe. I also tend to refer often as a blue chip type factor where it's a bit less cyclical than, say, for example, value or high dividend, you know, tends to do well in early cycle. You have value also does do well. I already mentioned value, but say low vol and end of the cycle. High quality is just going to be that steady, slow outperformance, not a huge outperformance over a short period or a huge underperformance over a short period. So I think that describes it well.

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Now, to put things in perspective, what are some of the key metrics that we that we look at to identify those companies? Because you mentioned we were going into the financial statements. We want to identify it relatively in a simple way, obviously. So what are some of the key metrics we're looking for to find those companies?

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Some common things that a quality screen would look at are free cash flow yield. So think of free cash flow yield is similar to earnings, but the difference between earnings is different accounting methodologies can actually change earnings. So we want to strip out any kind of bias to the way that you approach accounting. Think of a company in the US. They could actually use two different accounting policies or philosophies; one, for the sake of financial statements that are public in order to enhance their net income, but then you could actually use a different accounting policy or procedure to reduce your net earnings, to reduce your taxes. That is absolutely allowed. So we want to strip that out. We just want to look at if your business profitable. So that's why if you ever hear free cash flow yield relative to net earnings or margin, that's why quality tends to look at that screen. Return on invested capital as well. So, again, that would be an alternative to return on equity. So essentially, for every dollar of equity in the business, what is the dollar return expected to shareholders? Now, not the issue there, but the difference in that return on invested is it also takes into account debt. So we think this is the best gauge to look at sort of a 360 percent view on the true financial health of a company without taking into account any difference into accounting practices. The other thing or additional screen that we really like to look at is free cash flow yield variability. So think if you might have one company that has one year where maybe there is significant change that happens and all of a sudden they see a spike in profitability, we don't necessarily want to put too much of an emphasis over the last year, so we also take into account the last five years and how volatile that free cash flow metric has been. So not only companies that are profitable, but really companies that can be profitable across the entire business cycle, which is on average five years. Anything that you have to add there?

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No, that's pretty clear, that's really straightforward. I think one fat one, I guess, one variable that we tend to overlook is the last one that you mentioned, which is the earnings variability. And it's really a common trait of those companies that are, like I mentioned earlier, we're looking for compounders. Every quarter, they're just pumping out strong free cash flows, reinvesting it at a higher rate than their competitors. And it's really important to keep it in a less cyclical framework. And if you think of, you know, what's done well since the beginning of the year, you know, investors flock towards companies that had confidence in being around for the next 3, 5, 10 years and having earnings for the for that period of time. This is also a variable that's used often in low vol mandates, so low vol companies. So if you have low elasticity of your pricing, people basically will continue to buy your product regardless of the economic and macro backdrop. I think that speaks a lot to a company's ability to have quality traits. So I guess to build on that, we're going to talk a bit about stock specific examples later. But I think to get an overall perspective, it's good to look at the types of sectors that tend to display high quality because there's high quality businesses in every sector and every subsector that are better than their peers, that are able to generate a profit with some few exceptions, obviously, as we have a completely changing economy going forward, whether that's through COVID-19 or just through technology, taking a larger place in our daily lives. What are some of the common sectors that you think of when thinking high quality?

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So maybe I'll even start by sectors that are not high quality. That's good, all right, flip it on me. We'll get to high quality.

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But I was just thinking about, in the conversation I had the other day, what are things to look for that would not be common or would commonly be low quality, I should say. Think about businesses that result in a lot of capital expenditure, so heavy machinery or companies that need to invest a lot in order to turn a profit. So think of mining companies, think of energy companies, highly leveraged, highly cyclical. These companies are not free cash flow generating machines, but on the other side of it would be consumer sectors or software companies, companies that don't necessarily need significant investment in capital machinery. It's all R&D, and all of the income coming in through the selling or sale of goods. So a lot of them have high recurring revenue, so your overhead is a little bit lower. Sectors that really stands out to me are I.T. or specifically software companies or consumer discretionary, in some cases consumer staples as well, consumer like CPG companies… Anything I've missed?

[00:12:20]

No, that's covered it quite well. I think another common one that comes up is health care companies. You know, once you've developed a drug, say you're biotech or you developed a certain product, it's very easy to increase your margin. And that's kind of the common theme, I think. Great point. When you talk about, you know, when you think about it, you said you mentioned energy, how much capital it takes to pump out one barrel of oil is so much more than developing a software or a software as a service platform and then selling it to the masses where once you've built it out, you can scale production infinitely and not only increase your margin, but you can basically increase production without reducing your margins, which is the most important thing without necessarily increasing them. Then you get economies of scale. Exactly, you get economies of scale. Exactly. So I think that's a very prototypical. Another one that I think displays lower quality and once again comes back to capex spending is real estate, for example. It takes a lot of capital to purchase a building and then, you know, the margins on reads while they are relatively stable, because that is one of the key rates of quality companies, they tend to have lower margins. So to build on that, and I think this is where I want to go with the conversation here, because I think it pertains particularly well to the way that these companies are capitalized and the amount of debt levels. It's a theory that's been brought up in a lot of articles recently, whether that's on Bloomberg, whether that's in The Economist, is the rise of zombie companies. And this thesis basically states that over the past 10 years, given we've entered a very low economic growth cycle, if you wish, where economic growth is subdued, interest rates have been compressed significantly. A lot of companies are able to survive, not thrive, but are able to survive simply by having a very cheap access to capital without necessarily generating excess profits or having a return on equity that's significant. And that's led to strong performance of these high quality type companies. What is your take on that?

