Fidelity Connects

Étienne Joncas-Bouchard, ETF Strategist
Gord Thomson, Regional Vice President, Western Canada, Host

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Voiceover: Hello and welcome to Fidelity Connects — the Fidelity Investments Canada podcast — connecting you to the world of investing and helping you stay ahead.

We are joined today by ETF Strategist, Étienne Joncas-Bouchard to discuss trends he and his team are seeing in the ETF space.

You may know Étienne from the Fidelity ETF Exchange podcast series he co-hosts with Katrina Wilson. In today's podcast, he's speaking with host Gord Thomson, Regional VP Advisor Sales for Western Canada, and will share where he's been seeing the highest ETF flows this year, and take a deep dive on opportunities in the International space.

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[01:36]

Gord Thomson: Étienne, welcome.

Étienne Joncas-Bouchard: Hi Gord, how are you doing today?

Gord Thomson: Doing well. Thanks for joining us. Let's just take a step back and take a look at the ETF industry overall and how it's been performing year-to-date.

Étienne Joncas-Bouchard: Absolutely. I think that's a great place to start. What we've been seeing so far this year is actually a record year for ETFs, so obviously I'm very happy on that front as an industry player now for Fidelity. We actually entered the scene in 2018. For those of you that have been following along, we've been scaling up our product offerings. Some of the key trends we saw — I guess just with outright sales, I mentioned we're having a record year. We're close to 35 billion in positive net flows for the year, which is already way ahead of last year's, which was 28 billion, which was a previous record as well. That being said, we have seen some divergences in terms of categories that have been more popular among investors, advisors. This year we actually have equities leading the way, whereas last year fixed income had had an amazing, astounding year, especially on the active fixed income side where investors and advisors were looking for alternatives that were offering higher than benchmark yields, some diversification in terms of fixed income asset classes… That was a very popular trend last year.

As we saw one of the largest drawdowns in the history this year due to COVID-19, investors really looked to ETFs for a rebalancing tool and that's why I think equity has done so well. In March, we actually had outflows from fixed income ETFs, and then net inflows into equity mandates. That was definitely one of the key trends. From a factor standpoint is where we tend to play, so smart beta products. We also did have a rotation in terms of what's been popular. Last year was the year of low volatility mandates — products that look to have a lower beta, lower standard deviation in the broad market while staying invested 100% in equities. This year it's shifted quite a bit where we're looking at other types of factors like value, we're talking about quality mandates — which we'll touch a bit more on a bit later — but basically a little bit changed on that front as well.

The last point I will make is I think an emerging theme that we saw this year, not just because we're talking about it more, but on a performance and a risk standpoint, was the performance of high ESG-rated stocks. We've actually seen that flow through to the ETF sales where the AUM and ESG ETF has close to doubled in 2020. It's another emerging trend we're seeing in the industry.

[04:16]

Gord Thomson: Couple of follow-up questions for you, Étienne, based on what you just talked about. Number one is regarding the 35 billion, what's the split between active and passive?

Étienne Joncas-Bouchard: That's a great question. Last year we had seen actives slowly catching up. Obviously it's a much smaller portion of the total market. Most of the assets in the ETF space remain in the passively managed type format — we're talking about market-cap weighted products. Those are actually doing really well on the year. I think it was sort of by nature of how investors — once we had this drawdown I was talking about earlier — were looking for a way to rebalance and get exposure to the market without necessarily saying I want to take a specific bet or style bet on the market. Close to 75%, if not a little bit more, have gone into passively managed mandates so far this year.

[05:12]

Gord Thomson: When you look at the Fidelity Canada wind-up, I think we just passed a bit of a milestone recently, did we not?

Étienne Joncas-Bouchard: Yes, we did. We actually hit two billion in assets under management. Last December we became the fastest asset manager to hit one billion, and then in less than a year we were able to get to two billion. Thank you all of your support, for those who have participated in that. We're happy with the results and we're ready for next year when we can maybe climb into the top 10 in terms of AUM. Exciting things to come.

