ETF Exchange Podcast Episode13

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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. This is the 13th episode of the Fidelity ETF Exchange, and today's discussion is on the 2021 outlook for the Canadian ETF Industry, as well as a recap on notable trends that emerged in 2020.

Co-hosts Étienne Joncas Bouchard, Katrina Wilson and new co-host Himesh Patel note that some of the key things to look out for this year include ESG investing, sector and factor rotation to early cyclicals, as well as the headwinds for passively managed aggregate bond index ETFs.

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Hello everyone, and welcome to the first episode of 2021 of the Fidelity ETF Exchange. This is actually our 13th episode in total. I'm your host Étienne Joncas Bouchard and as always I'm joined by my co-host Katrina Wilson. Kat, how are you doing?

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Kat: I'm great. How are you. Happy 2021!.

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EJB: Thank you. Thank you. I'm doing all right.

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EJB: A little bit under the weather, but we will try to make sure that everything sounds all right, and I'm not disturbing anyone from my voice cracking up, some coughing. We'll make sure this is nice and smooth once the podcast is released. Before we get started on today's subject, which I'm really excited about, because we also have a guest which I'll be introducing soon, which we hope will become a recurring guest. Just a quick recap of the last episode we did before the end of the year in which Kat and I had the opportunity to sit down with Michael Robertson, who's a quantitative research analyst from our partners at Fidelity in Boston. He specialises in ESG investing, and that's really where the conversation went. So, it was a little bit different than usual where we're really ETF focused. And it was a really, really fun episode to record. And I probably shouldn't say this, because I love all our episodes equally, but I think it was my favourite that we've done to date. So if sustainable investing is something that's of interest to you,

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I'd definitely recommend you go back and have a listen to that episode.

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Enough with the recap. Today, we'll be doing an outlook for 2021. So I guess it's kind of the theme with most research reports coming out, with most content that's being produced right now. It's what to expect in the coming year. Obviously, we're going to focus around the ETF industry in Canada, asset allocation as well, trends to keep an eye out for and just a broad-based overlook of what we're going to be in store with markets in 2021. So giving an outlook also requires we look at what has happened in the past. So we'll definitely be reviewing some of the key notable trends of 2020.

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EJB: But before we get started, I'm very happy to welcome Himesh Patel on the show, also known as HP. We actually like abbreviations here quite a bit with EJB and HP. So Himesh is an ETF strategist at Fidelity, just like Kat and I, and he is making his ETF exchange debut as he joins us for today's episode. Himesh, welcome to the show.

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HP: Thanks, EJB. I think I like the nice ring of HP, EJB and maybe Kat, we'll have to figure out an acronym for you. Great to be on the show.

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EJB: The whole trio. Great. That's awesome. Well, thanks for being here and we're really excited to have you on to share your insights and your inputs on what can be expected in the coming year. So we're going to try to take this a little bit shorter than thirty minutes, around thirty minutes to discuss all these different trends. So let's not waste any time, and I'll open the conversation with a question for both of you. What trends or theme emerged in 2020 that you think will either continue or gain even more momentum in 2021 in the Canadian ETF or investment industry more broadly? So Kat, I'll ask you first and obviously HP chime in after that.

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Kat: So, when I think back to 2020, two trends that really stood out to me probably for personal investing reasons and things that stood out in the market were ESG and international investing. And to some degree, I think they do overlap. And we know international markets, for example, they're so far ahead of North America as relates to ESG. But I also just think there is a lot more consumer awareness around and investor awareness around ESG. But there's also so much investment management awareness around ESG, whether it's new rating agencies that have come into the space, a lot of new funds, active managers that are looking at ESG as part of their investment management process and obviously both from a theme standpoint, but also just from a standpoint of flows. We saw the march drawdown; that didn't slow ESG flows down at all. We've seen significant money flowing into international markets as well in the ETF space. So those are two trends that stood out and I think are something to watch in 2021 as well.

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HP: I agree with that. I think ESG is a big theme. And we always thought it was a big theme coming into 2020 and beyond. But I think the fact that we experienced a huge pandemic and all the volatility that we saw in the markets, I think it really just pulled forward that theme. And there's different camps with ESG, but I think we'll see a continued trend this year amongst retail investors, amongst institutional investors, which we're already seeing, and we'll see that continue into this year as well.

