Fidelity Connects

Factors for the Late Cycle

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[voice-over:]

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

Major U.S. markets have come off recent lows and the debate on where we are at in the business cycle seems to be shifting.

On today's show, ETF strategist Etienne Joncas-Bouchard shares that it feels like we're in a late-cycle environment and he'll note which factors he is paying attention to for the current market environment.

With host Quinn Flaherty, Manager Editorial Content, Etienne notes that investing in quality right now versus investing in value, has a higher probability of a positive outcome, based on this market environment in the past. Among other topics, Etienne also provides an update on the Fidelity All-in-One ETFs.

Today's podcast was recorded on August 16, 2022.

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Quinn Flaherty: Étienne, welcome back to Fidelity Connects. How are you doing this morning?

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Étienne Joncas-Bouchard: Doing very well, Quinn. Thanks for having me.

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Quinn Flaherty: So, Étienne, new inflation data is out and, of course, the debate now is where we're at in the cycle and where we go from here. My first question to you, of course, is from the market data you're looking at and reviewing, where do you think we're at in the market cycle right now?

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Étienne Joncas-Bouchard: That's a great question. I think there's been a nice sigh of relief from the market with regards to the change in direction for inflation. A 7.6% CPI reading now looks a lot better than it would have, say, a year ago. It almost seems like we've been in this environment for a little while now. It's something that's been in focus since the start of the year and probably even going back to, I'd say, Q3 of 2021, that story of a rising rate environment paired with higher than expected inflation numbers, keep on going up, going up, going up. Now that we finally have one that's actually going down, albeit still relatively high, it seems like, once again, that sigh of relief from the markets.

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To us on the ETF side, from the data that we're gathering, it does seem fairly clear that we are in some type of late-cycle environment. That's something that is characterized by slowing growth, obviously, eventually rolling over of inflation expectations, which has started to happen if you look a little bit further out like five-year and even one-year inflation expectations. Basically, the market kind of starting to realize that all the work that's being done by central banks, our team is looking at the impact of higher borrowing costs on future economic activity, comparing new orders from the ISM survey in the U.S. with the 24-month change in the 10-year advanced 18 months.

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Obviously, it takes some time to materialize. Consumers and businesses generally change their habits ratherly slow, but we're already starting to see new orders fall quite drastically, coming around significantly lower in July than most expected. That really has to do with the cost of money. That's one thing that we're definitely keeping an eye out on. When you start to look more like market fundamentals, I mean, it's going to be looking at earnings, which have been quite strong. One of the key metrics that we're targeting, especially to put it into a factor perspective, is where margin is going. We expect those to continue to kind of compress as those inflationary pressures from the past 12 months kind of get, not priced in but, obviously, digested, if you will, by businesses and consumer. Those are some things that we're keeping an eye on, but it definitely feels like a late-cycle type environment right now.

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Quinn Flaherty: With that being said, perhaps with late cycle, new orders perhaps slowing, but inflation may be curving a little bit. Let's talk a little bit about Fidelity factors. Every time we have you on Fidelity Connects there's always new storylines about the various factors at play here. From your perspective, when it comes to our ETF products and these factors, which of these factors are you really paying close attention to, especially now as we enter or are in the late cycle?

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Étienne Joncas-Bouchard: As we go through a business cycle and where we find ourselves now in that kind of slowing growth to the stall speed, factors like quality and momentum, as well as low volatility tend to be factors that do well. One that we're definitely keeping an eye out, and this is something that I've done quite a bit more research on recently with a white paper that we've put together, is high-quality businesses. Those that will display higher margins, higher return on invested capital. They're able to generate cash and then reinvest it at a higher rate than their peers. That also definitely display lower standard deviation of earnings, so they can navigate a tougher environment a little bit better than the average business.

