Fidelity ETF Exchange: Momentum Factor ETFs in focus

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Introduction: Hello and welcome to the 11th episode of the Fidelity ETF Exchange, powered by FidelityConnects. Connecting you to the world of investing and helping you stay ahead. In today's episode, Étienne Joncas Bouchard and Katrina Wilson explore Momentum Factor ETFs. What is a momentum factor? The momentum factor focuses on securities with improving fundamentals that have recently outperformed and may continue to do so over the medium-term. This is the fifth and final episode of a five-part series from Étienne and Katrina called "*Factors in Focus.*" In prior episodes, they have looked at Low Quality, Value, High Quality, and High Dividend Factor ETFs. Étienne and Katrina described how those factors have performed in the past, and most importantly how the various factor ETFs can be incorporated into portfolios. Today's podcast was recorded on December 1st, 2020. The views and opinions expressed on this podcast are those of the participants, and do not reflect those of Fidelity Investments Canada ULC or its affiliates. This podcast is for informational purposes only, and should not be construed as investment, tax or legal advice. It is not an offer to sell or buy, or an endorsement, recommendation, or sponsorship of any entity or security cited. Read a fund's prospectus before investing. Funds are not guaranteed. Their values change frequently, and past performance may not be repeated. Fees, expenses and commissions are all associated with fund investments.

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Étienne Joncas Bouchard: Hello everyone, and welcome to the 11th episode of the Fidelity ETF Exchange. I'm your host Étienne Joncas Bouchard, and as always, I'm joined by my co-host, Katrina Wilson. Start off, Katrina, how are you doing today?

Katrina Wilson: I'm doing well. It's finally winter, I guess. How are you?

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Étienne Joncas Bouchard: I'm doing very well. It is winter. We are recording on December 1st. So, yeah, no snow yet, but we are definitely heading into the final leg of 2020. We just had a quite interesting month of November, which just wrapped up, where we saw market leadership change, whether, you know, we talk on a geographic basis, on a style basis. So a lot of things that we discussed over the past week during our "Factors in Focus" series has actually been quite, quite relevant, I'd say, on depending on what, you know, how markets moved across the world. So if we just take a look at international, for example, it was one of the first months in a very long time where international equities outperformed US equities, as well as Canadian equities, on a style front value outperforming growth and momentum in other styles as such. But, the final episode of our "Factors in Focus" series, what are we going to be looking at today? We will be discussing the momentum factor. This is the fifth part and final part. And we're also going to close out the episode with a wrap-up on the series and sharing some information on potential pairing ideas, how you can position them together and I guess leverage the, the low correlation or the way that they're complementary in portfolio, in portfolio allocations. Before we do that, as usual, I like to do a quick recap of the last episode for those who haven't had a listen to, to that episode. We focused on the low volatility factor, so low volatility stocks. Also, we talked about the minimum variance approach and how they've performed in the past, what are low volatility stocks, what to expect from

them going forward. What are some of the key trends that they're impacting, low volatility stocks, and last but definitely not least, how you can incorporate them into your portfolios. So, you know, we kind of found ourselves talking about these stocks and realized, guess what, they're not the most exciting or, as you mentioned, Kat, they're actually quite boring in a sense. But nonetheless, they do offer a great tool for investors looking to get equity market exposure without full market beta. And generally speaking, they offer strong downside protection. So definitely a very strong or compelling use case in various portfolios, depending on what type of investor you are. And we did mention this would be good for retirees or people entering retirement, or even people looking to save for a specific investment in a few years to come. But enough about low vol. Let's finish up this, this segment with the momentum factor, with anyone less familiar with what a factor is, investment factors are quantifiable characteristics that can explain differences in stock returns. The objective is not to necessarily isolate or to outperform the market, but to isolate a certain style of investment, to meet a specific outcome. So the momentum factor is actually quite unique. And it's not one that we talk about too much because it's relatively new in terms of practical use cases in retail finance as well as in the institutional world, excuse me. But the reason I say that, and I think why we want to, to look at it and go a bit deeper is because it's a little bit more grey, kind of like when we discussed quality or high quality. What is the momentum factor? I guess to put it in context, to a lot of investors, it doesn't really make sense, because it goes completely against the classic saying 'buy low, sell high.' The momentum factor looks at building a portfolio of stocks that have displayed strong past performance. So you're, in a sense, you're buying high and an attempt to sell higher. This factor actually came about in large part due to the research conducted by Mark Carhart, who in the late '90s introduced what he called his four-factor model, which was able to statistically prove that companies that have done well tend to continue to do well, while companies that have performed poorly should continue to decline. Now, this would be a complete head scratcher for contrarian investors because they're doing the opposite, looking for good companies that have done poorly. But nonetheless, I think that just encapsulates a little bit what we're talking about. So, Kat, I guess my first question to you, how do we build a product to do this? How do we buy good stocks and I guess avoid stocks that have underperformed in a momentum factor?