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HP: I think the other theme that I would talk about, and this is more broad speaking, but I want to talk about the resiliency of the ETF market. One of the biggest critiques of the Canadian ETF market has been that it hasn't really experienced a market downturn, a correction, a significant correction that we've seen. And even in the global financial crisis, going back to 2008, 2009, the market was pretty much a fifth of the size as it is today. And that was one of the biggest critiques. And it was an easy argument to make. But I think what we've seen during the Covid correction and coming out of it is the ETF market, especially in Canada, globally as well, has been extremely, extremely resilient. Just looking at some of the numbers and from a flow's perspective, I think 40 billion of flows for the year 2020 in ETFs, in Canada, is extremely outstanding. And 10 billion of that actually came in February and March, the most volatile months in the whole year. So I think what you've seen is that institutional investors, retail investors really took to the ETF as a vehicle of choice during that time period. And I think we continue seeing that going forward as well.

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Kat: I think that's such a good point, Himesh, in resilience, the ETF space for sure is something you just made me think of. Resilience of the fixed-income ETF space as well, because I think with March, a lot of people, I used to have conversations about overall tracking your in the ETF fixed-income ETF space, what will spreads look like and it really hasn't slowed anything down. So I think that's a really good point to make.

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EJB: Absolutely. I'll add the fact that I think investors are more comfortable now with ETFs than they've ever been. And that's such a great point where we've seen flows into this type of vehicle just continually increase over time. We're talking about, you mentioned since the great financial crisis, over 15 percent compounded annualised growth in AUM for Canadian ETFs, which is absolutely massive. ESG. Also, Kat, I love that point. I think we talked a lot about it with Mike Robertson in our last episode. But just becoming a bigger and bigger part of portfolio management. We're talking about it in terms of investing in specific mandates focused on ESG characteristics or using ESG characteristics for stock selection or bond selections, things like that. But just the overall incorporation of ESG into any framework in asset management seems to be definitely a strong trend. One trend I'll mention, and it caught my eye when I was looking at the year-end data for flows in the Canadian ETF industry. So HP mentioned 40 billion and it's an outstanding year, obviously. One area that had amazing growth is the multi-asset class products. So balanced products. And this is something that's been very popular in the mutual fund space, so used by advisors and investors alike for a broad exposure. Core Holdings, the classic 60-40 that we often talk about, obviously great diversification benefits with fixed income being a large chunk of that. Those types of products or ETFs increased from close to five billion in assets to now close to nine billion in assets at the end of the year, with an increase of two point seven or in inflows of two point seven billion dollars

of new assets in the year. So a really strong point. And I think this is also due not only to the increased usage from advisors, but the increase in number of DIY investors. So do-it-yourself investors that are participating in the boom of the ETF industry. So having your own discretionary trading account, you can buy these products and use them as core portfolio holdings, and just make it a lot easier for people that are maybe newer to investing or that might offer them a more complete solution for their needs. So I guess, you know, in terms of I obviously, I think that's going to continue to 2021. That's why I mentioned it. But if we look at some ot her trends, I think one thing that would be important to note is the increase or I guess the comeback of passive ETFs. So we noticed that back in 2018, 2019, passive ETFs, obviously the large chunk of the whole pie in Canadian ETFs, but their growth had somewhat slowed and we saw the rise of all these smart beta products, actively managed ETFs, but that kind of took the back seat in 2020. So how do you guys see that developing this year? More of the same? Is it going to change? Any comments you have on a management style standpoint.

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Kat: I think the more, factors are still I'll say especially relative to passive nuance/newer. I think the more education research thought leadership goes into how smart beta factors can be used in the portfolio. I think they're going to be significant drivers of portfolio management tools or alpha generators going forward. I think it's just a lot of new research and learnings since they've really come to market. So I think it might take time. I think they're starting to definitely capture some of the flows, and that's something we've seen at Fidelity. But I think that will be really important going forward.