Gord Thomson: Great to hear. Why don't we dig into the topic at hand, which is investing international with our ETF lineup Just overall, the flows have been quite strong recently, what's the reasons behind that?

Étienne Joncas-Bouchard: I highlighted that one, I wanted to get back to it obviously. I was spending a bit of time on other points, but that has been one of the emerging trends over the last couple of months, and actually since the beginning of the year. Here, the way that we break it down at Fidelity, we actually split international and global, because global mandates usually have 40 to 50 or even more in certain cases of U.S. exposure. If we actually look just on a pure international basis — so that includes emerging markets, it includes Asia-Pacific, Europe, etc. — it's actually been a really, really strong… it garnered a lot of flows. I think there are really a few reasons for that. The outright first thing that we can look at — and this is just from a market perspective — we're talking about a much cheaper market. Since March we've had a wide divergence of performance from various sectors, regions, stockpiles, and what we've seen is that, obviously right now where we stand — this is as of October 31st so it's changed slightly over the last month, but not a ton — EAFE markets, international developed markets, are actually trading at a wide discount to the U.S. and also Canada.

I think investors' appetite for something that obviously has been trailing in terms of performance, as we saw a slow rotation begin in November where November 9th had the biggest rotation in terms of style where momentum sold off and everything that's been kind of reopening, or what falls now into the value bucket, dividend stocks, those rebounded well and the EAFE, I guess EAFE exposure or index is actually tilted toward factors. In the most recent drawdowns it's outperformed, and then when we had that little rotation beginning of November, was outperforming. For the month as a whole, international markets outperformed the U.S., which was the first time in a little while where we've seen that. There's an appetite there, I think, and it's likely going to continue as we go forward because there is also that diversification aspect that we kind of neglected over the past 3 to 5, even I'd say, 10 years as returns have been, generally speaking, much lower in that region.

We know, historically speaking, adding international will help reduce our volatility or increase our Sharpe just from a diversification standpoint, but often we tend to look at returns as the key driver there, not so much the volatility. So going all in on North America, or specifically the U.S. because Canada has been an even bigger struggle on that front, if we're invested in the S&P 500 we would have done much better than investing in MSCI EAFE for example.

That being said, when we do include it into an ACWI, for example, which combines both, so a global index, we are able to reduce our volatility. I think if we have a better return profile going forward, this strategy will definitely pay dividends, I guess, as we have some of this reflation cycle, or basically an index that's more diversified from a style standpoint I'd say.

[09:08]

Gord Thomson: A couple of follow-up questions. We actually got one from the audience and I'll jump in and ask. They were asking about the ETF flows, is there any way to distinguish between flows that are coming in from advisors, from investors and, for that matter, institutional flows?

Étienne Joncas-Bouchard: Unfortunately we do not have a methodology for that. This is just pure flows data that comes from Bloomberg, and that includes basically any creation or redemption that's made on ETFs, so it's very hard for us just to split which type of investors are pulling the weight. Unfortunately I don't really have a clear answer for that, but I'd say definitely on the retail side it's been a very strong component, especially during rebalancing. As a tool to enter the market very rapidly, to get a certain exposure really quickly and also if you were to move, say, to cash. We had a lot of investors who became a lot more conservative on the retail side, so there's also these new types of products in the ETF world called high interest savings ETFs. Those have garnered a lot of flows in the beginning of the year. Obviously we're seeing that getting deployed into the market now as there's a bit more optimism around entering this COVID-19 environment, we have positive news on a vaccine… so we're seeing outflows there, but that's been a really strong component that's been used by retail investors. The broad picture, I'd say, that pretty much everyone's participated, to what extent I'm not too sure. Sorry if I didn't answer that perfectly, but that's what I can give right now.

Gord Thomson: It's safe to assume though when you look at the pension plans that are out there and all the portfolio managers that use ETFs, it's probably quite large I would imagine.

Étienne Joncas-Bouchard: Absolutely.