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For sure. As you said it, I mean, there's been so much hearing that term in the last month, more than I probably had five years prior to. So obviously, it's something we're paying attention to, this is especially true. And we're seeing it in Europe and Asia. I mean, rates in North America are low, but they're still higher than what we're seeing in North America. And really, they bottomed out, call it, 10 years ago. So I think you're absolutely right in the sense that, you know, these companies are on essentially like incubators where they're not profitable, but they're being kept alive. They're still being listed on the exchanges.

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And in some cases, they have really big market cap.

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So they can actually be included in some of the passive indices like the MSCI index, but they're not turning a profit. So it's almost, I think, in periods where rates were a little bit higher, there was a difference between how profitable company A from Company B was. But now the margin of profitability between companies in these regions where rates has been so low for so long, it's so extreme that we're really being rewarded for owning those high quality companies.

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I don't know if you have anything to add on that, but I know it's something that's been a huge topic of conversation for both of us in the last month.

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Well, absolutely. And cost of capital is so important when you're looking at a company, right? I mean, if you think of a classical way, fundamental way of analyzing a company, you're discounting future cash flows at a certain cost of capital. And that's been compressed substantially over the past 10 years. And it's not necessarily that… Before it was the strongest survive and they come out on top. Now it's the weak can survive: they won't come out on top, but they're still there. And that's the thing that exposes somewhat of some potential issues with pure passive investing, with an index that obviously does not have any inclusion criteria or things like that. But it's really crazy how this theme is played out. And there's another way that it's described sometimes. It's also called the japanification of major economies. So it's basically once you've entered that really low, subdued economic growth and low rate environment, there's almost no way for value companies to rebound. We'll be talking about value in another episode. But, you know, what we used to call a value trap is falling into this type of zombie state where these value traps are everywhere. And while it does seem like a company is trading at a huge discount, well, there's maybe a reason for that. And I think high quality tends to remove some of that bias. And one last point I guess I'll add is we've actually seen this materialize. Like the high quality factor has performed very well. If we look at particularly in the international space since to the 2011 European banking crisis, when rates fell from the ECB lowering rates from approximately four to five percent to what we know them as of now, which is below one percent, sometimes in negative territory, has only increased the margin or the divergence between higher quality companies and these companies that are surviving. But I think it's quite an interesting development. And we often get questions, we've seen this in the international space. You know, do you think this is possible that it translate to North America as we go out of a COVID-19 crisis where, you know, huge economic impact rates, yield curves have been have been shifted down substantially? We talked about it last time with dividends, that being a tailwind. Is this also a tailwind for high quality in North America?

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For sure, and I think there's a lot of different criteria that in the last 10 years, everything's been driven really by multiple expansion in the US and the US tech sector in particular. So we think about valuations, even if they don't necessarily see a steep decline, but is tech going to continue to see that strong of a divergence. And frankly, there's some really great companies outside of the tech sector that maybe haven't been rewarded for this criteria that I think are going to become more and more prominent in the environment. And the other thing I'd touch on is, and we mentioned the election earlier, not to go too deep down that path, but if you're a low quality company, you don't necessarily have a lot of capital available for additional expenditures to essentially add value to your company and to your stock. And another topic that will become more and more prominent, or I should say, we feel companies will become rewarded for is ESG. And I know we're going to try and talk about that in another episode on its own, but that's something that quality companies have capital available. Management teams tend to be aligned when it comes to profitability and ESG ratings. If this is a new theme for anyone, ESG refers to environmental, social and governance factors. And it's something we're hearing a lot more about. And we're thinking about the market rewarding management teams and stocks that have a have a stronger ESG rating than peers. But you have to have profits to have resources and capital available to do that. So I think low interest rates is the dominant sort of driver here. But I also think there's other aspects of stocks that will be rewarded and you need capital in order to get to that place.

