Fidelity ETF Podcast

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Voiceover: Hello and welcome to the Fidelity ETF Exchange – powered by FidelityConnects – connecting you to the world of investing, and helping you stay ahead.

In the 22nd episode of the Fidelity ETF Exchange, co-hosts Étienne Joncas Bouchard and Himesh Patel welcome Rory Poole to the show for a discussion on Alternatives.

Rory is an Alternatives Strategist at Fidelity Investments Canada and today, Etienne, Himesh and Rory take some time to explore the different types of Alternative strategies that exist in the Canadian market place. They also look at what role Alternatives can play in a portfolio, as well as the potential for growth of Alternative strategies in the ETF space.

This podcast was recorded on September 23, 2021.

[00:01:30]

Étienne: Hello, everyone, and welcome to the Fidelity ETF Exchange. I'm your host, Étienne Joncas Bouchard, a.k.a. EJB. Joining me today, as always, is my co-host, Himesh Patel. How are you doing today, HP?

[00:01:42]

Himesh: Doing well, thank you. Finally fall. It's cold outside and very busy at work. So all is good.

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Étienne: And a bit of volatility in the markets. Get some stuff to talk about. And we actually, we're going to have a great guest on today that will help us talk about potential solutions to help manage volatility and portfolio. So I'm really excited for today. We're going to be welcoming on Rory Poole.

Rory is an alternative strategist at Fidelity Canada. In this role, he's responsible for supporting the Canadian sales team by providing expertise on Fidelity's alternatives lineup, portfolio construction ideas, as well as competitor intelligence and industry trends. So prior to this role, Rory was a senior product development analyst with Fidelity. Rory actually began his career nine years ago with Fidelity. So, Roy, you've been here a while, but we finally managed to get you on the podcast. So welcome to the show, my friend.

[00:02:35]

Rory: Thanks, guys, appreciate you having me on, and EJB and H.P., I guess I have to go by RP for this.

[00:02:42]

HP: Rolls off the tongue, rolls off the tongue

[00:02:46]

Étienne: Rolls off your tongue, indeed. Well, thank you so much for joining us. Before I get into asking you some questions, going over today's topic, I always do a little quick recap of our last session. And in that session, HP and I welcomed Cameron Chamberlain back to the show. So that was the second time that he joined us. And we had a long discussion, longer than usual. So thank you for those who bore with us. The rest of the show, we were discussing equities and more specifically regards to portfolio construction, because once again, Cam's role is really focused around portfolio strategy, how to optimize portfolios from a risk and return standpoint.

And the first time we had him on, we really broke everything down in the fixed-income space. But this most recent one, we really took a look at some of the key risk factors to consider when allocating between various equities, some comments on what are the potential issues that Cam encounters in some portfolios. Notably, one that we addressed was home bias. So we tend to invest a little bit more than what is potentially ideal in a portfolio allocation. So we discussed all the intricacies there.

And so for those who didn't have a chance to listen to that and would be interested in doing so, it is available via Fidelity connects on your favorite podcast app or on Fidelity.ca.

All right, guys, let's dive into today's topic. So given obviously our guest, Rory, is a specialist on the alternative side. You know, you guessed it. We'll be talking everything regards to the alt space and we're going to range from liquid alt mutual funds to what is an OM-Type product, what are liquid or excuse me, alternative ETFs. So we'll be identifying some key trends, best practices, most importantly, a deeper dive into how to incorporate them into portfolios. Because at the end of the day, that's why we're here, to help advisors, investors learn about portfolio construction, obviously with a tilt towards ETFs.

But definitely today, we're going to make a little step back and discuss more in depth the alt side. So before we pick your brain, Rory, my first question to you, so that the audience gets a good feel for what it is you do and who you are, can you tell us what a day in the life of Rory Poole looks like?

[00:05:05]

Rory: Sure. Thanks, EJB. I probably do a lot of stuff that's similar to what the two of you do in terms of the ETF world, but I just do it specific to Alternative's. Fidelity has entered the alternative market in a liquid form over the last year or so, launching three different solutions. And I'm there to kind of act as a little bit of a liaison or middleman, if you want to call it, between our portfolio managers, our sales folks and advisors at the end of the day. So whether it's providing perspectives on the strategies that we currently offer, helping with some education, because obviously this is a relatively new area for a lot of the retail advisory space across Canada, and providing perspectives on what the competitive landscape looks like and what the potential trajectory is moving forward. That's what I'm kind of here to do. So it's a combination of a bunch of external stuff, but as well, working on a bit of the product development side and the stuff that happens behind closed doors, as I think that we're hoping to become a big player within this area over the years to come.

