ETF_Episode10_LowVol.mp3

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Hello and welcome to the tenth episode of the Fidelity ETF Exchange powered by Fidelity Connects, connecting you to the world of investing and helping you stay ahead. Today, cohosts Etienne Joncas Bouchard and Katrina Wilson take a deep dive into low volatility factor ETFs. Low volatility investing focuses on providing similar returns to the broader market over time, but with less volatility, a smoother ride for the investor. Now, this is the fourth of a five part series called Factors in Focus, where Etienne and Katrina are offering their outlook on various investment factors, describing how they have performed in the past and most importantly, how advisors and investors can incorporate them into their portfolios. So head back to the last few episodes if you missed them and stay tuned for the fifth Factors in Focus episode coming soon. Today's podcast was recorded on November 26th, 2020.

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Hello, everyone, and welcome to the 10th episode of the Fidelity ETF Exchange. I'm your host at Etienne Joncas Bouchard, and as always, I'm joined by my co-host, Katrina Wilson. How are you doing, Kat?

[00:01:52]

I'm good, EJB. How are you?

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I'm doing very well. It's been a few weeks since we last had the chance to record an episode, so I'm very happy to be back behind the mic and putting out some content. But obviously it's been quite some busy weeks, some interesting market developments. So I hope we get a chance to talk about that a little bit, without taking up too much time. So we are trying once again to try to keep this short and sweet: twenty to twenty five minutes. It is actually the fourth installment, I guess, of our Factors in Focus series. We will be talking about the low volatility factor today. But before we do that, I always like to take a few minutes to do a quick recap for those who haven't listened to our last episode, but also in this in this case, to give a little bit of color of actually what's happened with the value factor, which was the topic of our last discussion. So we actually discussed the historical performance of value stocks, what to expect going forward, wWhat are some of the key trends that are impacting value stocks, and last – and I always say this – not least, how can you incorporate them into your portfolio. Because at the end of the day, that's kind of why we're here, for investors, for advisors to learn about these types of products and how they can better use them in their portfolio allocations. So I don't think the topic of our last discussion could have been any time earlier than it was, as we recorded our episode on November 5th, if I'm

correct. And November 9th was one of the largest days of outperformance for value stocks versus growth stocks since more than 15 years. The catalyst was the very encouraging vaccine testing results from Pfizer by biontech and followed by Moderna and AstraZeneca publishing positive results. But as we discussed in our last episode, value stocks are trading at historically large discount to the broad market. So I think this positive development was a really good injection into those companies, which are also part of what we like to categorize as reopening stocks, which tend to be cyclicals like energy, industrials, financials. And those stocks did really, really well and tend to fall into that value bucket. So we've actually also seen a strong uptick following these movements in terms of purchases of value and small cap factor ETFs in the US. And that's usually a really good indicator for Canadian activity. So I think this will be a really interesting development to watch as we head into 2021 and basically see if we can capture a longer term run or outperformance period for value stocks. Kat, did you have anything to add on the value front before we move to today's topic? I know I tended to ramble on a little bit there, but I would definitely like your input because I think it was really, really quite something over the past two weeks.

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No, I think that was perfect. And as you said it, as much as we love to take credit for the timing on that one, it just happened to fall in place. But as you said, I mean, we're seeing traction in the US. Last time we did some analysis, inflows in Canada typically lagged by one to three months. So, you know, we're sort of at the early stages of seeing a significant uptick in Canada. But it's something we would expect to see. And I think the thing to consider, too, is what value pairs really well with is momentum, and in particular in the US, which is garnering a ton of flows, even the passive US strategies, whether you track the S&P 500 or the Nasdaq, have a natural tilt to momentum. So it's not necessarily that we're seeing wholesale replacements to growth or momentum, but we're starting to see some of those profits coming off the table and really pairing with that value strategy. And it's certainly something, as you said, to keep an eye out for a trend that we're expecting to see in Canada.

