Fidelity Connects

From Value to Momentum: Factors at Play in 2021

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Voice over: Hello and welcome to Fidelity Connects. The Fidelity Investments Canadas podcast connecting you to the world of investing and helping you stay ahead.

Director of ETFs and Liquid Alternatives, Vivian Hsu, and Head of Quantitative Index Solutions, Bobby Barnes, join host Pamela Ritchie to talk about factor investing. They explore a variety of topics including debunking the fear of factor investing, what risks are on the horizon and when does growth kick back in?

Bobby and Vivian are seeing a lot of rotation in the factors throughout the economic cycle, and they say for 2021, value momentum and dividend factors are the top three at play this year.

But they also point out how hard it is to time the market and figure out which factors will actually outperform. They say a diversified portfolio is key.

When looking at the market, Bobby says the stay-at-home stocks are priced very high. He says we'll see a rotation in those frothy names down to the more pro-cyclical names where they are cheap. He feels this is almost a once-in-a- lifetime opportunity to buy these characteristics at these prices.

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[2:02]

Pamela Ritchie: Vivian, I'll turn to you to begin if you don't mind. I'd like you to give us a little bit of a view of what you see in terms of flows. Give us a sense of how we might want to think about portfolio construction, how things have evolved. First of all, what you're actually seeing that we might want to know on the flows front.

Vivian Hsu: Great question. Good morning everyone. Great to be here. I guess to answer that question let's start with where we ended the year 2020. 2020 - I guess even into 2021- to say the least, it's been a very eventful past 13 months. However, if you look at the ETF flow or just investment industry in general, it has really shown strong resilience through all the market volatility. Canadian ETF market ended its year on the highest note ever before, $260 billion in assets for the year 2020, more than $40 billion of inflows. Even though during the months of February-March, we've seen some volatility. However, it's really been almost a straight line up since then. We're seeing a lot of rotation within the different equity markets when we talk about factors, and there's so many factors at play here, which we'll dig into a bit more in today's webcast, but so far I would say in 2021 value momentum as well as dividend factors are the top three factors at play here. They've really done very well in all markets.

[3:56]

Pamela Ritchie: I want you to add a little bit there because we're going to go further into this with Bobby on some fronts, but just the evolution of portfolio construction using some of these factors. Just sort of sketch it out for us.

Vivian Hsu: Of course, portfolio construction always starts with [audio cuts out] and investment or financial goals are. We always talk about figuring out what your destination or where your destination is, and then find out the right path forward. When we think about portfolio construction, a lot of people think about is this particular client reaching closer to retirement, looking for some sort of downside protection, don't want to lose too much asset, or even already in retirement looking for some income supplement? That's where certain factors like dividend yield or low volatility has typically come in. That can help still give you that equity market exposure, but serve the specific needs of providing income or providing lower volatility [audio cuts out] returns. And then if you have a younger client base, then that's where your momentum or quality, these type of growthier type of factors, so these ones have done really well. So when we think about portfolio construction everyone is different. Every client is different, and that's why there's so many different types of products out there and not just equities. Fixed income help dampen the volatility even further providing stable income. All these different factors as well as asset classes added together to really put together a holistic portfolio.

[5:47]

Pamela Ritchie: That's great. Bobby, I'll ask you to add to that. We saw that slide. We might put that back up in a second. But first of all, sometimes talking about factors is almost scary for people and the portfolio construction that can use many of these factors, we need you to debunk the fear. It's not scary, right?

Bobby Barnes: That's right. I always like to demystify things by explaining it in plain English, which is that factors are just characteristics of stocks that have been found to outperform over time. Active managers, this is the way that we've been investing for quite a long time now. With the advent of factors and giving it a name basically what's happened is we've democratized access to these different characteristics where the individual investor can go out and buy a value, or a momentum, or high-quality portfolio in order to achieve this specific investment outcome, as Vivian mentioned, for their portfolios. And so, yes, the vernacular is new, but it's not something new to the investment landscape, and now more and more investors are taking advantage of having this access to such products.

[7:01]

Pamela Ritchie: The term democratizing access is something that we're hearing a lot about right now. We might come back to that later on. I want you to remind us, I can't believe we're calling this history, but about 11 months ago we went through this unbelievable disruption in the markets and obviously, in our lives. Tell us how for instance a low-vol product helped going into that, but what do you use to come back out of that trough that we saw through the end of March up until April? Explain the factors that work in each scenario.