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HP: I think the comeback of the passive ETF last year, I really attribute that to investors getting exposure to beta and looking for exposure to beta quick and easy. Right as we were coming out of the downturn, people were quickly realising that money, your money needed to be invested into the market; the passive ETF was the easy choice to do that. And I think that might continue into this year. But we might see a little bit more flows going into factor products, more thematic ETFs, multi-asset funds, just like you were mentioning, EJB. And we kind of saw that in the latter half in the U.S., in the latter half of last year, where the thematic ETFs were actually outselling the passive ETFs. So think sector ETFs, things of that nature and, typically flows in the U.S. ETF industry will lead flows in the Canadian tech industry. So we might see that trend kind of continuing into our market. But I think passive ETFs will definitely give you that core exposure with a cheap price tag on it with the exact BETA exposure that you need. But as Kat was talking about, factor ETFs with the research and thought leadership that continues to come out on these types of ETFs, we'll see that area of the market grow significantly, especially when there's a real value add proposition to be had for these kinds of exposures.

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EJB: I 100 % agree with both of you in the sense that when we hit the down, the bottom of the markets in March, the easiest way to just say I want to be invested in equity markets, like you said, adding beta, you just buy everything right. Because you don't necessarily know what will lead the market. And as we saw, there was a wide spread or divergence between the best-performing sectors, geographies, styles, with large-cap tech being at the absolute top and small-cap value being at the absolute bottom. Now that you're seeing, we're getting more into maybe an early-cycle phase of maybe other parts of the market that remain attractive while others are very well priced. So I think investors might turn towards those types of products from an equity standpoint. But I think another factor that we might not consider is the rollover in popularity or the flows that we saw into fixed income

versus equity. And most of the active ETFs that we have in Canada remain on the fixed-income side. And as investors moved away from fixed income and back into equities, with the drop that we saw in markets, naturally we saw more money go into passive. So if we have this repeat once again for 2021, where equities are still more in demand than fixed income, I think we still see that divergence now for Smart Beta, obviously still a small part of the market. But just the pure, passive and active, I think it has to do with a slight downturn in fixed income that we saw in 2020 just by investors looking for beta.

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Kat: I think that's a good point, especially as you addressed the fixed income market. I think we're going to continue to see more and more flows going to active, especially with where we are in terms of spreads yield. So that's a really good observation as it relates to it's not necessarily a passive versus active, but also just a natural bias because of the asset flows that we're seeing.

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HP: And rightfully so, the fixed-income market is so inefficient by its nature that you need to have an active angle on it, and especially in a world like today where you can't get income and you can't get yield from your fixed-income exposures, you need something active to search for that yield in the marketplace. And so we might see some of that flow temper down a little bit, especially given that we're in the early cycle of the early stages of the cycle right now. But, you know, for those that are seeking income and yield, that will still be an area of the market that will attract some flows.

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Kat: For sure. And actually, this made me think of something. I'd love to get both of your thoughts, sort of piggybacking on the idea that flows in equities have been strong, yields have been low. Obviously, anyone invested in dividends, dividend factors weren't necessarily where you wanted to be last year, despite rates coming down, the recovery in terms of 2021 themes, what are your thoughts on sort of the lags or a tailwind behind dividend factor?

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EJB: That's a great question. And I think the one. And this is a tailwind I feel that we've been talking about for such a long time and it just hasn't. And what I'm referring to here is decreasing bond yields, and just the overall mathematics of the fixed-income market seeming less and less attractive as durations increase and yields and spreads being extremely tight now, especially credit spreads, it seems like there should be demand for dividend-paying stocks, but it just hasn't materialised. It's tough to see because a lot of things are pointing in the right direction, in the sense that's one of them. That's obviously a macro tailwind. But if you look at the valuation of these companies, super cheap, we're talking in the bottom or 15th percentile of historical valuations pretty much across the board if you look geographically. So U.S., Canada, internationally. In Canada, we tend to have a bit more of a dividend bias just by the sector breakdown of our index. But if you look at U.S. dividend mandate, it seems to be well set up for an early-cycle reflation trade where you're overweight, financials, you have obviously some real estate in there that's been hit quite hard, but it looks very attractive. Now, once again, how long does it take to materialise? Do we have a rotation towards high yield? Where does this money go? I mean, it might not go here, but it seems like it should be going there at least a little bit.

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HP: I think that begs the question to look back at what really happened during that drawdown in March where we saw a bunch of these dividend-paying companies start cutting their dividends, announcing cuts to the dividends or dividend cessations. And that's what really drove a lot of the underperformance of those stocks and the dividend factor overall during that time period.