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That's such a great point. I actually wanted to touch on that because as we've been seeing more and more of these ESG or sustainable or themed products – and I say theme because, as you said, it's kind of a developing factor and we've heard some of our previous guests talk about it, but it's becoming a megatrend. But if you're not turning a profit and you're struggling to save a lot or keep your head out of the water, there's no way you can divert your focus to improving the quality of your employees' life, I guess, working in your company, all your stakeholders, making sure you're helping out. You're doing your part for the environment, cutting, trying to find ways to save money or even spend money in some cases, which is the hardest part. If you can save money while being, you know, doing good for our planet, good for you. But there's a lot of companies for which it represents more capex and more ways for investment to get there. While it may help save costs in the future, it's still a present investment. So these high quality companies, high margin companies have taken the lead on ESG. The others might catch up, but it will definitely take them more time I think. A question I want to get to, I think it's very important because of our audience, obviously, who are, generally speaking, mostly advisors. There's some investors listening in. You know, we talked about diversification last episode, and it's of utmost importance in uncertain markets and I think many investors learned that the hard way, unfortunately, over the past six months. And with that in mind, how can you use the high quality factor to diversify your equity or what has a low correlation to this particular investment style. So basically, what I'm trying to say in shorter terms is how can our advisors invest in high quality to diversify their current exposure depending on what they're doing?

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So probably one of my favorite sort of metrics to look at right now, and if we think about it, probably the most common thing we're hearing right now is "I've made a ton of money in the US, I've made a ton of money in tech, so I'm looking to take some profits off the table". And if I think about that, probably the biggest risk – we're nowhere near early 2000, so it's not a tech bubble, but, you know, I don't think there's any debate that valuations are rich in the tech sector. So it's OK. If I'm looking to take profits off the table, what criteria and what factors should I look at? The fascinating thing to me about quality is it's almost agnostic to valuation. We've seen so much great research that shows whether quality is expensive or cheap or fairly priced relative to historical. It actually doesn't necessarily have any direct correlation to outperformance. It tends to, as you said it earlier, just trying to take that big sports analogy, constantly hit singles. So to me, if you're looking to take profits off from the tech sector, you're worried about valuation, you want to take into consideration something that's less sensitive to valuation and has tailwinds behind it – which I think we sort of adjust perfectly with low interest rates – and you have diversification of holdings. To me, all of those things lead to the quality factor. And it's worth noting, I mean, quality when we saw tech sell off earlier this month outperformed by almost 10 percent. So it's a great way to diversify, not just from a holding standpoint, but also take into account sort of hedging any, you know, exposure to areas of the market that you feel are overvalued. What are your thoughts?

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That's a great point. Absolutely. And like you said, so you're going to be able to get access to these companies that, yes, are invested in some maybe of the pricier sectors, but you're still doing it with a fully diversified portfolio in terms of your overall sector allocation. Like we're not talking about, you know, focusing in on three sectors. We're talking about focusing on six or seven sectors that display relatively high quality. In terms of diversification, I say the way that you compare this, which is quite interesting, is if you look at some other typical classical factors like value and dividend, this is a great diversifier. It's really one that's going to be… if you look at the correlation of excess returns. So when one is outperforming, the other tends to underperform and vice versa. So I think as we head, there's going to be the elections, we're talking about a market that's relatively fairly priced. It's always important to keep a style diversification. So for anyone that already has maybe more of a growthier type exposure or momentum type exposure, maybe quality is not exactly the best factor to diversify with. But if you are more of a value investor yourself, so if you pick your own value stocks, you pick your own dividend stocks, this is a great way to diversify that equity exposure without taking on the full risk of the higher priced segment, which is, generally speaking, tech and some of the more growthier names in the market. So I think that covers most of it, Kat. But I've maybe one last thing I'll ask of you. Because of the performance once again this year, why do you think in the COVID-19 drawdown – specifically not because of any of the macro developments we've heard previously – high quality companies were rewarded?

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I think the main thing is, you know, high quality companies, as we touched on earlier on, is really looking at companies that are management teams that can manage a profitable company. And the fact that we look at variability over a full business cycle as well, in a recession quality screen give us sort of a clear visibility into what to expect. So if you think about any other criteria like dividend yield, which obviously didn't do well, dividend yield has a lot of uncertainty in a recession; will these dividends be cut or not? But if we think about the quality screen, it just this analyzing what the financial health of that company is. And so if the recession were to go on for a few years, maybe that would change. But given early on in a recession, those are typically the companies the market is the least worried about because we've already done our research ahead of that recession.

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So they're rewarded because they're well managed, they're well capitalized, and the business models tend to be very resilient in any recession. And so they're the least sold off or the least concerning segment, or I should say at least the least unknown segment of the market.

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That is such a great point. I love that. But you said the unknown. I think investors when a little panic comes in, a little volatility kicks in, where do you go back to your steady-Eddie. You said hitting singles, strong batting average. You're not trying to knock it out of the park. You know what to expect. And I really think that's the playbook that happened through COVID-19. Now that we're going forward. I think it's still a great way to invest as well as we enter a low rate, low growth environment. Definitely. Now, I think we'll leave it at that. We want to keep these episodes not too long, keep you all interested and hyped up for the next episode,

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so the part three of our Factors and Focus series. Once again, Kat, thank you for joining us. Thank you as always. Thanks everyone, thanks EJB.

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