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Étienne: Awesome. That's great, and I think it's a very interesting role, right, because it's quite unique in the sense that you're working really in tandem with our portfolio management team to, I guess, vehiculate, if you will, their message to our sales team and get that out. And all that to say that, I think, it brings me to my next question, which is you said education. Right? And that is a very core component in understanding, first of all, what does it mean, an alternative fund? What is an alternative strategy? It's quite new. So I think we need to lay some foundations for our audience.

[00:06:55]

Rory: Yeah, for sure, it's probably the best place to start. And what I would say to people is like, don't overthink it. The name is what it is. The alternatives are really investments that differ from that of traditional stocks, bonds or cash. So the term, I would say, itself covers a variety of different types of assets, strategies or products. And sometimes the definition of what an alternative really is or what constitutes an alternative can differ from person to person. I would say that alternatives can really be anything from certain types of financial investments, so whether that be like hedge funds or private equity, alternatives can also be more material assets like precious metals, even art or wine you could probably consider to be an alternative. I think the commonality across all of those things is that their value over time is not necessarily as impacted by traditional financial market movements.

And there's differing degrees of that. But the point is that what they offer or where and how they choose to invest is something that is a little bit different from that of your plain vanilla stock or bond. And I think from an asset management perspective or in some cases even a little bit more of an academic perspective, there's really kind of five key areas of investment when it comes to alternatives nowadays, and that's hedge funds; private equity or venture capital can be looped into that as well, private credit or private debt, private infrastructure and private real estate. I would say that the art and wine example that I gave earlier is a little bit more the individual consumer or investor level, but hopefully that gives you a little bit of a synopsis in the simple sense of what alts really are.

[00:08:52]

HP: Yeah, it's kind of like a catchall bucket of nontraditional equities, fixed-income investing, I guess, right?

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Rory: Yeah, exactly, and again, the space is, as I to refer to it, it's very heterogeneous. There's a lot of different types of opportunities for investors out there, whether they be tangible or non-tangible that you could probably consider as an alternative to what you hold in a stock portfolio or what you hold in terms of a bond fund or something along those lines.

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Étienne: It's really interesting. I think one thing that sticks out to me and you mentioned is that, yes, the idea is to differentiate from those typical asset classes that make up the majority of the portfolio. So to me, what resonates is you want something that has a lower correlation to, like you said, typical financial markets. And at the end of the day, this is an asset class where I guess types of strategies that are meant to be great, diversifiers in portfolios. You named a lot of them. I want to play a quick little game with you that I built out. It's four or five questions. It's nothing. It's a true or false.

[00:10:05]

Rory: cool

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Etienne: And I want you to say true or false. Is it alternative strategy? Why or why not? Quick little recap for each. And I'll start with a couple ones that are kind of out there right now in the media: crypto currencies.

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Rory: True.

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Etienne: True. OK, perfect. You have a little quick comment on why you would argue that those are alternative investment mediums?

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Rory: I'm no crypto expert by any stretch. But in terms of Bitcoin and in terms of any of those coins that are out there, they're really seen by many as a store of value, which I think is something that's different. And to the point that you made EJB in terms of they're not products that necessarily carry a lot of, if you want to call it: sensitivity or beta relative to that of traditional stocks and bonds. And with that being the case, I'd consider them an alternative.

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Etienne: Awesome. All right. What about commodities?

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Rory: I would say physical commodities, true. I would say derivatives of commodities, true. I would say equity of commodity producers, false.

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Étienne: Good. Like that. Awesome. Real estate?

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Rory: True, for sure. One of the large areas of investment, especially as Canadians. No one's living in a rabbit hole with regards to what's going on in the Canadian real estate market and throw a pandemic into the mix and how that's changed things. Definitely think real estate and hard assets like that will always be considered an alternative.

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Étienne: Awesome, and I got one last one, and it's kind of linked to the Bitcoin thing, but, and it's also because you mentioned art previously, NFTs or non-fungible tokens.

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Rory: I guess true...

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Etienne: Is it even investible right now?

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HP: What in the world is an NFT?

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Rory: I guess true. I don't think the academics have got to that yet. But I think that in terms of if you're looking at whether it's a non-fungible token like that, I mean, I think cryptocurrency, it's not the same, but obviously it rhymes with it a little bit. And so with that being the case, I mean, your liquidity might be a little bit tough, but is it an alternative? Yeah, sure.

