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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 ninth episode of the Fidelity ETF Exchange, co-hosts Etienne Joncas Bouchard and Katrina Wilson take a deep dive into Value Factor ETFs. This is the third of a five part series called Factors in Focus, with high dividend and high quality factor ETFs covered in past episodes. In this series, Etienne and Katrina offered 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 ninth episode of the Fidelity ETF Exchange, I'm your host at Etienne Joncas Bouchard and I'm joined by my co-host, Katrina Wilson. How are you doing? And good, how are you?

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I'm doing very well. I've managed to escape the city recently to establish myself at my family's cottage, and it's just been absolutely amazing with COVID restrictions popping up once again in Quebec. And I think something similar has been occurring in Ontario. And correct me if I'm wrong, but rumor has it is that you are also taking advantage of leaving the city. I traded in my railway view for beautiful mountains in Alberta.

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Wow, that sounds like a good deal. I'd take that for sure. So, Kat, last episode we took a deep dive into the high quality factor. It was the second episode of our Factors in Focus series. So we had initially started with high dividend companies. Then we went to, like I mentioned, high quality companies. And today we're going to be addressing the third factor in the lineup, or third of five, which is the value factor. Before we get into that, just a quick recap for those of you who haven't had the chance to listen to the to the previous episode. And I do recommend that you go back and do so. They're all available on any podcast service out there. We discussed the historical performance of high quality stocks, what to expect for them going forward. Obviously, we started with what they are and how we define them. We continued by talking about what are some of the key trends that are impacting high quality stocks. And last and definitely not least, I guess the real point of emphasis and why we really do this podcast is how investors and advisors can incorporate these types of portfolios into their own practice or investment practice. So we had a great discussion and one that I think may have been very educated for a lot of listeners, because the term quality gets thrown around a lot in finance. And I think we did a good job explaining what defines those companies and just the definition being a little bit more of a gray area than that pure high dividend stocks are really easy to identify, low volatility stocks are easy to identify. So I think our job was accomplished there. So for anyone less familiar with what an investment factor is, because I've been saying that word quite a bit since the beginning of the episode, investment factors are quantifiable characteristics that can explain differences in stock returns.

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So the objective is to isolate a certain style, not only to outperform the market, but to achieve a specific investment objective. Alright, let's move on to the third part of our Factors in Focus series; two down and there's three to go. So stay with us here today. We'll be taking a deep dive into the value factors. Where to start? I guess we can give a bit of background, because, in fact, the first ever non beta risk premium or risk premiua that was proven to be a valuable investment factor to predict stock returns was value. So obviously now we're talking more of academic research, using variables, using specific ratios. But the idea of value investing has existed forever. It's started a lot with Benjamin Graham, who's, I guess, Warren Buffett's initial teacher on finding intrinsic value companies that are underpriced versus what he believes their future cash flows are worth. So really, the fundamental way of finding a value company. Now, the value factor as we know it now, so this discovery, I guess, or this paper or thesis was developed by two academics, which for you CFAs and finance majors, these are names you're probably going to know: Eugene Fama and Kenneth French. So in their 1992 paper, they found that with statistical significance, companies that traded a low price to book tend to have better performance than those with a high price to book. Now obviously that's been adapted, revised, twisted, turned, and there's many iterations of a value factor or a value risk premia.

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But the fundamental finding remains, and I think it's still used a lot as an assumption for a lot of asset managers; is that cheap stocks or buying a stock at an attractive price tends to leave the future outperformance. So with that, I think I've done my little nerd spin on what value is. Kat, how would you define value investing or the value factor?

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I think you said it perfectly and it's really trying to identify companies that are trading at a discount relative to peers. And if we think about, you know, valuation, I like to really refer it back to how we think about pricing and housing.

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It's always, you know, like comparing the price of two different homes. Usually we're looking at price per square foot. So the same holds true in finance. So what we're looking at is how is your stock price relative to peers but looking at the profitability of the company? So, you know, obviously price to book is one we look at, other valuation metrics we're often hearing in the market price to earnings, price to free cash flows. Well, they're really just where your stock trading as it relates to different earnings or profitability metrics. And where is that relative to other peers?

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That's a great definition, I think the idea that was initially set out by by these academics is that we were looking at asset value, book value to talk to the relative market price, which is equities. We found so many different ways to identify or to measure value with metrics like you mentioned, like the price to earnings, the price to sales, the price to free cash flow, EV to a bit the free cash flow… You know, there's tons out there. But it all comes back to finding companies relative to their peers, like you said, seemingly attractive. And it's a lot easier, I think, to apply a value screen or a way to identify cheaper stocks when you compare with their peers, because obviously some of these metrics apply to certain sectors,

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Some apply to other sectors. Do you have any comment on that Kat?

