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Hello and welcome to the Fidelity ETF Exchange, powered by FidelityConnects, connecting you to the world of investing and helping you stay ahead. This is the 16th episode of the Fidelity ETF Exchange series, and today, co-hosts Étienne Joncas Bouchard and Himesh Patel sit down to recap notable trends and headlines in the Canadian ETF industry for the first quarter of 2021.

Some of the key topics being discussed include the continued growth in the multi-asset segment, the rise in ESG ETFs, the style rotation taking place in the factor space, among others. As mentioned, this is number 16 in the ETF exchange series. So please scroll back to past episodes if you missed them. Recent episodes include a deep dive on fixed-income ETFs, a quantitative approach to ETF investing, and a five-part look at factors. Today's podcast was recorded on March 31, 2021.

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Hello, everyone, and welcome to the Fidelity ETF Exchange. I'm your host Etienne Joncas Bouchard, and joining me today is my co-host, Himesh Patel. Himesh, how are you doing?

[00:01:50]

Himesh Patel: Great as can be on this fine, rainy day in Toronto.

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Étienne Joncas Bouchard: There you go. That's good. Well, the warm weather is coming up soon. We're already starting to see the spring. We're seeing a light at the end of the tunnel of the winter, which seemed longer than usual due to this covid-19 environment. But hang on, everyone. We're almost there. For you, loyal listeners, you may have noticed we actually took a short break and took some time off between episodes here. We usually try to keep them biweekly, but it's been close to a month now. And I think it's obviously normal, as we wrapped up RSP season. It was a very busy time for everyone. So we're glad to be back.

And we're going to take this time, and I guess take advantage of it, given the day we are today. We're March 31st. We're wrapping up the first quarter of the year. So the subject for today is we're going to recap some of the notable headlines, some themes, some trends that might have emerged in the first quarter of 2021 as much from a Flow's standpoint, so what's been popular for investors, for advisors, but also from a performance standpoint. So what's worked? What hasn't worked? What are some of the ways that we can take advantage of these trends that are emerging? So I think it's going to be a good episode. I think we're going to have another twenty, twenty-five minutes. This hopefully will be good.

Before we go ahead and start with the first question, Himesh, I'm going to take a few minutes to recap what we discussed last time, which was a really great episode in which you and I hosted a very special guest here at Fidelity, Vivian Hsu, director of ETFs and Alternatives. The subject was the ins and outs of multi-asset ETFs, which are also often referred to as balanced ETFs or ETF portfolios. And as many of you know, it's a very hot ETF category these days. In fact, and we'll probably talk a little bit more about this later, but flows are totalling 1.39 billion since the beginning of the year for that class of ETFs, that type of ETF, and that's as of March 19th. So that's good for close to 20 percent of all ETF flows.

So some of the notable subjects we addressed were the various options available to investors and advisors. What are the advantages of rebalancing? What is the difference between active and passive management in an asset allocation ETF and many, many more. So if you'd like to go back and listen to that, we have it on our landing page at Fidelity.ca. We also have it on any podcast platform under the banner fidelityconnects. So Housekeeping's out of the way. Let's get to it.

[04:29]

Himesh, I'll start by asking you, if we think back to our first episode of the year in which we kind of tried to predict or look into a crystal ball and see what trends could emerge in 2021, such as ESG, multi-asset ETFs, we just mentioned, style rotations. Which one do you think has manifested itself already just three months into the year?

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Himesh Patel: That's a great question, and I think obviously a very timely question to ask given where we are on March 31st, so to speak, as a report card of what we said about three months ago. But I think essentially every single topic or trend that we thought about has kind of played out in the market.

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Étienne Joncas Bouchard: Are you saying we have a crystal ball? I mean, we're not going to share, obviously.

[00:05:21]

Himesh Patel: Let's take a let's take a moment for a pat on the back, maybe. But we did predict some of these things that happened. And one of the biggest ones was the rise in the multi-asset ETFs, like you just talked about. We launched it in January, but the industry has kind of moved that way in terms of where the flows are going. And we're seeing them, like you said, one and a half billion dollars of flows into this category. And it's a great option for investors with not a lot of assets to invest who want that diversification. That's really why this asset class is driving so much of the flows year to date. I think another one of the big trends was ESG that we talked about. And that is clearly taking the forefront of the ETF industry, the investing industry in general, with ETFs being about two billion dollars of flows into ESG ETFs this year.