[00:12:41]

Étienne: Awesome. All right. Well, that's enough joking around. Thanks for doing that. That was cool, that was good. My next question now relates a bit more to the industry as a whole, because now we kind of get it. We got a good understanding of what these strategies are. What are the differences between one another. Why do you think there's been such an extraordinary growth in this industry and what's been the catalyst for this adoption among advisors and even retail investors to allocate towards these types of strategies? Because they've been around for a long time, but it seems like there's been a boom recently.

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Rory: Yeah, for sure. I think that there's a few things from my perspective that's fueled that. The first and probably the most obvious to most is this evolving macro backdrop that we see today as it relates to, in particular, traditional assets. And I think that that's kind of first and foremost. We've been pretty spoiled by a 30-year bull market in bonds with very little volatility. Many pockets of the equity market, if you think about it from a fundamental perspective, are definitely expensive, however, probably justified in some senses by lower rates. But I think institutional participants, when it comes to alternatives, have really led the charge for years. They've been well ahead of the curve when it comes to almost looking on a forward-looking basis, kind of looking at today and saying if we're faced with the environment as to which we're faced with, how do we access strategies or particular assets that are going to give us a little bit something different on a go-forward basis as it relates to risk and reward?

Another thing that I think, which is probably a little bit related to that is actually demographics, to be honest with you. With the amount of wealth and the stage of life that boomers are at nowadays, I think that they've reached the point where they're looking to protect a little bit of that wealth. And any textbook that's out there will definitely tell you that the best way to do that in a portfolio, in a simple sense, is through diversification. And that's exactly what alternatives are there to offer.

Another thing is that with all of this demand, whether it be in the institutional world or whether it be in the retail world, and layering on top of that kind of the reality of the stage we're at with respect to markets comes product innovation. Whether it's private market offerings or whether it's the new regulations that allow for alternative mutual funds, I think that the concepts around alternatives are much more easily attainable and understandable. And they're also heavily marketed, which always, I think helps to drive growth.

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HP: I liked your angle on demographics. I think that's very interesting as well. But just to dig a little deeper into one of your first comments on sort of the evolution. I think it really just stems from the fact that, like you said, we've experienced a bull market, a multiyear bull market in bond markets, a very strong equity market up until last year. And this is a period where we've seen correlations kind of go in the opposite direction between equities and fixed income and your traditional asset classes.

So alternatives really serve that point of diversification in an overall portfolio that the institutional investor was kind of ahead of the game to at first. And like you just mentioned, we're now seeing that flow through to the retail audience via advisors and investors, through the new regulations on liquid alternatives. So I think that a good follow up question is you talked about hedge funds, private market offerings and now liquid alternative products. What are some of the differences or similarities between these types of alternative strategies?

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Rory: Yeah, for sure. In terms of if you're looking at like a liquid alternative versus a hedge fund and the traditional mutual fund, there's probably a few things that you can relate or differentiate, I would say, amongst those three types of vehicles. At a high level, I'd say, liquid alternatives really take some of the strategies that have been previously available through a traditional hedge fund offering, and they provide that within the mutual fund vehicle. So if you think of traditional hedge funds versus a conventional mutual fund, the hedge fund tends to be less liquid. So the ability to buy and sell units as a limited partner tends to be on, let's call it, less-than-daily basis, whether it's monthly, weekly or quarterly or anything along those lines. They also require higher investment minimums. In most cases, if it's a private market offering, you have to be an accredited investor. And typically being an accredited investor, not only do you have to meet asset thresholds, but you also have to have a certain amount of money that the hedge fund will require in order to invest in it.

Another thing is that they have little by way of restrictions when it comes to what the strategy can and cannot do. And that could be on multiple different levels. Maybe it's related to leverage, maybe it's related to security concentration, liquidity or illiquidity. The list goes on. But I think liquid Alts kind of takes some of the leverage and shorting flexibility that you typically find within a hedge fund product, where they put some guardrails on it. And the reason being is it's now offered in a regulated instrument, being a mutual, sorry, I should say, a more regulated instrument being a mutual fund. They offer greater liquidity. So liquid alternatives are priced on a daily basis. So every day at 4:00 p.m., it strikes the NAV just like a mutual fund product, so you can buy or sell as an investor. It offers higher regulatory oversight given that it falls under national instrument 81-102, and it's a much more attractive entry point in terms of price. Most liquid alt funds, the initial investment is the same as that of a traditional mutual fund, at least at a company like Fidelity.

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Étienne: That's great, that's great answers, and I think it also gives us some insights that you mentioned, for example, is that, you know, the liquidity aspect, I think was a huge proponent also to the growth of the industry. Like, yes, there's the market dynamics, but having the access to these types of products in a mutual fund structure is amazing for the retail advisor and investor.