[10:52]

Gord Thomson: You graphed the valuations there of Europe, Asia and the Far East, what would be the best valuation currently in those three regions?

Étienne Joncas-Bouchard: That's actually quite interesting. When we look at the S&P 500 we're talking about one country, in the TSX, whereas the EAFE, there's more than 20 geographies that encompasses this type of index. If we break it down a little bit more granular, I actually took a look at this yesterday, there are some parts compared to other regions in that space are more fairly priced, some are definitely more attractive. One that stands out is definitely the UK, we're talking about 14.4 times forward earnings. Japan is on the other side, so it's a little bit more expensive with close to 18 times forward price-to-earnings, while if we look at Europe as a whole — greater Europe, we're talking developed Europe, also emerging Europe, which is kind of Eastern Europe and those smaller countries — we're talking about 16.9 times. There's definitely some divergences there, but I think the ideal thing here is that you want a broader perspective. Making a call on one certain specific international economy is especially hard to do given the types of products available, but it also leads to, obviously, taking on some bets. I don't think in the environment that we're in right now, taking on massive bets — and this is something that we also hear from our macro team, whether that's Jurrien which I'm sure many of you have listened to through Fidelity Connects, also says maybe having some type of barbell approach from a sector region — but also style standpoint makes sense going forward. But there is definitely some divergence there.

To give some perspective, EM is actually more expensive than the UK right now. So that, once again, goes to show how many opportunities there are in Europe right now. We haven't even touched on the aspect of the cheaper U.S. dollar, which was, according to our macro team, likely to continue in the next coming months — so short term, medium, term which — will likely benefit especially emerging market economies, but also some European economies. I guess that's the thesis for international, but if we transition — and I may be stealing your thunder here a little bit, Gord — but the reason why we're here is also to talk about what are some of the ways we can invest internationally because, obviously, yes, like we said it helps diversification, there seems to be some value proposition there, but how do we do it? It's been extremely tough to do so,o we understand this domestic bias that we have as Canadian investors, where we tend to focus on North America because it's closer to home, we understand it better. If we look at what's out there in terms of products to use, I'd say the most common strategy that I see from investors and advisors in Canada is either going with an actively managed fund, or a passive index like the MSCI EAFE in ETF form. Looking at, say, the 10 year of all funds outperforming this broad benchmark, that's only 25% that have managed to outperform, and that's without considering that the index itself has been a dog over the past 10 years. So it's been a difficult thing to do.

We feel there are some great ways to invest internationally. We've identified some, not inefficiencies, but some things that stood out to tell us that not only is it hard to beat that benchmark, we actually feel that the MSCI EAFE has some inefficiencies embedded in it, and there's some problems with investing on a pure passive basis for the international space. Really, it stems from a very, very low rate environment which, obviously, if we can go back 10 years in Europe, in the European banking crisis, we had Portugal, Italy, Greece, Spain entering potential defaults on some government bonds, there's a lot of volatility and it caused the European Central Bank to lower interest rates substantially. We went from close to 4% to below 1% for almost the entirety of the curve, and now we're even talking negative rates. This is a theme that's obviously been developing over multiple years, but that's also led to certain spaces of that index to perform very well and some to be left out.

When I say that, if you're buying the whole international space with a passive product like MSCI EAFE, replicated ETF, you're buying 903 equities that have a very diverse investment profile. What we found is that in this environment stocks that — I guess I'll use the term right now because we'll get to it eventually — are avoiding zombie companies. This is something I'm sure many of you have heard of recently, is that low rates have only increased the number of firms that are able to survive due to the cheap access to capital that they have, not necessarily by strong earnings growth, but their ability to reinvest at a higher rate. So it's created huge divergence between companies that have strong balance sheets are able to generate a lot of free cash flow, and those companies that are basically in survival mode but are still a large part of that index.

[16:06]

Gord Thomson: Back to from a standpoint of flows into the industry and when you look at this space, what are the biggest selling, effectively, ETFs in this space currently that you've highlighted?