And I don't think that trend is going to go away anytime soon either, which is something we took a real deep dive into in our first episode this year, as well as a couple of ones that you guys did last year. But I think one of the other biggest trends that we noticed, and you talked about this a lot, was the style rotation. So what have we seen from styles and regional rotation perspective?

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Étienne Joncas Bouchard: Absolutely, and right now, we're talking really about money flows or what are people looking to add to. Where's the money flowing? We'll get more into performance and specifics later. But I think you hit the nail on the head with pretty much every single one of these. I feel like every week you're going to hear about a new ESG ETF being launched and then being relatively popular. I'm sure that in the near future, we're going to see a combination of two of those trends, with balanced ESG ETFs, like where you're combining an ESG-themed fixed-income mandate with an ESG-Themed equity mandate or any other type of solution in the thematic environment, social or governance space. But definitely from a flow standpoint, those have been strong.

Another one that we can point to, I think, south of the border, obviously, and it's becoming more and more popular here in Canada, is the rise, or not the rise because it's been around for a while, but the continued adoption of thematic ETFs. For example, one of the most popular down in the U.S. are being a very higher type, growth mandates, technology, various segments of technology.

Just recently we had a launch of a space ETF, which includes names like John Deere, surprisingly. But anyways, I'm deviating from the point here. But those have become very popular, whether that's online betting, social sentiment. So for those of you that know of people at Barstool Sports, for example, launching their own ETF, we've entered a realm where it seems like almost anything is possible in the ETF space since the beginning of the year. But, how does that translate going forward? It's going to be very tough to tell how long these can be popular. Was it just more a function of what did well last year and the market being a little bit, or the retail investor stepping in and playing a much larger role?

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Himesh Patel: Maybe it's all the stimmy checks?

[00:08:49]

Étienne Joncas Bouchard: Exactly. That's what it is, right? It's that these are sexier ETFs, right? They sound cool. They seem to add some value, obviously, from a performance standpoint. And I'm sure they could also from a portfolio construction standpoint. But I'm deviating from the point a little bit. And I want to go back to some of the trends that we saw impact performance and where assets are currently, because these are kind of things that are emerging, and assets are being gathered here and there.

You mentioned a style rotation, a rotation from maybe moving from U.S. money being invested in the U.S. to anything ex-U.S., whether that's Canada, emerging markets, international. But there's really one I need to talk about for some reason because I get asked a lot by advisors what's happening in the fixed-income space. The fixed-income markets have been more volatile recently than they have been in a long time just because we've had a rally, I guess, in bond yields. So my question is what is your take on this? How has this impacted the ETF landscape? Obviously, the majority of fixed-income assets in the ETF space are held in passively managed fixed-income ETFs. So what's been the impact on these products?

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Himesh Patel: It's been very negative, to say the least, and we talked about this in our first episode of this year as well. I think it was pretty much common knowledge that given where we ended off last year in terms of the yield curve and where yields were, there was no place for yields to go really, but up. And obviously, nobody could have predicted the really sharp increase which we saw pretty much over a 30-day period. Really rising about 1% on the yield curve, on the U.S. 10-year yield, but it was pretty much common knowledge across the industry that yields are going up at some point in 2021.

And so those investors that positioned themselves with more actively managed fixed-income ETFs and funds did do a little bit better than, like you said, the passive ETFs because they had the ability to take lower-duration risk or go into other sectors of the market that weren't as tied to the interest rates and do better when rates rise like high-yield bonds and floating-rate bonds.

Anybody that was invested in the passive Canadian bond indices, ETFs or U.S. aggregate bond ETFs were really, really hurt just given the fact that duration on these ETFs are around 7 to 8 years. And so that was essentially a 7 to 8% negative price return, given that yields spiked about one percent.

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Étienne Joncas Bouchard: It's a tough thing to digest as an investor. And you look at your fixed-income portion of your book and obviously plays a massive role in equity corrections. Generally speaking, the long-duration trade has been the way to go. You could even say back to 30 years. If you look on an aggregate perspective, yields have been generally trending down, and this rapid rise has really exposed us to how we position ourselves relative to the yield curve and obviously relative to the asset classes that you mentioned, because there's obviously some portions of the fixed-income market that are much less sensitive to moves and interest rates.