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Rory: Yeah, and I would just say on top of that, like, obviously there's some limitations with liquid alts because the instruments that you're actually investing in on an underlying basis have to be liquid. So intraday traded in most cases or there's maybe a small percentage of the portfolio that can be illiquid. But like you would never be able to put, for instance, private real estate or private infrastructure in a liquid alternative product, or at least we've yet to see the ability to do so because of the fact that the actual assets that they're investing in are so lumpy or they require such a long lockup period that it would not be feasible for a portfolio manager to, like, fund redemptions or put capital to work that quickly. They just don't match up.

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Étienne: or simply provide daily NAV, just assessing the value of what your basket's holding. And actually that brings me to my next point. Actually, I'll ask HP first and Rory, feel free to jump in after. We've definitely seen more growth on the fund side. How do you think we're starting to see a lot more of these strategies, maybe a little bit more simple strategies find its way through an ETF vehicle? And do you think the ETF can support these types of strategies HP, or is it you know, maybe? It depends, obviously, I think might be the answer. But what are your thoughts on the ETF vehicle to operate alt strategies?

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HP: I think it really depends. So, we look at the Canadian ETF industry and we've got about five billion dollars in, quote unquote, alternative ETFs. Now, a large share of that AUM is recently just been increased just because of the rise of these cryptocurrency ETFs, which are categorized as alternative. But this is a category that I think is very ripe for growth and has continue to grow as the ETF industry is experiencing tremendous amounts of growth this year as well. So, in terms of the underlying strategies and the liquidity of it, I think it really depends. So, for example, for some of these cryptocurrency ETFs out there, these can be relatively high compared to your traditional mutual funds. So you can pay somewhere between one percent to one and a half percent.

But one thing that we talk about with ETFs specifically, not as often, but I think something that's big for a lot of investors is the cost of trading. So, when you're talking about making markets in the underlying securities or the underlying investments in an ETF, if they're not as liquid, then you're going to be paying a spread or a difference from the market price versus the NAV. And for a lot of these alternative ETFs, those spreads can be quite significant in the range of 50 to 100 basis points. So another point five to one percent.

So the all-in cost can actually be a lot more expensive than what you might see on the cover of the vehicle. Right? So I think it really depends. But there is a lot of growth in your traditional, I guess not traditional, but your more liquid type of alternative strategies, like market-neutral strategies, like private or long/short equities. Those tend to be a lot more liquid, obviously, because the underlying securities are just equities, which is a very liquid market. And for those types of ETFs, spreads can be really tight. So I think the range really depends.

And again, this is a scenario where if you're looking at a particular ETF, you really, really need to look at what's the underlying holdings, what the ETF is, what the investment strategy is of the ETF, to understand what the all-in cost is and what the liquidity might be.

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Rory: Yeah, and I think that I would just add on to what HP just said in that the flows definitely skew within the liquid alt space towards mutual funds. I think that there's probably a few reasons behind why that's the case. But another kind of added dynamic is that this space right now is very much active. So there's not a lot of systematic or passive that's currently in there. And I can imagine, I can't speak, but I've been in conversation with before with market makers as it pertains to some of these products and the fact that there is dual directionality on them and the fact that they are active. So from a disclosure standpoint, hedging inventory can be can be tricky with some, it can be easier with others. So to your point, it really depends in terms of how that how that mosaic of different variables really factor into spreads, in particular as it pertains to the liquid alt ETFs.

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Étienne: All right. So I guess to summarize that is that it depends on what the underlying is and what the manager is trying to do with those underlyings. So, once again, I think this is an area that the ETF industry might grow going forward, especially given what you said, Rory. We're getting we're starting to see a lot more active ETFs in the marketplace, and either market makers and or asset managers getting more comfortable with that idea being the fact you don't necessarily have to disclose your holdings on a daily basis like you would in a pure, passive solution.

We've got like five minutes or so left. Guys, I want to switch the conversations really quick to portfolio construction. And Rory, I want you to, if possible, you know, give us an idea of, if you start with a balanced model or a classic portfolio that you see among many advisors, let's say a 60/40 or 50/50 allocation to equity and fixed income, what would you say is a reasonable allocation to alts? Obviously we're generalizing here because for every client is very different. But, how would you incorporate alts for, say, a large majority, a majority of investors?

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Rory: Yeah, I think that there's a line, right? Alts, generally speaking, are not meant to be big core positions within a retail investor's portfolio, especially if they are more illiquid. So more on the private market side of things. Liquid alternatives lend themselves pretty well towards that. But I think that that's the big elephant in the room these days, EJB, is the question of, OK, where does the 60/40 portfolio go from here? And what do I do as an adviser or an investor in order to adapt to that? And although it's a really understandable question, as you mentioned, based on different investor scenarios, it's very much dependent on those in terms of the advice that I would give someone.