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HP: I think as we come into this year, yes, it looks good from a macro tailwind perspective; it looks good from a fundamental perspective and a valuation perspective, but these companies will eventually start doing better. And we're seeing that kind of come through through the first few weeks of this year. Financials are doing better, energy, we all know, is doing better because given the oil prices that we're seeing in the market. But as earnings come through and the fundamentals come through, I think dividend investing will come back to a certain degree because the yields you look at today, they're still yielding around four and a half to five percent gross to fees. That's a pretty attractive proposition for a low-yield environment that we're in today.

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Kat: I think we can't forget the idea that we've obviously come off a decade where growth has been a clear leader in the market. It almost seems like from a capital allocation standpoint, the markets have been rewarding those that are reinvesting in their companies from a growth standpoint versus those that are paying out in terms of dividends. So that can obviously start to be a shift that we see as well.

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HP: That's a good another good point. Buybacks. I think we'll see a lot more buybacks coming into this year as well. And that doesn't play out in dividends, but it plays out in an overall total return of a company. And typically these restrictions are now being lifted, especially in the U.S. where financials, and we'll see that happening with Canadian banks as well. So another positive.

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EJB: And it makes a lot of sense. Also, like you mentioned, HP with earnings coming back and kind of just this return to normalcy. And that also, you have to consider the return to normalcy in terms of everybody's daily lives. If we have positive views on vaccines worldwide, a reopening of the economy, a lot of the policies by these companies of stopping their dividend, just completely cutting their dividend. If earnings do recover, you're likely going to go back to a more normal dividend policy and less preservation or protection of the balance sheet. So if earnings do come back, they're going to have more flexibility to get creative and find ways to reimburse, or not reimburse, but to compensate their investors. So definitely something to watch out for in the coming year. And where I'll take the conversation next, and this was kind of one of my top ideas, the dividend stocks for the year. So what are your guys' top ideas from an asset allocation perspective that you can execute obviously with ETFs if possible. But what seems to be a good trade idea for 2021? Kat, you can go ahead and start.

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Kat: I'm still on ESG. I really don't feel as though the markets have properly priced in ESG risks and especially as rates have come down. I think we've been talking about it for a while and the impact of low rates on the quality factor and how these companies are really benefiting from low rates. We've seen a pretty significant sort of gap between how these companies are being valued, the low interest rate environment. The same holds true of ESG. ESG criteria will impact your cost of capital. And the same theory holds true that in a low interest rate environment, that's going to be even more material. I don't think the markets have priced that in, and I think that's really going to start to shine through. So as we chatted with my last podcast, I think it's something to watch. And I think the markets are not only going to start discounting companies with poor ESG ratings, but I really think they're going to start rewarding companies with positive or improving. So the ESG factor. So that's definitely number one on my list. And number two is international. I mean, especially Canadians have such a huge home bias. We've been talking about allocating outside of Canada for five, call it ten years. But it's all gone to the U.S. Trade played out. But now all of a sudden we're starting to see valuations in international markets, maybe another commodity cycle which will bode well for emerging markets. So I'm really looking at that sort of next trade outside of North America.

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HP: Sometimes the best thing to do is nothing,

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EJB: I like that.

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HP: We liked ESG last year, we liked International last year. I think I agree with you Kat. I think that continues into this year and we should definitely be thinking about allocating assets that way. So quality is my top pick right now. I think for the time being, as we come out of the bottom and we start seeing positive vaccine news, positive reopening stories, quality is where you want to be staying invested in those companies that can generate the cash flows, return that cash flow to investors in a positive manner. But as we look out to later in the year, there might be some areas of opportunity, like we talked about in dividends, like we might talk about in value stocks where it's cheap. At this point in the cycle, these stocks are trading at 13, 14 times earnings and haven't really been rewarded last year. We saw a pretty significant shift into growth and momentum last year, value kind of took a backseat. We might see that play into this year, as we've seen in the last few weeks, where value small-caps have done well, given all this positive news from the vaccine and the roll out perspective. And then as we look out later in the year, that might be a time to add a little more risk into your portfolios. So here I'm thinking momentum or maybe even high yield.

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HP: High yield, technically, will do well in markets where the equity markets are rallying. You've seen a positive backdrop but from a macroeconomic perspective, and we're kind of seeing the light at the end of the tunnel, so to speak, EJB, towards the end of the year. So maybe that might be a place to look as well.