Obviously, those that are more tied to credit spreads or not spreads, excuse me, but credit risk that are more tied to the business activity that's going on, as well as just overall financial conditions. And we really saw those asset classes shine. But unfortunately, there's just not that many assets there. So we tend to own really the kind of boring fixed income, which is a little bit more sensitive.

Would you say that there's been any rotation, and we're going back to a flow standpoint because performance, we've obviously addressed that right now. But have you seen or spoken to advisors that were looking to change the way that they were positioned based on what's moved in the short term? So maybe reducing their overall duration, maybe allocating a bit more to those other asset classes? Or is it just more, a sell-off in fixed income markets will hold, and we'll see where we are come the end of the year?

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Himesh Patel: I think it's kind of a mixed story, depends on the investor profile, where there's the risk and tolerance in terms of time horizons as well, and obviously at the stage of where they are in their investing careers. So I think those investors that have had that fixed-income exposure, and longer-duration bonds, and getting that nice yield over the last couple of years as well, have started to move into other asset classes like dividend-paying equities because they need that yield in their retirement, and they need that income to be generated from their portfolio, which in today's environment, you can get a nice solid dividend yield of about 3 to 4% relative to fixed income, which is only offering you 1½%.

And I think one of the bigger points of that is, for those investors that maybe were 60/40 portfolio investors, 60 equities, 40 fixed income, they've now had the chance to take on a little bit more risk because of the rising yields, and where we've seen equity positioning going back over the last five to seven years, predominantly in the growth area and momentum area, has now sort of repriced and rotated. So I know you have a lot of insight into what's happening here. I'm curious to see what you're thinking on that, how that rise in interest rates has impacted these equities and growth and momentum.

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Well, you kind of led me there also with the dividend story, because those mandates, any dividend-focused ETF or the majority of dividend stocks last year had a relatively weak year in terms of performance. It was a tough, very tough environment. You know, obviously with covid-19 lockdown's, a lot of companies were forced to shut their doors, protect their balance sheets, which eventually leads to keeping more cash flows in house. So you're not distributing them to shareholders. But there was a big catalyst in November with the announcement of the covid-19 vaccine from Pfizer and Bion Tech, which kind of started what you know, however you want to call it, but this kind of great early cycle rotation where the typical asset classes that tend to do well when we're in a recovering economic phase of the market, have really responded and have showed up this year. And that also speaks to overweighting equities vs. fixed income, because as we recover from an economic standpoint, that tends to lead to higher inflation, which eventually will push yields up.

But from a rotation standpoint, there's really three or four that you could point to that have manifested themselves. One of them is U.S. versus ex-U.S., large-cap versus small-cap, and then growth to value. So you've seen those. It's starting to take place. We're obviously nowhere near historical norms from either an evaluation or performance standpoint.

But how has that impacted conversations you've had with advisors in the sense that this is taking place; it might be here for a little while, at least until we get more clarity on it, on inflation globally. How do you see this playing out? Let's start with, for example, with the first one, which I think is the most talked about: it's growth to value. How has that manifested itself? What are you seeing?

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Himesh Patel: So we're definitely seeing a lot of interest and a lot of questions surrounding that. I think flows tell a really good story in terms of what is actually transpiring and how people are positioning. So the Canadian market, the Canadian ETF market, value ETFs have taken in about four hundred million dollars of flows year to date.

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Himesh Patel: And if you look down to the U.S., you add a couple of zeros to that. It's about six billion dollars of flows into value-oriented ETFs. And so I think, for most investors, you and me both put together as well, it's kind of a hard pill to swallow, to think about value as being the outperformer right now, as well as what the outlook might be. Right? Because we've been in such a great environment for growth and momentum, it's kind of hard to leave that trade and switch over and rotate. But I think as time goes on, we might continue to see this outperformance. Like you said, who knows what the future will tell us? But I think it makes, from an overall portfolio perspective, prudent sense to at least get some of that exposure to value.

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Étienne Joncas Bouchard: And another great point is diversification. After you've had a very strong, say, three- to five-year outperformance of a certain style or, in the certain case, asset class, it tends of one point you revert to the mean, or I hope you would revert to the mean in a certain way. And it doesn't necessarily mean that your growth stocks will not work anymore. From a relative standpoint, though, they might not do as well as other things which have been left out of the market. And, even from a sector standpoint, we talked about it earlier before this podcast.