But I think the obvious answer for many nowadays is take kind of 10 to 20 percent out of your traditional fixed-income exposure and put it into alts. And I think a lot of that just has to do with really the perceived headwinds that we may be faced on a go-forward basis as it pertains to traditional fixed income. And I think that that might work for some people, but it also probably doesn't work for many out there. I think alternatives generally carry a higher risk rating at a lot of dealers out there, whether you be in an advice setting or in a DIY setting, despite their actual volatility profile, which in many cases tends to be lower.

But it can lead to issues for an investor from a KYC perspective. So to use our example before of like a boomer who is worried about fixed income on a go-forward basis. But when you look at it from the dealer's perspective, you're actually adding risk to the portfolio just based on how the security is actually labeled. That can be tricky. So I think, honestly, if it were me right now, and this is a very broad answer, but I'd probably take equally from both. So call it 10 percent from equity and 10 percent from traditional fixed income. And the reason being is that that way you're not necessarily making a call you may or may not regret as it pertains to the two larger traditional asset classes. And with that being the case, like you're really utilizing alternatives for the way that I think that they should be utilized, which is further diversification and improving an investor's compounding potential over time. And on top of that, I would say don't use one product, use a few different types of products. So whether it be an equity long/short fund and a market neutral fund or a multi-strategy or credit long/short so that you're providing different types of exposures within that little carve out, if you want to call it, and eliminating some of the key man or key manager risk.

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HP: Yeah, that's a great point you make on risk, because I think that's first and foremost, especially when you're reallocating a 60/40 typical portfolio. I think the conversation also needs to expand to if you're considering alternatives as a sleeve in a portfolio, what are you really trying to achieve? Right? And you kind of alluded to it by saying spread it across different products or different strategies. One example I think we can all agree on is the growth of this private credit strategy in the space where because fixed-income yields are so low across the globe, this is where a lot of investors are flocking to in terms of investing their alternatives budget because you can get attractive yields.

But again, like you said, that comes with very not incremental, but additional risk in terms of the overall portfolio. So if you're trying to get that additional yield, you're obviously going to have to take a little more risk for that. Or if you're trying to reduce the volatility of the portfolio, increase the diversification. A market-neutral strategy might work in that scenario as well just because it has a very low beta, almost zero in most instances and gives you that diversification from an upside and downside perspective. So I think that's a very, very good point about talking about risk. And in the overall portfolio context.

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Rory: That's one thing that you can't paint everything with the same brush and the constant question these days of like, what do I do with a 60/40 portfolio? It's like, well, there's a ton of different things you can do with a 60/40 portfolio. It just depends on what the investor or the advisor, for that matter, or the institutional participant like. What are they looking to achieve with the fund that they're looking to invest in? What exposure within their portfolio right now are they looking to augment? Maybe they're perfectly fine with their traditional fixed-income holdings that pay them a coupon quarterly. And when the equity market goes through the floor, they're pretty steady. So, I mean, it's not necessarily a one size fits all.

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Étienne: One comment that I like that you said Rory also is, you know, maybe for you and like you said, don't treat every portfolio the same. But to take away equally from equities and fixed income is probably not a bad idea. What Himesh mentioned also earlier is, you know, some things that we've seen recently is selling fixed income because the outlook is relatively, you know, a lot of headwinds there. And then you find yourself maybe a little bit more correlated to equity markets than you found, because maybe also you haven't diversified your alt exposure and you've chosen something that might not be exactly what you're looking for.

So the last thing I'd say before we wrap it up is just make sure you know what you're buying, because they're not necessarily as simple strategies as, for example, a pure equity strategy. To understand what the portfolio manager is doing, what the objective is, I think is super important in this space, given you're taking away from those traditional asset classes. So that's my two cents. But I'll let you, Rory, with a little closing thoughts before we wrap it up.

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Rory: No, I think it's a good place to close it off. Like, due diligence is super important when it comes to these types of funds. So, whatever partner you're working with, whether it be Fidelity or anybody else out there, leverage those individuals to ensure that, especially if it's your first time getting into some of these types of products, again, that is a little bit different. And from an adviser's perspective, something difficult or could be difficult and different to explain to your investor. You want to make sure that you're kind of fully equipped in order to do so.

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Étienne: Perfect. Let's leave it at that. HP, Rory, thank you so much. Rory, we'll look forward to having you back on again. Once again. Thanks for joining us.

[00:32:40]

Rory: Anytime, guys. Thanks a lot.

[00:32:44]

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