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EJB: All right. I like all of these ideas. I think the one that we have the most, I guess it must be the most conviction because we all kind of think the same thing is going overseas, which has been a really common theme just because if you look at performance, it's been lagging for a very long time. If you look at valuations, take a broad index like the MSCI Eafe versus the S&P 500, significantly cheaper. And there's a lot of other little tailwinds, if you look at a weakening U.S. dollar, that's very good for emerging markets and it is also good for developed international markets. As we look at some research that we've done, we've looked at the correlation between a stronger euro and outperformance in the international space, and it's actually pretty strong. So we like this trend that we're seeing. This doesn't pertain to international stocks necessarily, but obviously will impact them just by the nature of being part of the global financial market, is also the result that we saw in the U.S. election where fiscal stimulus is kind of around the door and it's going to be paired with very strong monetary policy as well. So if you have kind of a loaded gun in terms of government intervention, that is, generally speaking, very good indications of early-cycle styles or sectors that will do well. So I like value as well. I don't know if this is a long-term solution as we are probably going to be in a low economic growth environment going forward. We have some of our managers that love to remind us that demographics is something that's going to hold us back for the next decade. But I think in the short to medium term, you're going to have this really strong reflation cycle. And obviously there's some signs that are pointing up and performance is only starting to show up now. So I think in the short to medium term, that's a place where you want to be. And I just don't see that much downside risk from here where it's very hard to get cheaper than it is now relative to the rest of the market. So that would be one place I'd like to be. And if you want to double down international value, so international markets are cheap and then if you look at mandates that are focused around cheap stocks, you're kind of doubling down. So that might be a good place as well.

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HP: You said it best. There's not a lot of downside to it. And I think that's the key behind it from a valuation perspective. The opportunity is definitely there.

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EJB: And I'll add to that is that we've been hearing more and more about what to expect in the next year. If there's some people think kind of what I was saying where early cycle could do well or we might just have a continuation of what's done well over the past three years, where you should maybe be looking at a barbell approach, like why not diversify from a style, from a region standpoint seems to make a lot of sense. And if you look at most value type products or funds or ETFs, they're actually very different than what we also like on the long-term quality and ESG, which is a bit more tech, a bit more health care, and if you look at value, it's more energy, industrials, basic materials. So stuff that's maybe not necessarily the strongest e-score, might be good at S.N.G. So I think combining both is a really good strategy long term for any investor.

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Kat: I think that's a good theme to remind people of is that barbell. We even hear it in fixed income. Right. Go long, Gubbi store corporate. A nice, easy way to think of diversification.

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EJB: It's a simplified way, so I guess that was the positive part. I don't want to necessarily throw anything under the bus here because obviously, depending on what your asset allocation looks like, some of these asset classes definitely makes sense in an overall portfolio. But I'm going to ask you guys a tougher question which is: what are some areas that might struggle in 2021 and what seems to be maybe not off to the right foot or once again, just probably not the absolute best place to be or that is just facing many headwinds in general? It might fight through them, but it doesn't seem to be the best setup. So HP, we'll start with you this time.

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HP: Yeah, that's a good question. I think my pick here would be low-volatility equities. And, there's definitely a case to be made to have them in your portfolio for that downside protection. But I do think on a relative basis, they will underperform going into this year and we're seeing that kind of play out in the recent trading days as well, where with all the inauguration news and Biden coming in, growth stocks have really started to come back again, value is coming back. Small caps are coming back. Low volatility last year kind of lagged. And we're seeing that continue to lag this year as well. And so for the remainder of the year, I think on an absolute basis, low-volatility stocks will provide positive returns, but relatively speaking, I think they'll underperform overall.

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Kat: I'm with HP on this one, I think that's probably the factor that doesn't have a ton of catalysts behind it. And I think as we look at what is the recovery out of Covid look like, where's capital flowing? Like I said, there just doesn't seem to be any catalyst behind it. And typically at this stage of the cycle is not necessarily, HP said it perfectly, it can still be valuable for a portfolio construction standpoint. But if you're looking at what factor is likely to lead the way or be sort of a driver of portfolio performance going forward, I don't see low vol being that at all either.