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Katrina Wilson: Yeah, I think I heard it being referred to as the 'FOMO' factor [laughter], for lack of a better term, makes sense in context. But you touched on it. It's looking at stocks that have done well, looking at liquidity. So what's the frequency of trading of these given stocks? Because what that tells us is, it's a great indicator to sentiment. So really what we're looking to identify is companies that have done well, both from a performance standpoint, but also that characteristics in the market are telling us there's really strong sentiment out there and an appetite for those stocks and then making sure that we're including them in the portfolio and perhaps we're even seeing increased weightings. How do you define momentum or how have you thought about it in the past?

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Étienne Joncas Bouchard: The basis of it is performance. But, like you said, there's tons of other layers of momentum that we can add on volumes and trading habits is definitely one. Another one that's actually quite interesting, I find, is when we look at momentum of fundamentals continually beating earnings estimates by analysts earnings estimates, you can also have earnings revisions. So if you have upward revisions in your, you know, guidance, or in your forecasted earnings, these are all ways to track underlying momentum of a company's operations, the services and goods they offer, how well they're executing their plans and are they basically doing better than expected, which, in the long-term, means positive momentum. So I think those are, that's another way we can approach it, combining obviously all of this is probably the ideal way to go. And it also opens the door

for tons of different ways we can do it. I mean, I haven't personally thought of, of any other ones off the top of my head, but it just leaves a lot of room for development. Because at base, this factor was developed looking only at returns. Um, so I guess on that note, the next point I want to go to is the way that we use the term momentum. We talked also in one of the past episodes how value is often associated to a conservative management style or a conservative mandate, which would tend to fall more into the low vol type framework that we discussed last episode. And momentum is often associated with growth.

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Katrina Wilson: Well, it's interesting because that is something we hear all the time. And I mean, if you look at it right now, a momentum strategy would resonate with a growth strategy. But growth is work. So just like you described it, momentum is going to buy what has worked, assuming it will continue to work. So if we actually break down to the sort of granular level, what one strategy means versus another, growth is looking at companies that are expected to grow earnings over time. And the theory there is that stock prices follow earnings more closely than any other factor. So, and you touched on it, you know, momentum strategies can, depending on the screen that any given strategy looks at, can look at earnings growth estimates over time or improvements over time. But at the same time, if all of a sudden value comes back into favour in a big way, momentum is going to chase that trend. So I think momentum in a lot of periods does tend to look like growth. I'm not saying momentum is going to look like value tomorrow, but you'll see momentum kind of waver. But certainly because growth has worked so well in the past, it does resemble that right now. And I mean, you touched, like I said, on a few different criteria. So how are you, whether you're adding it to your portfolio or looking at it, you've obviously been so bullish on value, so how do you see momentum transitioning with kind of value starting to come back into favour?

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Étienne Joncas Bouchard: That's a great question. Um, I think the key here, and you touched on it, is it changes over time. It doesn't look the same from one period to another. Like depending on where we are in the markets, like it's not going to look the same. So like when we looked at it at the beginning of the year, it looked a lot like low vol quality. You know there was some like some growth your names, but it was mostly like low vol. And now we look at it now and it's definitely filled a lot more tech, a lot more, you know, what's worked basically year to date, will it look like value going forward? That's still, I think it's really hard to, to, to see right now. I think it has to, there has to be really sustained period of outperformance on that front. But, you know, you mentioned calling momentum the FOMO factor, and I love that because it really is that, where you're basically always buying companies that have performed well in the past, you're basically chasing returns. But, and that's why I said the logic doesn't make sense, but it does over time, there's proof that it works. Another term that I've used or that I've heard is the chameleon factor. And it goes back to how it changes over time. It adapts to where the market is, what the market's been doing, what's performed well, what sectors have done well. So it really is dynamic in that sense. So when you buy momentum, six months down the road, it could look completely different. So in, in a sense, I think this is a type of product that you can hold for, for the longterm. It's a, it's a buy and hold more than a tactical purchase into a portfolio. So to that end, how has momentum performed year to date? How has it performed, historically speaking, in terms of where does it usually do well? Or actually are there periods where it tends to do better than others because or, or does it, does it not really matter because of how it changes over time?

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Katrina Wilson: Well, it does. And I think that's a good kind of topic, because right now it almost sounds like the perfect factor, right? It's like it will adapt based on changing environments. But the reality is sometimes markets or signals are delayed in terms of acknowledging a new trend. So I think that's for any listeners that, you know, it's a great strategy that will adapt over time. But where you can expect to lag is an inflection point in the market. So once we see a major change, whether it be business cycle change, whether it be style factor change, the momentum factor is designed to hopefully pick that up, but it's not going to be able to predict it ahead of time. And so you're going to see that transition period where there might be a lag between when the momentum factor can pick it up. But that's also something and why we've or a lot of providers design this as a strategy with higher turnover in terms of rebalancing. So, you know, you have a Masters of Finance. So maybe you can kind of elaborate on sort of the rebound strategy specifically related to that factor.