Bobby Barnes: 2020 as you alluded to is an amazing case study, where even at the start of the year you had slowing growth globally, and then with the COVID pandemic it accelerated that and put us into a recession, probably the deepest recession that any of us have ever experienced in our lifetimes. If you look at factor performance during that period, say from the start of the year till March, these factors deliver upon their promise, where low vol, I believe, around March was actually the best performing factor, and it provided that downside protection that investors in that strategy were looking for.

Similarly momentum and quality kind of have that same attribute to them and they also outperform. But then as you mentioned, the global economic activity kind of bottomed around the March-April-May timeframe, and we've seen a reacceleration of economic activity not to prior levels, but still getting better. What we've seen is here again, factors starting to behave like they typically do when economic activity is increasing.

Where we show the economic cycles and how factors perform in each economic cycle, you'll see that historically, as we see here, on the far right we've got recession, and you asked about low vol, and you can see that low vol has the two plus signs which means it does particularly well when you're in a recessionary environment. We have since bottomed out and things are going from, still they're bad, but they're going from bad to less bad so that's indicative of an economic recovery. You see that in the far left where we call that early cycle. If I echo back to something Vivian said at the outset, you're seeing a rotation into those pro-cyclical factors that tend to do well in an economic reacceleration and hence, as the slide shows, those tend to be value and high dividend and small size.

[9:48]

Pamela Ritchie: Vivian, take us through the effect of an all-in-one because walking into that nobody knew how much we were going to need the low vol, but then also on the way back up how much we were going to need exposure to momentum and other factors.

Vivian Hsu: Exactly, as Bobby was talking about the business cycle before, and I think we're really seeing that business cycle really, the timeframe really shrunk over the past year where we really drastically went to recessionary periods, and then immediately a few months later started ramping up to early, and some people might say, depending on the country, we might even be in mid cycle now. It's really hard to time the market. It's really hard to time which factor would outperform. So that's why we [audio cuts out] factor. I think a very interesting talking point, talking about which factor outperform or underperform for what reason, but when we think about the end investor and seeing the volatility that's been happening in the market to help provide investors a more diversified type of allocation and investment solution. That's why we have the factors blended together and then with exposure to various different factors on the equity side plus the fixed income having exposure to your global, Canadian, domestic fixed income providing an all-in-one solution to help mitigate some of that drastic volatility and help make the ride a little bit easier for the investor.

[11:40]

Pamela Ritchie: That was pretty clear. There was just a couple of break-ups in your audio so we're just going to look into that quickly. I'm just going to go to Bobby for a question here. Bobby, some of the questions about where we are right now in the markets can apply to what Vivian was just talking about as well. Some will say that it is straight up from here. There's a new administration that's clearly about to pump a lot of money into the system. A lot of money already there. There are others that say it's frothy, it's concerning. How do you walk into this with factors being used to help diversify your portfolio?

Bobby Barnes: That's a great question. Ironically it's not necessarily that any one of those camps are wrong. I think you have to preface it with which pocket of the market are you looking at? So to your frothy question, there are pockets that are frothy and rightfully so. If I go back to the comment I made earlier about certain factors behaving exactly as you expected them to during the course of 2020, one of those factors would be, say, like momentum. With the stay-at-home economy, those stocks had worked for a long time, and that kind of got picked up in the momentum factor. While they worked, while the global economy was shut down, they got frothy. They are expensive. We have slide one, which we had open earlier, you can see that where the valuation of momentum compared to history is near the upper 90s. It's the 98th percentile. That's about as expensive as you can possibly get.

That being said, I think there is an environment where we are going to be reopening as 2021 progresses and we have the vaccine rollout. On top of that we've got the Fed pumping liquidity into the system. So under that backdrop what you will see is a rotation. Momentum is not likely to work because stay-at-home stocks are priced very highly. But as we get more economic reacceleration what will happen is that you will get rotation from those frothy names down to the more pro-cyclical names, which are actually cheap as we saw on that prior slide where value, and small size and high dividend. Those things are about as cheap today as they've ever been. This is almost a once-in-a-lifetime opportunity to buy those certain characteristics at these prices. So yes, I think that there's an opportunity for both camps to be right, but you have to be more specific about the pockets of the market that we're talking about.