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Very interesting. And I think like you said, it's going to be an interesting development to see the appetite from investors, because I think we mentioned the last episode, the term value has been thrown around so much over the past five years that I think it may take some time. But if we do enter this this phase of outperformance, I mean, we might be in the first inning of a very, very long game. So anyways, to be continued. But enough about value, because I think we could talk another 20 minutes about that subject. But let's move on to the fourth part of our Factors in Focus series. So we've done three. There's two to go, including today. We'll be taking a deep dive into the low volatility factor. But before we take a more practical approach, I think it's important to understand how this factor came about. In fact, there are two distinct approaches to this investment style. And it's something that we see in the practical form where if we compare two types of low volatility factor ETFs and the differences is one is the minimum variance approach and one is a low volatility scoring methodology. So I think it's important to differentiate both. We'll probably do that over the course of this episode here. But minimum variance is a very interesting concept, and it's considered somewhat of an anomaly to modern portfolio theory, which is kind of the basis for how we construct portfolios, now, looking at standard deviation and expected return. And basically a minimum of variance theory says that over the long term, it's not necessarily the stocks with higher volatility that you can get an expected return, but you can actually get an equal or even better return with the portfolios that are on the complete left side of the efficient frontier, which in theory when this came out a long time ago, didn't really make quite some sense. So these findings brought on a wave of research looking at various ratios

and variables that defined the volatility of different stocks – not necessarily portfolios, because in this framework, we're looking at a portfolio as a whole, whereas here we're talking about ways to identify stocks with low volatility characteristics. So low volatility stock portfolios are created based on these variables. And I guess that's where we're going to start, Kat, my first question being, what are some of these key variables that we that we use to identify as stocks volatility and how they can fit into a low vol framework?

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I think you said it perfectly, there are so many different ways to approach it now. I love that you continuously use the term vol as opposed to risk, because a lot of the metrics that we look at like volatility, oftentimes we forget to consider that an outlier in terms of a year where perhaps you have a really strong positive return, can impact that standard deviation metric the same way that a strong negative return can. So certainly the focus is on low volatility or variance. And I'd say the two common ones that were always coming up or seeing in the industry are standard deviation. So think of both of those as being metrics as it relates to the variance of return. So how much do those returns typically deviate from the average, for the difference being that is really looking at how much do you deviate as it relates to market returns? So I'd say beta is something that's important to consider. iIf you're looking at a benchmark. Do you care what the S&P 500 does relative to what your portfolio does? And how much does your portfolio sort of participates in the moves of the S&P 500? And then obviously, if we look at traditional standard deviation, we're just looking at, relative to your historical average, what is the probability that your return over the next 12 months will deviate from that average? So really looking at consistent returns over time and, you know, less deviation, so more predictable returns stream than others. I know there's obviously tons of other criteria, but I'd say those are the two main ones that we often come across. And I don't know if you have anything to add there? No, absolutely.

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I think you covered it very well because, yes, those are the two most popular metrics that we find. And the interesting part is that we've seen some products rely only on one, some combining both, some combining even other metrics; like, you know, here at Fidelity, we also consider the standard deviation of earnings per share, which is another way to look at volatility. So, yes, when we look at data and at standard deviation, we're talking about price or the return profile of the stock itself. But if we can actually apply this type of framework to underlying fundamentals as well. And that helps us give us some clarity when we're going through different market cycles, especially when we're looking obviously at earnings in this case. But definitely those are the two most important. And when you compare them, really, you mentioned relative versus absolute volatility. And I think that's super important as well. So definitely good point. Now, my next question is what type of companies generally fall into this type of factor or profile or investable investment profile? Excuse me. So what are some of the sectors that that fit the bill? Does this change over time, you know, through market cycles? What are we looking at in terms of exposure in a low volatility portfolio?

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You know what always is the first to come to mind for me, which is not for anyone listening who is expecting some really fun, exciting answer? It's utilities. It's a boring utility stock that, you know, if you think about the revenue of a utility company, it's not going to be overly sensitive to where we are in the market. People are still turning their lights on, they're still using air conditioning if they have access to that in the summer, heating in the winter. So to

me, it's thinking about those. I always think low vol is boring businesses, predictable businesses. And you said or you asked or mentioned, you know, does it change over the cycle? I think this is the first time where we've seen a notable change this year through COVID of a new sector emerging as appearing to be global, and that's tech.

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That is such an interesting point. And I was hoping we're going to get to that because it really changed the dynamics of what has been characterized as low volatility. You mentioned some of the classic ones, you know, utilities, telecoms. But there was also some sectors, especially if we look at a Canadian focused mandate, that we look at the low volatility. We also have financials and real estate, which, you know, through COVID has had extremely difficult time in terms of performance. So the actual downside protection of low vol, which is generally very, very strong, wasn't so much the case this time around. And the downside protecting sector was technology stocks as we were quarantined, everybody relies even more on technology than we did before. I'm just curious to see how this shapes out over the long term, because, you know, I think it's hard to argue that a lot of those sectors are complete or are going to be more volatile going forward. Yes, there's going to be maybe a bit more a bit more volatility. But I don't expect the actual structure of these products to change drastically to reflect what we've seen this year. What's your take on that? Do you think we're going to see more… Basically my question is, do you think we're going to see more technology in low vol type mandates going forward?