Étienne Joncas-Bouchard: It's the passive stuff. The two bigger players in Canada for ETFs are BMO and iShares. They both have their own version of the MSCI EAFE index — ZEA is the ticker for BMO and XEF would be the one for iShares. Those are the two big heavyweights, and it's invested in this index which we feel once again, that there might be some cracks, I guess, in the foundation where we don't necessarily have this problem in the U.S. If you think of the S&P 500, you're buying a passive S&P 500 product, there are some embedded inclusion criteria that you are taking on, which is somewhat of what we call a quality screen. If you think about Tesla, that announcement that it's going to be added to the S&P 500, huge news, it's the biggest inclusion that we've ever had, well it took some time. The reason why is first of all there are volume criteria, trading criteria, so it has to be very liquid, but the other thing that S&P 500 considers is you need to have positive trailing 12 month earnings and then last quarter earnings need to be positive as well. That is not something that's embedded into an index like the MSCI EAFE, where it's solely based on market cap and liquidity. So you're not basically screening out for companies that are not profitable.

[17:29]

Gord Thomson: The actual EAFE index is composed of 899 equities. So some of these zombie companies that you're talking about, effectively these ETFs, those two tickers you mentioned are like the walking dead ETFs.

Étienne Joncas-Bouchard: Exactly. The walking dead. It's crazy to think, because if you look at the underlying numbers you'd think it would be 10,-5 companies. And this is actually something for those of you that are interested in this type of stuff. We heard a lot about this when MSCI was working around a Chinese equity passive strategy… basically an index where people were saying, well, tons of these companies are not necessarily shell companies, but they're publicized as a huge industrial production company and you get there and it's like a small shop. That was kind of the little grain of salt that got me thinking. There's got to be these companies that are there that are not necessarily meeting expectations, that have an investment profile that might not be as attractive over the long term, and like I said, interest rates have only exacerbated this.

We can actually see a number as this shows up. This is obviously theoretical, but there's practical proof that this is actually the case. The percentage of unprofitable companies that find themselves in a product like ZEA, which is — no bashing on BMO at all — just we're replicating an index that exists out there so it's more on the structure of that. There's 16.7% of companies that have not turned a profit over the past 12 months. If we look at some other metrics, like the profit margin or return on equity, we're able to, with a product like the Fidelity International High Quality mandate which we haven't really talked about yet, solve some of these inefficiencies by targeting the cream of the crop in the index. Historically we've gotten a much more attractive risk return profile by investing in these companies that are perennial compounders, best-in-class in terms of their industry peers, and just have a great type of investment profile if we do believe that stocks follow earnings, obviously. It doesn't mean that the companies that aren't profitable are necessarily bad, obviously this is a situation where a lot of companies did have negative profits over the short term, but this has been the case for a little while and it's jumped to 17% this year, but it was close to 10% before COVID-19. This is they lay of the land that we have right now where if we are looking to invest internationally, but find those companies and sectors that tend to do well in this type of environment where there's low economic growth, there's low inflation, these companies are able to grow regardless of that environment. That's really what we're trying to focus on here or invest in. These are some of the key metrics, there's multiple others that we could point to that I think highlights the case for what we call high quality companies.

[20:40]

Gord Thomson: Thanks for those comments. In terms of the FCIQ, how many holdings are in that compared to the 899 would be in those passively managed ETFS?

Étienne Joncas-Bouchard: We target 100 stocks, which are rebalanced on a semi-annual basis. This is what we would call a smart beta product, or factor product. It is rebalanced systematically in the sense that this is a model that is programmed to run according to certain criteria that are established by a team of quant analysts, but also a team of fundamental analysts which say, if we want this type of exposure, these are the variables that we need to use to identify these stocks. Those variables — I won't go into details in this because it is definitely very technical — but we actually screen for three key variables for this factor; which is free cash margin — we want to look more granular than pure earnings just obviously avoid as many tax loopholes as we can —, we also use the return on invested capital — which considers debt unlike return on equity —, and lastly — and I think most importantly — the standard deviation of earnings per share. We also want companies that, throughout a market cycle, are going to be relatively steady compared to their peers. Obviously if we're going international, there might be some country risk, sector risk and things like that, but here we're trying to find those companies that have been really steady over the past five years. We're looking at standard deviation of EPS over the past five years. That's really what investors were looking for during COVID-19 is that I want to be comfortable with the stocks that I hold, I want to know that in the next 12, 24, 60 months down the road, they're still going to be able to turn a profit and be able to sell their goods and services and be a solid company versus their peers.