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Those are the types of companies that have historically done well throughout the cycle. It doesn't mean other things can't work, but on a relative basis those are places that generally are in their periods of alpha ... that's when they're generating alpha the most is in that late cycle/ recessionary period. It's extremely hard ... we were just talking two minutes ago that we feel that we're in the late cycle. What are going to be the effects of all these things that we're talking about? Obviously, inflation, we expect margins to come down. We expect new orders to come down. We expect consumers to react and start maybe spending a little bit less because the cost of goods and services is higher. But will that lead us to a soft landing? Will that lead us to an actual more persistent growth contraction like a deeper recession? It's really hard to tell. So for us, it's about making the highest probability allocation in a portfolio.

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If I invest in quality right now versus investing in value, I'm giving myself a better probability of a positive outcome with something that typically does well in this environment. But once again, if we do see, for example, inflation come down and the Fed not necessarily having to cut rates and just leaving them as they are right now, we basically get that soft landing in which growth doesn't stall. We could find ourselves pushing back to a mid-cycle type environment, where there's moderate growth but there's still growth. But right now, that's kind of the base case. The lower probability or the ends of the bell curve would be a deeper recession and kind of a reset, a complete reset. We're kind of in that growth stall period, we feel like.

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Quinn Flaherty: You mentioned high quality factor, we talked a little bit about value. From a valuation perspective right now in the markets, we've had obviously bit of a sell-off in the last few weeks and months, now a bit of a rally, from a valuation perspective, where is the high quality factor? Is it considered cheaper over price at the moment? What are you seeing?

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Étienne Joncas-Bouchard: That's a great question. It's hard to say. The way that we like to look at it is on a relative basis based on its historical average relative to the broad benchmark. Quality stocks generally trade pretty much at par with a benchmark index. For the U.S., it would be the Russell 1000 that we look at. Our U.S. high-quality ETFs would be trading historically at about .98 times the broad benchmark from a P/E perspective, so price/earnings. Right now, it's trading at around .95, so it's at a slight discount, albeit it's pretty rare that we do get a discount in high-quality stocks, so it's actually in the bottom quartile of its historical valuations.

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High quality, being it was a little bit pricier to start the year, was actually much more negatively impacted when we saw rates going up. Valuations are a way to see sensitivity to moves in rates, similar to what you would see with duration with bonds. Obviously, anybody who was invested in growth stocks going into the year, it's been a tougher area to invest given the valuations that were in place there and discounting future cash flows further and further out from a time standpoint. Your discount rate has a bigger impact the longer you look at it.

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If you look at high quality right now, it's gone from about the 75th percentile to the 25th percentile. It's not a screaming buy on valuation, but it's definitely a good correction that we've seen. Things that are extremely cheap right now, value, which is quite surprising given the relative performance it's had, it's also due to the fact that we feel that earnings have held up very well. If you look at places like energy, for example, are at cycle highs from a free cash flow standpoint and from an earnings standpoint. That's kind of helped on the valuation side there.

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Let's just say quality from a valuation perspective, it's not an issue anymore. You're not overpaying for these businesses like you were maybe going into 2019, 2020 when they were off a two-three-year kind of run there. We feel now it's more adequate from a valuation perspective, not to discount the fact that earnings revisions actually has been really good on the quality side. We've actually seen the businesses that we bucket into high quality, actually positive revisions, while other factors actually have negative revisions like small-caps, for example, which have been underperforming so far this year.

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Quinn Flaherty: We're just wrapping up earnings season and I think a logical follow-up question to what you just mentioned is, looking at high quality, what is the actual definition of high quality, especially here at Fidelity? We do have a couple of different mandates in the high-quality factor, probably best for our audience to have a good understanding of how we define it.

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Étienne Joncas-Bouchard: I'll say 'we' by our ETF team. We talk to our active managers and those that focus on quality at a reasonable price, which is kind of like a GARP approach a little bit. If I look at the portfolio of a manager like Will Danoff, for example, it displays very high quality from the metrics that we look at. But the way that we construct our ETF is using three main metrics. I kind of alluded to them earlier, but I'll go through them again just to make sure that we're all on track here. The three metrics that we score each company in our investment universe on is, firstly, the free cash flow margin. So, the one-year free cash flow margin, how much free cash flow is the company able to generate? Are they profitable? That allows them to not only manage their debt load, it also allows them to invest, it also allows them to produce and offer new goods and services, so basically do R&D based on capex, etc. That's one of the key metrics.