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Étienne Joncas Bouchard: It's an interesting concept to consider when you're looking at rebalancing, you're talking about how we want to keep this relevant. So basically not have it be a static allocation because that would mitigate the validity of the model, which is momentum. So momentum changes, it can change really quickly. And you touched on that when there's an inflection point in the markets and I think I'd agree with you there, that's usually when it underperforms is when you've had a really strong momentum in a certain part of the market, you're invested in there, and then you have a massive change. And that usually comes at the late end cycle. And as we enter a recessionary period, because there's a shift in leadership where companies that had done really well tend to be higher valued and sell off more than the other parts of the market, which we did not see at all this year, where the companies that were expensive got even more expensive and the companies that were cheap, got even cheaper. That's why I think momentum's been an extremely strong strategy year to date. Um, but yeah, I think rebalancing is key. To go back to your question, rebalancing really is key because it allows you to stay dynamic and not have this static exposure to certain areas of the market. You want it to be, although it is backward looking, to be as quick to adjust to changes in leadership, because the longer you can, the longer you wait for that, it can basically ruin the objective, I guess, or the or the, the specific outcome we're looking for with momentum. But, yeah, so, you know, that's really important, I think, you know, whether it's on a quarterly or semiannual basis, it allows you to adapt. And I think now, you mentioned earlier, what do we expect going forward? Well, 2021's probably going to lead to some turnover in these types of products. So given that momentum has performed so well this year, what are valuations looking like for this factor? And specifically, are they expensive? Are they cheap? You know, what does it look like on whether that's in the US, Canada or internationally? How are they positioned in terms of pricing versus the broader market?

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Katrina Wilson: So especially if we think about the US, and this is something that through a lot of the research we've done in the last year has probably stood out to me the most, is momentum's expensive. But ironically, momentum actually does well. And you touched on this, the idea stocks that have done well will continue to do well. So it's been interesting to see how some factors are so sensitive to valuations versus others aren't. And some are a bit counterintuitive. So momentum is expensive right now. Historically, that does not mean overvalued, specifically for that factor, it actually typically means it will continue to do well. But as you touched on, we're starting to see some of that change in leadership. And I know it obviously depends on regional as well. And the US is obviously the screaming momentum region, I will say, with the obvious tech bias.

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Étienne Joncas Bouchard: Yeah, absolutely, and I think you touched on it perfectly, where you can actually see momentums from a sector standpoint, from a subsector standpoint, but also from a geographic standpoint, where the US has just built this so strong, like binding US markets has built such a strong momentum over the past decade where other regions have been lagging, I guess, to that market, where now it seems like a value opportunity elsewhere. And we talked about that when we're talking, when we discussed value and maybe even going overseas in international European markets, seems to offering relative value. I think we've covered momentum quite well. The last part of the show that we want to get to in order to give you guys a full on overview of what we've discussed over the past five episodes is, I guess, well, it's the wrap-up of our "Factors in Focus" series, and a discussion on how we can potentially pair certain factors that are seemingly uncorrelated and can offer great diversification benefits, but also potentially increase your performance over time by, by, by combining them. So my first question is, if you had to pick a pair of factors to put together, what would it be and why?

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Katrina Wilson: Interesting. So at this stage of the cycle, I'm definitely quality at my core. I think quality is a great way to participate. I'm not one to swing for the fences. I got a home run once in my life, I was very proud. But [laughter] so I think quality also tends to have the lowest benchmark risk. So for anyone who is focused on outperforming the benchmark, quality tends to have the highest batting average, offers some downside protection, which I think is great in periods of turmoil. But I think the underperformance of value, as we've made the case in our last session, is maybe at the tail end, will it outperform or not, but based on valuations, based on a lot of the sort of recovery data, value has in similar, um, you know, cycles or periods of the cycle that we are in today can add significant outperformance. So I would be a quality is my core holding and then a sleeve of value as my kind of tactical position. And that's how my portfolio is today. What are you [laughter] Do I ask?