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Well, I think that's a great point, and I think probably a perfect example is, you know, energy versus software companies. So if we get too stuck on just the absolute valuation, you might end up coming up with a portfolio that owns a whole lot of energy names and staying away from software companies.

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But at the end of the day, you can't really compare them. I mean, think about energy companies, they have a lot of debt and they're highly leveraged; whereas if you think about a software company, they're actually typically cash flow generating machines that don't have to borrow in order to boost profitability. So you would expect them to be a little bit more expensive.

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So I'll definitely reiterate that point, that relative to peers is very important when it comes to looking at valuation.

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Absolutely, and I think not only when we're talking about relative value from one sector to another, I'm going to get to that question in a second. One point I want to make is that we cannot use one single metric for all sectors. So, you know, it's fairly easy to analyze the book value of a bank, for example. But to do that for a software company which may be filled with intangible assets such as goodwill or intellectual property, it doesn't necessarily apply. So I think that just brings back the importance of having multiple metrics. So we get a broader picture. And I think those were really the strong type value ETFs, the ones that are able to combine lots of variables to avoid potential value traps because of the sector biases there. But I guess to move on to my question… First, let me actually just add something.

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Sorry, go for it. I just want to add something on that, because I think it's such a great point.

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And looking at multiple metrics, that's something I remember hearing a portfolio manager say, you know, not even just looking at different metrics, but looking at different metrics from different financial statements.

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And that really resonated with me because we've been hearing the active managers for a long time talking about price to earnings, for example, a metric, a traditional value metric we look at. But earnings can, to a degree, be manipulated by different accounting principles. And so if you compare to companies price to earnings or maybe one of them using accounting principles to reduce their earnings in order to reduce taxes payable in that year, that is fully allowed; whereas maybe some are taking a different approach and different accounting principles.

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So I love talking about, looking at different metrics and most importantly, making sure that they sort of are covered by different financial statements like the free cash flow statement that can't be impacted by different accounting principles.

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Absolutely.

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And I guess last point to that, that's in one given time period now, I think we're talking about the same person who shared this this information with us, because I remember the exact conversation. And another point was different time periods. So, you know, certain market cycles will make some metrics really significant statistically and some will just be left out. So if we go back to what happened in March, a period of super heightened volatility, some panic in the markets due to a unique health event that occurred, which is a COVID-19 pandemic, analysts forecast... So if you're using a forward metric like a forward price to earnings or forward price to sales, it's very, very hard to have trust in that actual metric because companies are removing guidance, analysts are having a much harder time to set a specific target on earnings, a specific target on sales, margins, etc. Things go out of whack. So you have to revert to other metrics once again, highlighting the benefit of using multiple instead of just using one. So definitely the one thing to consider, and I think very important as you choose what type of value mandate manager or ETF that you're that you're looking at now.

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I'm actually going to say that just made me think, well… I'm sorry if I'm jumping the gun, but, you know, value ETF or value PM.

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And I think that sort of a good segway, because something we always hear in the question we always get is the value factor tends to perform differently than, say, a value manager.

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Absolutely, and actually, well, let me get to a question I had here, which is from having worked with advisors over the past three to four years, I often hear the term value put in the same context as lower volatility, better downside protection. You know, somebody that's more conservative tends to be a value manager.

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Now, I don't think that's necessarily the case, is it?

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I think it is definitely something we hear all the time, and it's such a good point to bring up because I do think there's a big difference between an active value manager and the value factor.

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And so I think the word value is sort of used maybe a little bit more liberally with active managers or the way people describe active managers, I should say. I know something that you and I have come across is even looking at some funds in the industry and the word value is in the name. And then when we actually do factor analysis, it actually comes out to have no exposure to value. So I think the way that we've sort of heard from a security selection standpoint where value where the line itself is better downside is the idea of, from a security level standpoint, and the idea that if you think the over the thesis goes, you know, if you think a stock should be trading at ten dollars and it's trading at five, that kind of gives you a five dollar buffer for that company to see some bad news come to market. And you might not see a massive decline on the stock price because it's already trading a discount. So the idea that bad news is priced into that stock. So I think that if we're specifically thinking about value in downside, that's a very specific case. But then obviously what you and I are talking about is value from a factor standpoint.

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So, you know, maybe you can expand on that story and really like, where do you see value from a downside perspective?

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Well, I think if we look at long term, the performance of the value factor, it's very cyclical.