[14:32]

Pamela Ritchie: And this really allows you to go to those specifics as you say. Vivian, I think we're all clear. Let's bring in something that Bobby just talked about there a little bit. People are concerned about the vaccine rollout. We're also talking to Canadian investors who are dealing … every country is different, what sort of risks on the horizon could factors help you invest through for instance? I'm thinking about the rollout itself which is really a discussion of growth. When does growth kick back in because we're vaccinated or however you want to look at that, but how do you protect and invest through it?

Vivian Hsu: I think we actually have seen that in the market already. If you look at the factor performance as well as the flows and sales of different equity factors in the Canadian market, we've already seen signs. There's a lot more inflow so far this year into the cheaper factors that Bobby was talking about earlier so the dividend, value, small-cap. These high-torque ramp-up recovery type of factors have already seen quite a lot of inflows as people start to rotate and transition, whether it's out of their existing high-growth names or even just to provide a bit more diversification. They are so heavily into growth, techy names or high-momentum names. There are a lot of people that we've seen where they're striving to already shift their assets, trying to diversify a little bit to get ready for the eventual economy opening up. I think market is always very much a forward-looking vehicle, and we're already seeing a lot of investors taking advantage of that.

[16:31]

Pamela Ritchie: Bobby, I'm going to go this question of the 60/40. It got batted around a bit for a while. Does that still work? [audio cuts out] How do you look at that broadly, and then how does this work when you're taking this strategy [audio cuts out]?

Bobby Barnes: Yes, sure. 60/40 is an interesting one because at the end of 2019 there was a lot of narrative around it being dead, ironically, and this kind of gets back to 2020 being a beautiful case study. With the decline in the market and the subsequent recovery, it actually highlighted the power of the 60/40. The mechanics for how that works is that the 60/40 provided you a balanced portfolio that has protection via the fixed-income piece of it on the way down. But these all-in-one solutions that are doing the 60/40 for you, the beauty of it is when you're at the bottom of the market, basically you need to rebalance the portfolio. Your 40 which is typically your fixed-income allocation is too high, and you need to own more equities. Having that all-in-one solution do that for you actually positions you to be in the right place for the economic recovery that you see on the other side of that where many markets, the TSX and the S&P 500, if you look at the performance from the trough today, it's a big number. It's north of 50%, it's quite big.

The 60/40 balanced portfolio, I like to think of it as [indecipherable] portfolio. You can set it, and it's going to do what it's supposed to do at the right times in order to provide value for the shareholder.

[18:17]

Pamela Ritchie: There's a specific question here, Bobby, about value factors being applied to Canadian equity. You kind of talked around that, but because this specific question's coming in, how effective is a value factor when applied to Canadian equity? We tend to get lumped into that reflation trade discussion a lot.

Bobby Barnes: I always like to segment things. The Canadian market, because it's very energy heavy, when you're comparing that to a global portfolio then you could just buy the cap-weighted Canadian market and participate in a global reacceleration. However, you can improve upon that participation further if within your Canadian portfolio you buy those stocks that are cheaper because value as a characteristic tends to do better in that economic backdrop where things are improving. That's kind of the way that you have to think about and decompose those two questions. If you have a mandate that allows you to allocate out of Canada and into Canada, as an example, you're making two decisions, but they're both related. The global economy is improving, so I'm going to Canada and then within Canada, the playbook from that backdrop would be an allocation to value.

[19:41]

Pamela Ritchie: Vivian, pick up on what Bobby just said. In Canada we all react to headlines that have to do with our own nation. The political landscape right now, they've got a lot of things to try to deal with. There is emotion involved in investing anyway, you might argue this is kind of an enhanced emotional moment, headlines going here and there. Based on what Bobby said to look at the Canadian investor but taking some of the Canadian emotion out of it, how does the strategy come around to helping you do that?