You look at some of the sectors are doing well year to date from a performance standpoint, energy, financials, real estate. I mean, that's literally the opposite of what worked last year and that's worked over the past four years. Ever since 2016, when we had somewhat of a little reflation trade following the collapse in commodity prices at the end of 2015, there really hasn't been much love for those asset classes.

And obviously it was warranted because it wasn't working, and we were entering that really low, once again, low rates, low growth, which very much emphasizes the need for companies that are compounding at a higher rate. But that low correlation, asset class or not asset class, but style, that value provides versus what we've unknowingly owned more of, which is growth, because if U.S. large-cap growth was 10 percent of your portfolio three years ago, it definitely wasn't 10 percent unless you rebalanced annually or quarterly, it's definitely worth more than that.

So I think we've left ourselves a little bit less hedged to a rotation than before, unless obviously you're holding a very diversified strategy, in which case you're happy both ways. But I think that's one that really sticks out and will continue to be a hot topic. It's always been. But now we are definitely getting more questions on how to play that, and how to incorporate it into portfolios.

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Himesh Patel: And I would say it actually increased given the rise in rates, just because now when you're looking at a growth stock at a valuation rate of 1.5% versus the valuation rate of 1%, that stock looks now a little bit more expensive than it should have in the past. And that's giving more rise to more flows, even moving towards value, because these stocks are still trading at 12, 13 times earnings. You can still get really good companies, and they've shown that they can perform over the last number of months. We've seen that value as an overall factor has outperformed growth by about 10% globally. So the dispersion is definitely there. But going back to your earlier point about sectors and the cyclical rotation that dovetails into a nice little story about the U.S. versus ex-U.S. trade. Why don't you elaborate on that?

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Étienne Joncas Bouchard: Yeah, absolutely. It tends to fall into one of those things as well, where when you have a peak in markets. I think it really comes back to what you were saying in valuations. Valuations like duration, the longer duration you have or the highest valuation you have on a stock or on a fund, the more sensitive you will be to move in interest rates. You were talking about it with a growth stock. Well, if you're valuing this company heavily based on future income or future cash flows, your discount rate increases, and you're basically left with less intrinsic value now.

And if you take that from a larger geographic perspective, well, U.S. markets were a lot more expensive than international markets. So it comes back to that value, I don't want to say value to growth because you're buying an entire market. So you have a little bit of everything in there. But from an absolute perspective, it was a cheaper market, and I think that's the first domino to fall. And then if you think of emerging markets, for example, tend to benefit from a weaker U.S. dollar. We actually saw the U.S. dollar weaken in the first quarter of the year, obviously now changing a little bit. But, you know, overall was weaker.

And obviously, from a sector standpoint, you find a lot more of the lesser-liked sectors. So relative to the US, if you look at the MSCI EAFE index, for example, which is international developed markets, there's more basic materials, there's more industrials, there's also more energy slightly and there's also more financials. So you have more cyclicality embedded into your index. And naturally. And it would be the same if we look from a factor standpoint, our value factor that we have at Fidelity internationally versus the U.S., I mean, you're overweighting sectors that are already larger weights. So even in the U.S., whether you like tech or not, and you want it to be part of your framework, it's still such a large portion of that index that you can't get much lower than 15, 20%.

So those are some points. If obviously there's anything to add, please go ahead, because I know you've been doing lots of client meetings regarding this subject because there is an appetite for reducing U.S. exposure and going elsewhere.

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Himesh Patel: Yeah, there's definitely an appetite. We'll see exactly how that transpires to the remainder of this year. But I think, this begs the question, so we've identified some of these trends earlier this year, and they've clearly played out. What's your outlook for the remainder of this year? Do you still think that value, cyclicals, international?

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Étienne Joncas Bouchard: We were one for one on our calls at the beginning of the year. Now we got to do this again, the chance to mess it up. No, I'm just kidding.

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Himesh Patel: But you have to be critical of your report card.

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Étienne Joncas Bouchard: Exactly. Keep ourselves honest here. That's a good question, I think this value rotation — maybe not to the speed or the extent that we've seen so far — I think that continues to play out at least until say the end of the year, unless we have obviously notable change. And once again, we do not have a crystal ball, but there just hasn't been necessarily any catalyst to the other side. I mean, yes, inflation hasn't manifested itself, but you're getting lots of indicators saying that inflation will likely be higher in six to 12 months from now. How much of that has the market priced in? It's, obviously, impossible to tell, but given it's forward looking. But I really feel that the catalyst in place for that value rotation remains in place.