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So to say that it's going to be a lower beta or a lower volatility to the market, I don't think I'd be willing to go there. The one thing I would say is, though, we're obviously in a period like right now where, you know, this is a factor that's underperformed quite substantially over the past 10 years. It's a lot or even if we just take year to date, so 2020, since the beginning of the year, those stocks have been the K-shape recovery that we've been hearing about. Value stocks have been at the bottom of the K. So now when we're seeing drawdowns like we saw in September and October, values actually acting as a downside protector because they're still very cheap compared to the rest of the market. So in that sense, I absolutely agree with you where a lot of it might be priced in or baked in, in the sense that it can't get much worse for these companies right now. Which brings me to my next point, is that it has underperformed over the past 10 years. And, you know, we've heard a lot about how value has changed over time, the way that, you know, interest rate policies and the actions of central banks have kind of helped growth companies and neglected value companies. What's kind of some of the reasons that you see why values had such a hard time since, say, the great financial crisis? In fact, there hasn't been a really strong cycle over multiple years since then.

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For sure, and I think that's absolutely true and it's something we hear a lot about, but, you know, I always debate and I'm interested to hear your thoughts on this, is it that values underperform or is it the growth has outperformed? And I was reading a really interesting stat the other day, and I know they kind of go hand in hand, but what's the driver?

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Right.

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And I read a stat the other day and it was over the last 10 years, the S&P 500 has returned to 12.6%.

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Ten point five of that has come from earnings growth. And so that really got me thinking about, yes, there's definitely reasons why values underperformed. And I'm going to hand it over to you shortly to cover that.

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But I think it just got me thinking a little bit is that value has been underperforming, but the tech stocks out of the US market rate, and those are really the ones that have been driving earnings growth and have also seen valuations become more rich. Snd then value still underperformed the S&P 500, but not quite by the same margin. I know you've done a lot of research on value as well, so I'm really interested to hear your thoughts on that. But I thought I'd just quickly share that perspective as well.

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Absolutely, so I am known by many internally as being a value enthusiast and a believer that value is not dead and buried and gone. Studying finance, if you if you believe anything that you've studied and whether that's in a quantitative method methodology, looking at any academic papers, you consider that anything that deviates so substantially from the mean or the historical average eventually has to revert. Now we're talking in terms of underperformance and even valuations, you know, of a value to momentum and growth and quality and those higher priced segments of the market. It's trading at a discount that is historically low. We're talking about underperformance that has never before seen for a given period of time.

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We're talking worse than the tech bubble. So for me, at one point something is going to have to give, whether that is three months, six months, 12 months. I have no idea. But when you have an event like this, that's so how could I say… not… It's deviated so much from its historical average. Whether that's driven, obviously it's been driven. There's a reason for that. So a lot of these companies are in secular downtrends. There's less earnings growth, like you mentioned. But at some point there is a rotation in style when growth will go out of favor. Not necessarily because it's not growing faster than the market, but because maybe we're paying too much for that because, you know, for X, Y and Z reason, we were willing to pay that premium. Eventually that premium can go away. Last comment I'll make before I switch it back to you is I was reading a Financial Times article two weeks ago, and I thought it was really, really eye opening because once again, I was thinking statistically how what are the probabilities of this to go on for another couple of years? A lot of people say yes, obviously, but what they were saying in this article is that basically they took data going back to the 1800s. So they, with the help of people from Yale University, were able to find a dividend yield on stocks before we had actual financial data in 1927. And what they said is that the value factor as the way that they define it is going along cheap stocks and shorting the higher priced growth stocks. And there has never been a drawdown from a peak – this is from 2007 until now of that factor, so long value, short growth in more than two hundred years – so this is a one once in two hundred years. What's the percentage probability of that happening? It is very, very, very low. So we will not necessarily mean we're reverting back to 2007 levels. But just to have it back to normalization would mean a massive outperformance by value. So I think the statistics are on that side; now is the macro and the tailwinds and everything set up for that right now? I don't know. But the statistically speaking that seems odd. That's for sure.

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And that's such fascinating research. And I know one of the things you and I have talked a lot about is, is value going to come back? And if so, as you just made the case, revert to the mean, certainly expectation that adding some value to the portfolio could be attractive.

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But what are your thoughts in terms of catalysts, like what are you… you have mastered the finance factor investing. What are you looking for in the market to see maybe signs? You mentioned in the last two months we've started seeing the decline values and outperforming. What signals are you really watching?