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I don't think so. I think, you know, I don't necessarily see a drastic change in leadership as it relates to low vol. I think obviously COVID was an unprecedented event where a lot of new industries were forced to emerge. So we might see going forward that the underweight to technology might shift. But if we actually dissect the technology sector as well and we look at sensitivity to valuations in the way that they're trading right now, in particular, you know, some tech, some areas of the tech sector were already trading quite rich, and through the COVID have now become even more expensive just because of that sort of leadership through that secular change in the market. So I think it's not necessarily going to be defined by technology, but I certainly think there are some businesses or sub-industries within the tech sector that in the new world might have more of a low volatility profile than, let's say, they did even a year ago just because of the way the world has changed and the way that their revenue streams will change.

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They might be less cyclical than, say, they were, like I said a year ago. That's such a great point, because, like you said, I think a lot of businesses were starting to realize their business models were a heck of a lot stickier than they used to be, making the third variable that I mentioned, you know, being stable, change drastically like software as a service, a business will maybe choose, like we saw, to shut down their office, stop paying their rent before they stop paying theirenterprise resource software. So that's not something that we would have seen 10 years ago. I think there's arguments for both sides. Also, one thing to keep in mind, like you did say, if we're using a metric like standard deviation, we're also capturing upside volatility. So this last 12 months has been such a strong outperformance period that it's not necessarily going to be part of a low vol framework going forward. We'll see. You know, things are obviously still to be determined as we move forward on that front. But it should be an interesting place to go from here, then.

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If we specifically, you know, you talked to the standard deviation of earnings being something a little bit more unique in terms of a low vol strategy, that's one place where maybe technology would appear. You know, I agree with you less so maybe on the beta or the standard deviation of stock prices, would technology fit into low vol that maybe standard deviation of earnings, something to think about? Maybe that would be a catalyst to have more technology than, say, a strategy that just had beta?

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Absolutely. And I think that's why there's going to continue to be developments in the way that we built these products going forward. There's going to be other metrics that we're going to have to consider other than pure standard deviation and beta, whether that's the standard deviation of earnings per share, whether that's you know… We could do the same thing with revenues, we could find some type of measure through the balance sheet, looking at the way we're capitalized, things like that. So there's a lot of room to innovate as well in that front, I think. And this is also one of the factors with dividend, which was the first one we mentioned, which has been around for the longest. It's kind of the classic one that I think appeals to a lot of investors. So you want to participate in the market, you want to be invested in equities, but you can't handle you can't you know, you can't really allow yourself to loot to have a 30% draw down. And I think that's really where the rise of these products came about. And especially now that we have, you know, a demographic that is definitely going to the older end that's across the world. You know, this is a great type of product to use in portfolio construction for investors that are in retirement or getting closer to retirement. Is there any other use cases that you've seen, you know, for these types of products, either in diversification or just on an absolute basis, as a holding in a portfolio?

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Well, I think you touched on it. I mean, I'd say one is aging demographics that maybe want to take on some equity market rest, but they're not necessarily worried about or focused on "am I going to outperform the S&P 500 tomorrow?" But yields are up. So they also can't necessarily afford to make between one and three percent in fixed income in terms of income. So they may be looking at increasing exposure to equities, but don't necessarily want to have a drastic shift as it relates to their risk profile. Or the second thing to consider is maybe you're younger, but maybe you have a five year plan. Maybe you want to buy a house in five years. And, you know, maybe you had significant exposure to momentum and now you're slowly taking profits off the table. Maybe you're not close enough to that goal yet to fully get out of the market or go to fixed income. So that's kind of, I'd say, a stepping stone of let's stay in the market, we still have the risk appetite for equities, but I just want to be a little bit more stable as it relates to the return stream. So I think kind of both scenarios could definitely be an asset.

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That's a great point. And I'll spin on this a little bit. Something we talked about for high dividend was an alternative to fixed income in terms of, you know, it's going to be tougher and tougher to find yield out there. Investment grade yielding below two percent, treasuries below one percent and high yields and around three to four. Now, if you go to high div, you're taking on more cyclicality risk, you're taking on more downside risk. With a low vol portfolio, there is actually some similarities that you see in terms of sector tilts with high dividend, but an emphasis maybe not on the cheapest and highest yielding stocks, but you end up with a portfolio that on

average will yield more than the broad market because of the sector exposures that you have. So it's less volatile than a normal basket of equities, generally speaking, and it's going to yield a little bit more. I think that's an interesting value proposition going forward, given the current environment that we're in, in terms of yields, but also just in terms of equity risk. So my little spin on it there. We'll see if that sticks with investors and advisors, but it seems to make sense to me when talking about it. Definitely.