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Étienne Joncas Bouchard: Yeah, it's a good question. I like, uh, so where you're more quality focused right now, I think, well, first of all, I think that's a really great combo because when we look at historical correlations between both, the actual excess return, excess returns excuse me, are negatively correlated. So when one outperforms, the other underperforms, and vice versa as we move throughout the market cycle. So I actually really like those as well. In terms of outlook and which ones I'd be pairing right now, I really like looking at value as the, the core position just because of, you know, if we go back to that episode, maybe, yes, I did sound quite bullish on it, but it's just looking at where we are from a historical standpoint, that factor's straight trading under its fifth percentile relative to the market. It's rarely been cheaper. And you can also find value mandates like the ones that we offer here at Fidelity that offer great diversification from a sector standpoint as well. So you're not necessarily buying a basket of stocks that are deep value, but you do have a play on the reopening of our economy. You have a positive sector tilt into more cyclical segments. And, and I think that that would be the core. But either pairing it with quality, which is a bit higher priced, but offers exposure to companies that are less cyclical, that are very steady, strong cash flows, or momentum, I think either one of those two could be really good pairings to value. So I think I'd start with value and then find something that complements it well, which at the end of the day, we would get to the same end game. But you starting with quality, me starting with value, and then we'd meet in the middle with, with a pairing. So those are two great examples. You could also do something very similar if you're looking for a dividend focus with something like quality, for example. So high dividend and quality tend to be very good pairings. Is there any other that just comes to mind off the top of your head, whether that's maybe not your favourite choice, but that could be good for, for, for investors, depending on what their approach is?

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Katrina Wilson: I think, depending on, yeah, risk appetite, I mean, low vol and quality don't necessarily have negative correlation as it relates to excess return, but they both tend to be the strongest as it relates to downside protection. And we've seen some recessions where one outperforms the other, although they typically both outperform. I think that's a great way to really minimize your downside capture. But with still adding some market participation and adding some diverse style diversification as well. And then there's value momentum, which tend to be the most sort of strongest correlation, if we just look at pure core metrics.

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Étienne Joncas Bouchard: Yeah, they're on the opposite end of the spectrum usually, because one you're buying high, high priced stocks, the other one you're buying low priced stocks. So that makes a lot of sense. I actually really like the point you made on quality and low vol, because they both actually have downside protection in the sense that they have a downside capture ratio below 100 percent, and they actually have good sector diversification where quality avoids all the CapEx heavy sectors like utilities, real estate, uh, yeah, energy, and low vol obviously will not have energy, but it will definitely have utilities and real estate. So definitely a good complement to see there. And I guess the last question I'll ask you, Kat, before we wrap this up is we've been talking about factors from just the pure style standpoint, but you can get these style exposures in every single region. Is there a specific factor for each region that you feel, depending on what the macro looks like, looks like on the international front, US and Canada, that you'd say, okay, I think this factor is well positioned because of this, uh, from a macro standpoint. You don't have to go for each region, but if there's one that stands out in your mind, feel free to share that.

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Katrina Wilson: Well, I think it's interesting, right, because we just talked about pairings and then, you know, perfect transition, 'cause I think what a lot of people don't realize is passive indices have a natural tilt. So that's what's really interesting as well. And I'd say in the last few months, we've seen a lot of money rotating out of passive into factor strategies. And I think that's been a big part of why, is realizing, well passive strategies have a natural tilt, and so if I'm not comfortable with that tilt, how do I pair it? So I mean, the US, for example, has more of a momentum tilt, whereas if you look at the MSCI EAFE Index, that tends to have more of a natural bias to value. So I don't know if that's something kind of in your own portfolio as you're having discussions, is that starting to come up for you as well?

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Étienne Joncas Bouchard: Yeah, absolutely. And that's where I kind of was going, where you can actually buy a certain factor exposure, in so, for example, international markets, you mentioned value tilt trading at a discount relative to other regions. But then you can buy a product like an international quality mandate that is going to give you an exposure that is very different to the benchmark that can allow you to diversify from a style standpoint and potentially allow you to outperform. I won't go into the details of the reasons why we like quality so much in the international space. We actually did that a little bit in the high quality segment, but that's a way that you can complement the underlying biases that you mentioned in a passive index. And it could be the same story, but on the flip side in the US, where value is still relatively cheap to, to the broader market. So, yeah, any final words for our "Factors in Focus" series? We made it through, that's five total episodes. And next episode we will have different content for all of you. But, Kat, final words?

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Katrina Wilson: Final words for me are hopefully it gives us a better perspective on what a factor is. I think it's something that there's so many ways to define it. So what we're trying to achieve here is just understanding how can they actually be used, that's what matters for all of us as investors, as advisors. So, you know, I shared what I'm doing in my portfolio, but hopefully everyone gets sort of a better understanding that doesn't have to be a one size fits all.

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Étienne Joncas Bouchard: Absolutely. Thank you very much for those closing words. I think our objective, like you said, was to debunk some of the, not myths that exist, but just give more clarity on what these are, because we often throw the words around like low volatility, quality dividend, but we don't take the time to say what's under the hood, how do they work, why? And that was really the objective here. And I hope we achieved that. And thank you all for listening in. Be on the lookout for our next episode where we look at, we hope we'll be able to get a great guest on to talk about ESG investing in ETFs and just more broadly, so keep an eye out for that. And thank you once again.

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