Vivian Hsu: That's a great question, Pamela. I think Canadian social media certainly has sort of fueled a lot of these headlines and different things happening around the world. Everyone can find out instantaneously, and so it becomes even harder to stay the course and take the emotion out of investments. What Bobby was talking about earlier when we were chatting about the 60/40, the fact that your portfolio - let's say the equity part - is doing really well. It's really hard for an investor [audio cuts out] and say, okay, I'm actually going to sell down some of my equities and buy the fixed income which is a little bit lower valuation, not providing as much return. It's very hard for an investor to do that. That's the beauty of these all-in-one 60/40 or 85/15, these type of portfolios because you have portfolio managers who are there to help you stay the course and help you make those hard-to-make decisions during the pivotal moments in the market to take the emotion out and actually make the decision to look for your long-term goal of, okay, do I want it to be 60/40? I don't want a 70/30, so to balance it back down to the 60/40, to help take the administrative work as well as the emotional stress out of it as well. That's why these wrap solutions are still so relevant in todays' market. When we look at the Canadian flows, there's a lot more money flowing into these multi-asset or balanced ETF solutions now, and you see a lot more firms coming to market providing investors various differentiated solution simply because of these benefits.

[22:24]

Pamela Ritchie: Bobby, inflation. There's no way of not talking about inflation. Some will say fuel is being added to the fire for their stimulus money. We're talking about that today. Apart from low rates, the 60/40 that you hit, how do you deal with inflation for protecting people using the right factors, making sure they're going into the strategy with inflation not in the rear-view mirror, but ahead on the road?

Bobby Barnes: The first point that I would make with regards to inflation is that where we are right now, you want inflation. We typically associate it with being a bad thing, and it erodes purchasing power over a long period of time, but right now we want to reflate the economy. The first thing to get across is that our clients should not be thinking of inflation in a negative way right now. That being said, the way that you can hedge against inflation, if you have a long-term concern about it, is actually by investing in equities. If you look back over time, over the last 50 years or so, equities are a good hedge at preserving your purchasing power in inflationary environments, and there are several ways you can use factors as a way of increasing that purchasing power. As an example, typically speaking in an inflationary environment energy tends to do quite well as a sector. And energy typically is cheaper than a broader market and that kind of dovetails into value as a way of getting into that energy exposure so that you're invested in companies that can pass along those inflationary pressures, and it kind of flows through down to … they preserve their earnings, basically the mechanics, and that ends up boosting the return of those stocks, and hence the shareholders are able to maintain their purchasing power of their assets by investing in such strategies.

[24:31]

Pamela Ritchie: I want to ask you a question about ESG, options for people who are thinking about this maybe today, but also maybe for the future. How can they make sure that they're taking into consideration companies and factors that give them exposure to ESG trends?

Vivian Hsu: I think that is a very topical point of view these days. I think everyone's talking about thematic and ESG sort of being the big trend in 2021. I guess really it started in 2020 already. When we think about ESG it will become more common. I think there's a lot of [audio cuts] how do you define ESG, what is the right definition of sustainable investing. I think that's why we've seen a lot of headlines around ESG as well. I think this will become a broader investment theme, and a lot of these companies tend to be higher quality because they think about their environmental impact, social impact as well as how their governance controls the rest of the company and its operation. These type of companies tend to be quality if you want to bucket it into an equity factor. They tend to lean towards the quality factor and that's done quite well. It helps protect on the downside. These are bigger names with strong balance sheets on their books, and these type of companies are starting to get more and more recognition in the market.

[26:22]

Pamela Ritchie: I'm just going to squeeze in another topical discussion. We've got about a minute here, Bobby, so I'll just ask you to explain Bitcoin in less than 60 seconds if you don't mind. Are you watching cryptocurrencies, really is the question and where might you incorporate them?

Bobby Barnes: Yes, we are watching the crypto market. I think the two-minute elevator pitch for why Bitcoin is its premise is that it's another way to preserve purchasing power, that phrase I used earlier. The traditional way has always been to either go into gold or, as I mentioned, equities have served that purpose over time as well. Bitcoin is something that, and crypto more broadly, is something that we're watching our eye on and I think, like a lot of people, trying to understand. But at the same time working towards ways to provide access to that should our shareholders ask for such products.

[27:23]

Pamela Ritchie: Fascinating to speak with both of you. Thank you very much for providing so many new factors and options and really just things to discuss. Bobby and Vivian, thank you and look forward to seeing you again soon.

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Thanks again and see you next time.

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