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HP: And the market's telling us that too with the renewed lockdown's that we were experiencing over the past couple of months here in Canada as well as globally; the market's kind of looking forward and out of that as we were getting the positive vaccine news. So we haven't really seen any drastic pullbacks in the market and for low-volatility stocks, that unfortunately doesn't mean that they'll do the best coming out of this.

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EJB: I'll add one thing to that low-vol point and low vol has evolved. We talked about it a bit in our episode. [When Kat and I record it, HP, you'd better listen to it, otherwise you're on the hook.] No, we basically said that low vol might change the way, what it looks like, right now we're looking at typical or we think of typical low-vol sectors, we're talking utilities, real estate, in Canada financials obviously was a big one, but that's not really what was low volatility in the past year or so. What is it going to look like when all these types of products or managers adjust themselves to what is a low beta, low-standard deviation type product and especially low earnings per share deviation type products? So maybe low vol will look a little bit different next year. Maybe it'll have a bit more tech, maybe it'll have a bit of more discretionary, some discretionary spending like retail, online retail, for example, has fallen into that bucket because people pretty much shop online for everything now. So is that now making it less volatile? But, yeah, I tend to agree that there's just not that many tailwinds behind it right now.

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Kat: I think it's also just become expensive. And I think right now, obviously significantly lower than they were a year ago even, but before the Covid drawdown there was a lot of discussion about rates have bottomed. And I think a lot of, we started to see some fixed-income money flowing to low vol and just become expensive. That's something to keep in mind as well.

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HP: EJB, somewhere in there, I think you just identified the next topic for the podcast.

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EJB: Which is?

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HP: Which is the difference in what we might seem to think is low vol or might seem to think is value. I think you're right. I think you're on the right track there with thinking about these factors a little bit differently from the historical context. A low-vol company today might not be a low-vol company next quarter or next year. And we could say the same thing about value, too. So, another interesting rabbit hole we can go down.

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EJB: I guess I'll add one. And we kind of touched on it earlier because we were talking about active fixed income versus passive fixed income. And given where we are in terms of yield, obviously looking at government bond yields. And if you look at any pure passive fixed-income product, if you're benchmarking yourself to the, if you're in Canada, the FTSE TMX universe bond, if you're in the U.S. ,U.S. aggregate bond index, it's filled with government bonds, it has high duration, and you're not getting compensated for that exceeding or expanding risk profile that's taken over over the past couple of years. So I think that those types of products, while they had an amazing year last year with a shift in the yield curve down, it's going to be a tough area to generate returns this year, I believe, from a purely passive standpoint. I think investors should potentially look at adding to those smaller asset classes that, yes, they're not attractive on an absolute basis, but on a relative basis, they're much, much more attractive, whether that be below investment grade. So high-yield bonds or if you look at other segments like leveraged loans, even corporate bonds, investment-grade corporate bonds, once again are trading at extremely tight spreads, but they're still probably a bit more attractive than pure government bonds. So, that's one area that might see a bit of difficulty. Obviously, it'll still be there for diversification benefits. If we have a downturn, likely it will do what it's supposed to. But if we're in a strong equity market type of year, it probably won't be the best return profile for that segment.

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HP: I think you're right. I think from a risk perspective, we're pretty much out of the woods for now. And it doesn't seem like there's anything on the horizon. So especially in fixed income, it might be prudent to get some exposure in some of those other asset classes, like high yield and leveraged loans and floating rate bonds, just to boost your yield, but still maintain that diversification if we do have some sort of a correction or downturn.

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EJB: Absolutely. All right, well, with that, any final words of wisdom?

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EJB: Kat, Himesh, no.

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Yes,

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Kat: I'm sticking ESG as my final word of wisdom. I think we started to see some real lags behind the trade last year, it's still underrepresented in portfolios. So that's my final word of wisdom, would be really take into account what sort of the ESG profile of your portfolio is. And I think it's a great way to get in front of new investors as well for any advisors online.

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EJB: Absolutely.

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HP: Stay invested. Look out the long term and maybe don't make any drastic changes in the portfolio.

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EJB: All right. Well, if it ain't broke, don't fix it. I like that. All right. So with that, thank you, everyone, for listening in.

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EJB: Thank you Himesh. Thank you, Kat, for joining me, as always. And see you next time.

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