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Now this is where it gets really interesting, because I think we were starting to really see some positive underlying signals, the first one just being on an absolute valuation… like we're talking it's trading at a fourth or fifth percentile of its historical value relative to the broad benchmark. So that's one thing. Check it off. It's really cheap. Second of all, we had a very strong recessionary period. We have not exited that yet. But value tends to do extremely well in an economic recovery. And we were starting to see signs of a bottoming in economic activity, whether that's on the manufacturing side, consumer spending or unemployment. It had peaked to a certain extent. So we were getting more you know… we're getting closer to an early cycle than to still being at the bottom of the recession. So that's a second point. Third point, yields had bottomed. So if you looked at the 10 year yield in the US, it had seemingly been slowly creeping up for the past couple of months. Now, the elections have obviously brought somewhat of a halt to that because I think the expectations were maybe for a stronger Democratic wave, which would have brought on a lot more fiscal stimulus. And if obviously the House of Representatives, and I'm not going to get into politics was definitely not my cup of tea, but we've seen that over the past three days. So we're November 5th today. The past couple of days have been really, really strong for growth companies and tech companies. So it's kind of pushed that back a little bit. So in pair with the yields bottoming, we also had forward inflation rates starting to rise quite substantially. And that's usually a very good environment for value stocks. So we had the five year forward inflation rate creeping towards two percent in the US, which the historical average is at two point two. We were getting back close to historical average. So value stocks having underperformed so much, that would have been a good time for it to play catch up a little bit. And then lastly, you know, for us to really, I think, be outside of this whole COVID-19 environment was a vaccine. So I think if we have news on a vaccine, the reopening stocks, which tend to be the current value stocks, I think would have done quite well. Now, once again, I just remain to the fact that I would never recommend to anyone to say sell your growth by value. I think it's an aspect of diversification as well. And I think that's where I'll ship it back over to you unless you have any quick comments on indicators you've seen; is that value a great diversifier too, what's expensive right now in the market.

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And that's what we're seeing, right? We just recently saw flows for US ETF flows in the US, typically Canadian flows are following and I think something that we often forget about is talking about factors.

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A lot of the passive indices do have a factor tilt. Nasdaq, for example, people buy ETFs to track the Nasdaq. It's done exceptionally well. It's been a great place to be. But what you don't necessarily realize, or maybe you do, you have a significant overweight to momentum and growth. The S&P 500, frankly, is the same. And so what we've seen in the last month is both starting to go to value. And I think it's exactly what you said. It's not so much making a call that value is going to come back, but it's hedging that position.

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And as you mentioned, taking that sort of value, momentum barbell approach has historically led to barely any drawdowns or capital losses. So I think it's more. Yes, there are certainly catalysts. And you perfectly cover those. But I think it's really more of a diversification story right now as we're kind of waiting. So I don't know if you have anything to add in terms of that, but certainly the value momentum pairing is what we're seeing.

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Absolutely. And we've seen it recently. So in the most recent drawdowns, like we mentioned earlier, where, you know, what's really expensive tends to snap back a little bit when we have these pullbacks in the market. But the historical diversification benefits of those two factors that you mentioned, which are very present in the in the broad indexes just by what's been performing well, like if you have a market cap weighted index, eventually you're going to be tilted to one factor or the other because of what's done well, so your weight is increasing in those companies. So right now, if it's growth and momentum, according to our data, value actually has a negative correlation of excess returns to those factors. So when one is outperforming, the other one underperforms and vice versa. So if we do have a slowdown in those segments of the market, well value is likely going to be the one outperforming. So great way to hedge out, like you mentioned, and to play a barbell on your equity side, on your equity holdings. So, yeah, I mean, Kat we're always we're almost up to twenty five minutes. We'd like to keep these nice, short and sweet. Do you have any last comments before we turn this back over?

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I think that's everything for me. I mean, we're three factors in and hopefully we've been able to give a good landscape in terms of what the factors mean, particularly for the advisors or investors on the line in terms of your portfolio and hopefully from a value standpoint know. Yes, it's been a significant underperformer for the better part of the decade, but it doesn't necessarily need to be your main alpha driver in the portfolio. But if you are overweight growth and momentum, it's been one of the top selling factors in the US and a great way to sort of hedge some of that valuation risk there. Not sure if you have anything to add there Etienne?

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Oh, yeah, I'll close it off with a thank you so much Kat, once again, for joining me here. I think we've covered really good points for all three factors so far. So high dividend, high quality, now value. I really think I like the way your angle on it, is that, you know, this is a great time to buy insurance. At the end of the day. Like, if you're looking for a way to diversify your equity, this could potentially be a great option depending on what you hold. So definitely something to keep on the radar. If we go back to a cycle like the early 2000s or even the first couple of years coming out of the great financial crisis, you know, value could be there. So keep an eye out. Thank you once again for joining us. We'll be back in a few weeks with another factor. We've got two to go. Once again, thank you, Kat.

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