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The second one is the return on invested capital. Once they've generated that cash, are their business initiatives, their operations, profitable and are they creating economic value with those operations? The return on invested capital has historically been a really strong metric to find those kind of compounders or long-term leaders, those companies that are able to keep some type of moat versus their peers. That's another way that we can kind of characterize high-quality companies. It's those that are kind of tough to lose their competitive edge or that have some type of edge versus their peers, whether it's just because they're more efficient or it's because they offer something that their competitors just can't at that price point, for example.

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The last metric, which is particularly important when we find ourselves in a recessionary period, and that's why I think, obviously, high quality does well in those two lighter parts of the cycle is we also look at the five-year standard deviation of cash flows or earnings/share. We're trying to find businesses that through a five-year period won't have a dramatically different margins or just all out earnings potential. You can think of sectors like, for example, energy, which is right now generating a lot of free cash flow and has a high return of invested capital. Unfortunately, it's not really stable over a five-year period, so it's kind of like a double-edged sword right now, where the cyclical sectors look good on one side, but then that's kind of holding them back to say, we still need businesses that are stable if things get tougher. That's something that's more typical of a low-volatility factor historically. We want companies that have very stable and boring businesses. We're looking for, not only, a lower beta but also a low standard deviation in their earnings. Those would be the main ways to characterize it.

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Quinn Flaherty: You just mentioned low volatility and I wanted to ask you a little bit about that. How is low volatility factor performing and do you have any thoughts on the factor going forward?

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Étienne Joncas-Bouchard: Well, it's doing quite well. The VIX is a tricky, tricky metric, I think. Albeit, it would say that it's a relatively low-vol environment. I just feel like sentiment is fairly … it feels like investors aren't completely convinced of one direction or the other which, when there's uncertainty like that, actually lends really well to those defensive sectors. The issue right now, obviously, is that they're fairly expensive. They've done well from a performance standpoint and they're just trading at a sizeable premium right now, about 1.12 times if we're looking at the U.S. market and I'll keep it to the U.S. market, it's just easier from a factor perspective because we can apply it to Canada and international markets.

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Across the board, actually, on a geographic perspective, low-volatility companies are expensive, so you're paying a premium to get safety, which historically is pretty much the case. It usually trades about 1 times the benchmark, right now it's at 1.12 times. That's something that from an entry point perspective could hinder a little bit, but if I own defensive, low-vol businesses, it is entering that period when you see earnings start to slow down on the more cyclical side, when you see more uncertainty from a macro perspective, it is a factor that does well. You're overweight sectors like utilities, telecoms, staples, kind of those more dull sectors. For investors that are looking for that market-like return over a multi-year period but want to capture less downside and lower beta, it is a good factor, I think, for, say, the next 12 months. If we do see signs of a kind of bottoming out in the business cycle, it does tend to lag in the early and mid-cycle like it did in 2020 and the beginning parts of 2021 and now has really kind of picked back up as we've seen this uncertainty, if you will, remain in equity markets.

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Quinn Flaherty: I know I do want to get to our Fidelity All-in-One ETFs, but there's a question about the size factor and the question is, can you explain how we define size? Are these small-caps or when we talk about the size factor are these simply large-caps?

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Étienne Joncas-Bouchard: It is confusing. We should just write exactly what it is instead of just putting size. It's not a factor that we currently offer in an ETF format here at Fidelity Canada. We use it because it gives us an indication of the way small-caps do. It's actually somewhat of a … it would be kind of more benchmark to the Russell 2000. It's a way to equal weight stocks, more or less, to get a small-cap bias in a portfolio. If you look at a typical passive investment, you're basing it off market cap and you are getting more exposure to the bigger companies. We're trying to take that out. That's basically what the size factor would be. Albeit, like I said, we don't offer that type of strategy, it does give us an indication of how small-caps more broadly are doing, which hasn't been so well right now which is, once again, pretty typical of a late-cycle environment given that they are more sensitive to, not only, a domestic economy but also, in general, will be a little bit more volatile on the earnings front, when things get tough their access to capital can be a bit tougher than large-caps also. Whether that's the cost of borrowing or just the cost of the price at which they're doing equity raises can be more expensive than, say, large-caps. To answer the question in size, small-caps not large caps.