I was looking the other day at the manufacturing PMI in the U.S. and splitting it up between all the different categories. And for those of you that are unfamiliar with that report, it's a survey among manufacturers on their business activity. So as much as orders they're taking in, what's their inventory levels at? What are the prices they pay for their goods that they produce? And I looked at two categories that really struck me. The first one was the prices paid, so how much it cost to produce goods. And we found ourselves in an environment where we reduced supply substantially last year because everybody could not go to work for health reasons. And obviously, so supply was constrained. We left demand off, but now demand is creeping back up. So you've seen the price of a lot of commodities rise rapidly, which is eventually going to make its way to the price of goods.

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Himesh Patel: Falling to the consumer essentially.

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Étienne Joncas Bouchard: Exactly. And to that point, the prices paid, I guess, scorecard for on average manufacturers — and this is automakers, chemicals, every single category — it's at the highest that it's been since 2008. So the prices we're paying for goods. Now, if you look at the other factor, the customer inventory. The businesses that are buying these goods and then selling them off to customers, their inventories are at the lowest level they've been in more than 15 years.

So if you pair that with highest prices paid with the lowest inventories, you're going to have forced buying at the highest price. And it's the same thing with the housing market. I think there's maybe a little bit of room for this inflation narrative, at least for the narrative to continue to go on. But obviously, how much of that is priced in? Very difficult to tell. Anyways, I'm rambling, but I really do think value is definitely not, that rotation is not over. And from a valuation perspective, we're still bottom quartile from a historical perspective. So that's one definitely I expect will continue at least for some more time.

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Himesh Patel: And how would you position yourselves in this sort of environment, given where rates are, your inflation expectations, the outlook on cyclicals?

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Étienne Joncas Bouchard: I mean, to stay diversified. Once again, I might have a little bit of conviction on this trade, but things can change very rapidly. You've got the central bank stepping in and forcing the hand, keeping short-term rates low, and that's going to eventually calm the yield curve steepening that's happening. And you might just go back to growth. So I think the words of wisdom, and I think this may be boring to say without very strongly having conviction on one end or the other, just pairing strategies that seem to have a low correlation to each other. So if you own a growth manager on the active side well maybe pair it with some value, a value ETF, or flip side, you own value managers, add some quality or momentum or a passive indice that is more growth-tilted like the Nasdaq, for example, just keeping a diversified basket.

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Étienne Joncas Bouchard: Same thing for fixed income. I wouldn't be trying to play the duration game right now, if you want, like calling to go long or calling to go short. I think in both situations it could be more detrimental than something else. I'd probably recommend going with an active manager that's very nimble and can go into other asset classes. What about you? I've been rambling for like five, six minutes here, and I need some Himesh comments.

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Himesh Patel: No, I definitely agree. And exactly what I was trying to get to is there's no pound the table trade at the moment right now where if you buy into this asset class or this category right now, you're guaranteed to get some upside. I think the name of the game right now is making those pair trades, ensuring that your portfolios are diversified across factors, across sectors, across geographies. And that's actually where we're seeing a lot of our success as an industry where clients are now realising, yeah, maybe I have a little bit too much growth, too much U.S. exposure. And that's exactly what's happening with flows where we're seeing lots of money going into value, international ETFs, small-cap ETFs, even to some degree. So I would say, yeah, I totally agree with you, and I think the name of the game for the remainder of this year should be try to keep your volatility as low as possible because we know we're in for a pretty volatile ride for the rest of this year.

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Étienne Joncas Bouchard: It's going to be a fun ride, though, and we're going to enjoy it along the way.

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Himesh Patel: Lots to talk about

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And we're going to bring you more content. And we're going to keep doing these podcasts and try to share our insights of what we hear, what we see. I think we're going to close it off at that, Himesh. We're up to close to 30 minutes now. You know, I really liked this episode. I think it was fun. We got to talk about some stuff that was very timely as well. And once again, I think Himesh had mentioned it last episode. Feel free to reach out to us. You can find us on LinkedIn. Give us your feedback. Tell us what you want to hear about, and we'll make sure to incorporate it in our future episodes.

[00:30:18]

Himesh Patel: Tell us if we're right or wrong in our calls too.

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Étienne Joncas Bouchard: Keep us honest. All right. Well, thank you very much for joining me, Himesh. Thank you, everyone, for listening in and see you next time.

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