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Well, I guess that kind of ties perfectly into utilities, like we mentioned earlier.

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Exactly. Utilities. I mean, there's some REITs that you can yield between 7 to 12 percent. So, yes, you're not focusing in on that variable, so you're not going to optimize it. But you still, you know, get some yield, just by the way that you're trying to minimize volatility. Yeah, exactly. Another question. I guess that we're talking about some of the ways that these are built and I think some factors have certain side tilts, if you wish. So, for example, we talked about quality having certain ESG characteristics. Low volatility tends to fall into a large cap bias. Would you agree with that? And do you think there's a reason for that, that in most low vol portfolios there is a market cap bias to the larger companies?

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I think it's a natural tilt just by the basis of the criteria you look at, that they would typically have a bias to blue chip companies, companies that are mature. You know, if you think about growth companies, momentum, it's often companies that are reinvesting earnings in order to innovate or invest in R&D to boost earnings in future years, but once you hit to a certain point of maturity in your business cycle, you tend to be more of a mature company, youtake a bit of a different approach to the capital structure, and that usually ends up resulting in, you know, less variability as it relates to earnings over time and standard deviation, because often earnings can be a little bit more predictable for a mature blue chip company as well. So I think that's the key, it's the stage of the business cycle that they tend to be in. And frankly, we're also just thinking about industries, right? I mean, if utilities are a sector that typically are prominent in a low vol portfolio, it's not necessarily an industry where you're seeing new companies popping up every week. So a lot of them have been around for a long time, maybe it's an oligopoly or monopoly, but I think that's the key here.

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Are you pointing towards telecoms in Canada, by any chance? Not at all! I think that that makes so much sense, because obviously, if you've been around for a longer period of time, you have a better idea of what to expect and I think that falls into the low volatility framework for sure. I know there might be some managers at Fidelity to disagree that there's not some defensive ball small caps, but we'll keep that for another time. So I have one last question, Kat, because we've mentioned valuations with value at the start when we were just recapping. But what does low volatility look like on, you know, on a valuation basis versus the broad market? Whether that's if we look at the average price earnings for the portfolio versus, say, the S&P 500 or the S&P TSX. What is low vol trading like right now?

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So I know when we've done this research recently, I mean, low vol is looking a little bit expensive and I think a big part of that is in a low interest rate environment. We have seen some money reallocated outside of fixed income and equities, and it's frankly flocked to, as you said it perfectly, low vol dividend yielding sectors. And so that has led to valuations being a little bit rich. But what we've noticed historically is, you know, it might lead to underperformance, small excess return relative to the index. But a lot of the investors who are looking at this type of product are not worried about being benchmark. And so I think that's the key here, that valuations are rich, but historically, that hasn't necessarily led to a significant underperformance or it has not led to less insurance built into that product in the sense that it's not when it gets expensive that the low volatility framework doesn't work. It just tends to be at the stage of the cycle where it might not be outperforming the benchmark. But as I said, typically those that are looking at this type of product benchmark as not their main objective. It's minimizing those return fluctuations.

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Also, I think that… Sorry, go ahead, go ahead. I was going to wrap it up because we're getting close to twenty five minutes here. So once again, thank you for joining me, as always. And I just going to leave you with a final word, if you have any, and then we'll end the show for today.

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Well, I guess my final words were at factor four of five, if I have that correct. I don't know if we're going to time the others as well as value. But I think the key here for low vol, it might not necessarily be the strategy or the factor that at certain points of the cycle have a strong buy or sell indicator. But it's really just designed to be that steady performer across the business cycle. And really where we're seeing flows going into the product is those that might start to look at taking profits off the table of growth and momentum strategies and are thinking about the next opportunity; or those that maybe when they first invested were kind of 10 years from their retirement or from buying a house and now are closer to that five year period and are just looking to maintain some exposure to equity markets, but are really starting to dial it back. So it can be used in a variety of ways in a portfolio. But hopefully this was insightful today.

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Awesome, thanks, Kat. So I guess in summary, there's no good or bad time to buy low vol, it always is.

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You know, it does what it does and it's a great diversifier for any equity sleeve. So, once again, thank you, everyone, for joining us. Thank you, Kat. And see you next time.

[00:26:33]

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