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Quinn Flaherty: Awesome. We've talked about high quality, we've talked about low volatility and we did touch on the size factor. For, perhaps, many advisor clients, there's really not one factor that perhaps want to focus on, but let's talk a little bit about our Fidelity All-in-One ETFs. I'm super excited about this kind of range of ETF products. Maybe just give our audience today a bit of an overview about the All-in-One ETFs and their composition.

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Étienne Joncas-Bouchard: We're really happy to have these products now out. It's the culmination of a lot of years' work for a lot of people on the ETF team at Fidelity Canada. What these are are kind of turnkey solutions, portfolios that offer a balanced multi-asset class approach ranging for every ... or the majority of investors. We have a version that's the All-in-One conservative available in an ETF and a fund, which is important to remind all of our audience. A lot of our ETFs are actually available in series B and series F. It is something that can find its way on your product shelf. These portfolios range from 60% fixed income and 40% equities all the way to 100% equity. I say 100% equity but caveat, we actually include also a third asset class, which is quite unique to the marketplace. We include a small allocation to cryptocurrency via our Bitcoin ETF to the range of 1 to 3% depending on the risk profile. So really unique portfolio with an objective to, in the long term, benefit and harvest the long-term alpha that these various factors can generate.

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If we look over a 20–25-year period, every single one of those factors has displayed significant evidence showing that it provides alpha relative to a broad index. Now, it doesn't do it throughout the cycle necessarily. We see value, value's not going to outperform through the whole cycle, but it's going to have enough time in the sun where if you look at the end of the cycle, it should have outperformed its broad benchmark. If we do that and we think about it that way for momentum, value, quality, and low vol, which are the four factors that we use in the All-in-Ones, if we can tack on between 1.1 to about 2.6%, which is over a 30-year period, the range for each factor of annualized alpha, if we can compound that over time by investing in the four various factors across three geographies, or much more than three geographies, but we bucket into international, Canada and U.S., so it's a global product, if we can capture 1.1 or 2.5 points to 6%, minus a small fee, we're going to be able to compound with these ETF portfolios at a faster pace than, say, a purely passive approach or index-based approach. So that's the idea.

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Obviously, the combination of factors on top of that kind of alpha potential is also we're thinking about risk management, right? Having factors like value and quality that actually have a negative excess return correlation. When one's outperforming the index usually the other one is underperforming. Combining them is going to give you great diversification and able to kind of capture the success of both of those factors over time. Really great products, we're really happy with the way that they've done so far, great turnkey portfolio, simple.

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Quinn Flaherty: I'm really interested to know, with the changing market conditions that we've all experienced in the last few months, talk about diversification of this suite of All-in-One ETFs, how have they performed given what's happened in the last few months?

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Étienne Joncas-Bouchard: They've done quite well. As advertised, the idea here … obviously, one thing that … I mentioned the Bitcoin allocation, 1 to 3%. Thankfully, it was 1 to 3%. That's also the idea behind these portfolios is to not be taking on excessive risk, we're not trying to chase performance here. We want to have a really strong Sharpe ratio. So far, that's been the case relative to, once again, the way that we compare is just looking at a 60/40, for example, with our balanced solution of just indices bundled together and they've really delivered. One of the key reasons for that is the fact that we have value and low vol. Those two factors have done better year-to-date. All of a sudden, since mid-June, now quality is the one that's leading the way. We've been talking about quality for about four or five months, but timing that whole cycle is extremely difficult. We have dozens, way more than that, we've got 30 people trying to figure out where we are in that chart, the fact of combining all those factors takes away that job. We are constantly rebalancing among the factors, making sure that you're well positioned, well diversified because when you think about it, you always want to own that best factor. It's really challenging to do.