I think there was a flight to safety, or more stable companies, definitely on the international space especially. That's a bit of the quality factor there and, once again, the 100 stocks, and that's the framework that we have for all of our factors as well because we obviously do have the others in space like value, volatility, dividend, among others… But the quality factor has really shone, and unless we have this massive rotation where if you see interest rates rising substantially in Europe, maybe there will be an eventual rotation to value and dividend mandates. I think in the short and medium term it's very hard to see, even with the great positive news we saw from a vaccine standpoint, which actually today where the first doses of vaccines being handed out in the UK, which is a great day I think. Very positive news.

[23:22]

Gord Thomson: They're calling it V-Day in the UK right now, building off of the old way of describing the end of World War II and that type of thing. Just quickly checking in from the standpoint of the flows into FCIQ and total assets in that ETF.

Étienne Joncas-Bouchard: It's been our most popular mandate other than our global unconstrained fixed income mandate called Global Core Plus. It's actually garnered close to 250 to 300 million flows. I'm not sure of the exact number, but it's definitely been our most popular option. I think the momentum really started to kick in around May, where we saw some bank models including it into their platforms. Not to name names, but that was really a positive turn where this became a core holding into the international sleeve for those discretionary accounts. Then we saw following that up with advisor interest, and also just pure investor interest as well. I think it's definitely been a success story. We're very confident in its profile going forward, so definitely want to keep an eye on it.

[24:41]

Gord Thomson: As you know we've got a huge lineup of actively managed international mutual funds, so we have a question that came in from the audience: How do active ETFs and active mutual funds complement each other?

Étienne Joncas-Bouchard: That's a great question. I guess the case that we're making here isn't just for ETFs. What we're trying to achieve is to highlight some of the potential inefficiencies of the pure passive product, which has no consideration for anything else than market cap in a sense. An active manager that has a specific style, we have some great managers here at Fidelity, I can take one for example, the International Growth Fund managed by Jed Weiss which obviously, it says it in the name, a little bit of a growthier focus. Our quality mandate tends to fall in line with that a little bit. If we look at another mandate like the International Concentrated Equity managed by Patrice Quirion — another great manager — which is a bit more right now tilted, I think, towards value and cyclicals would be a very, very good complement to a strategy like International High Quality just because of the, first of all, sector exposures, the market cap exposures as well. We will tend to be more mid-, to large-cap where there is obviously flexibility on that standpoint. I think it just really has to come down to diversification. You don't want a smart beta product that tries to mimic what your active manager's trying to accomplish. If you hold a fund of a value tilted active manager on the international side, do not buy a value or dividend type international mandate, consider quality. Flip side, if you've got a growthier mandate maybe you want to use those smart beta products like value and dividend. It's all about balance and I think that's really the key message here, is that this should be part of a larger composition of a few holdings internationally to diversify from a style standpoint. It will allow you to have a much more stable beta, it's going to be better in terms of downside, and then still be there for the upside which is also a key thing for this mandate in particular, the high quality, which is very good on the downside as well.

[26:59]

Gord Thomson: Thanks for that. We're almost out of time, but I'll just close by saying that if anybody's interested in getting more information on this, Étienne's written a white paper. Don't worry, it's not 30 pages long, it's a nice concise three pages long white paper that Étienne has authored. Secondly, Étienne, you host a podcast, the ETF Exchange Podcast that you can access through fidelity.ca or wherever you access your podcasts. So Étienne, great job, thanks very much for joining us today, really appreciated your insight and thoughts.

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