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We all want diversification when it's a bit too late to be diversified. The way that these portfolios are built and with, I guess, frame of mind we had was to always have that diversification and to capture the long-term benefits, not to look at the short-term tactical plays, because it's not a tactical mandate. We're not making calls on a daily basis saying, okay, well, right now we like quality. Does that mean we want to take away value and own the overall quality? No. Or if we get into a much more volatile environment, oh, maybe we should sell some value to my low vol. We're not making those calls. We're making sure that we have some type of a neutral mix. We let the factors drift a little bit and benefit from momentum. Individual factors, not the momentum factor itself, but factors as a whole can display some momentum. When value does well it usually does well for, you know, it's not like a month. It usually lasts a certain period of time. We want to let that drift and then we rebalance at the end of the year to make sure we start fresh.

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Quinn Flaherty: Excellent. Thoughts on energy and, specifically, the composition of energy in the energy sector within some of our factors and ETF portfolios. Wondering if you could touch on that?

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Étienne Joncas-Bouchard: That is a great question. It's probably the most trivial sector right now because you're getting very different signals. It's not a sector that typically does well when we are in a, I guess, economy that is beginning to show signs of slowing and likely will continue to slow as, once again, the higher rates, the expectations and just the economy, activity starts to slow. But at the same time, you're looking at it, valuations are still great. Free cash flow margins are great. Return on equity, return on invested capital, these businesses are making money for the first time in quite a while, to this extent, anyways. It's kind of conflicting signals that we're getting. Macro says no, fundamentals say yes, so you kind of have to pick which side you want to take.

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From a long-term perspective, there are still some structural issues with regards to supply. I think that has to do a lot with the environment, the ESG turn that governments are taking and that we are taking as individuals. Either supply is constrained because we don't want to make new investments in energy, so that means that current assets are worth more because there's just going to be less competitors, if you will. At the same time, you're getting a whole electrification process, which will create … there's still going to be energy demand short term and long term likely starts to deteriorate.

But it doesn't mean that energy stocks are a bad investment because of what I was mentioning with regards to the value of their assets. It's a long answered question to say it really is an interesting one right now. It's, obviously, overweight in dividend, it's overweight in value, it's overweight in Canadian quality, which is quite surprising. The last time that was the case was in 2003, 2004 when commodities in Canada did well relative to the U.S. market. Does that mean that we're going to get that same type of run going forward? It's very tough to tell. We're rebalancing a majority of our factor ETFs in three days and I'm quite interested to see if it does fall into that quality bucket. Stay tuned for those keeping an eye out on it.

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Quinn Flaherty: Very quickly, last question. Mid-way through August, we'll be in the fall in no time. Obviously, we'll all be keeping a close eye on energy based on your comments there. Anything else you're looking at in the markets as we get into the fall, especially considering ETFs in our factor investments?

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Étienne Joncas-Bouchard: I think just from a market perspective, it's to see the tone of the central banks as we head into the fall. If we get to subsequent sizeable drops in inflation, is that going to be enough? You're seeing also signs of a slowing economy. Is that going to be enough for central banks to say, okay, we've done enough. That could, potentially, be a very good thing for markets. On the flip side, if inflation is more persistent and, say, we dip for one month and we see a higher number the month after for whatever reason, that could be the flip side. So just really kind of seeing what central banks and the way they're going to react in the next few months because markets are already starting to price in cuts next year. Maybe we're getting a bit ahead of ourselves, but that's really what I'm keeping an eye on right now.

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Quinn Flaherty: Étienne, thanks so much for joining us today on Fidelity Connects. Always a pleasure to speak with you and, hopefully, we'll have you back to talk about some factors in the weeks and months ahead. Thanks again.

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Étienne Joncas-Bouchard: Thank you very much. Have a great day.

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Quinn Flaherty: Thanks for joining us. I'm Quinn Flaherty.

[voice-over:]

Thanks for listening to today's Fidelity Connects podcast. For more from Etienne, please check out his podcast episodes "The Fidelity ETF Exchange," posted monthly within this Fidelity Connects channel. Recent episodes include a Q2 2022 recap, and a look at overall portfolio construction. Also, make sure to visit fidelity.ca for more information on future live webcasts. Thanks again, see you tomorrow.

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