Voiceover

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

Today we're joined by Vice President of Product, Andrew Clee, to discuss what trends he saw in 2020 and what trends we could see in 2021 for ETFs and Liquid Alternatives.

According to Andrew, 2020 really highlighted why it was important to use active management as an investor, and as long as there is volatility in the markets, there is an opportunity for active managers of all investment styles.

Andrew and host Dave Bushnell, Senior Vice President of Advisor National Sales, also discuss growth and value opportunities in 2021, and major changes they've seen in ETFs.

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[01:02]

[01:41]

David Bushnell: Andrew, always good to see you.

Andrew Clee: Yeah, good to see you Dave. Thanks for having me.

[01:46]

David Bushnell: Perfect. So, I'm looking forward to a great Q&A today. Andrew, the way I think we're going to walk through this today is we're going to talk about mutual funds, we're going to talk about ETFs and we're going to talk about new and exciting alternative products. But let's start with the mutual fund landscape. Last year Andrew you and I were talking about this. We'll call it a comeback year if you will, and we've seen so many things in the media of X number of mutual funds are actively managed, don't outperform benchmarks. We've all seen these, but boy was that not the case last year. Can you really talk about what did you see in 2020?

Andrew Clee: Sure Dave. For everyone that knows my background, I come from the ETF side, but at the same time, I've always pounded the table in the sense that it's not one versus the other. It's not active versus passive. It's active and passive, and I think that was really displayed in the year of 2020 and the reason I say that is everything goes through cycles and coming from a quantitative background in nature, we always believe in mean reversions. So, when you see those SPIVA headline reports that say, "Passive vehicles have outperformed active for the past decade," that's when you start to kind of worry, saying, "Okay. Is this trend going to continue?" And then when you kind of bring it back to the business cycle, they typically last let's call it seven, eight years or ten years in more recent time if we consider the bottom March 2009 to where we saw the COVID drawdown.

But I think this really highlighted why it's important to own active management in your business. I would say this was the comeback of active management, and for everyone that went one way or the other, I think that's what points out to taking a risk of a complete isolated approach that, if you were in a passive strategy last year, your return was not nearly the magnitude of what we saw at our active suite. And similarly, in prior years it was great to be in lower cost, more strategic beta, or passive strategies when correlations were low, and volatility was down.

So, I think that's one of the key themes I see going forward for this year is look at sector dispersion from a valuation standpoint. It's absolutely bonkers right now. We have some major winners. We have some major losers, and that's where active management in your book is incredibly important because they'll be more agile, they'll turn over the portfolio a little bit more quickly than an ETF vehicle can. And those are years where you can see alpha in the 20%, 30% and even 50% plus range in some of our mandates across the board.

[04:12]

David Bushnell: Andrew, you and I were talking before this about opportunities. Last year there was to your point great dispersion, great opportunity for active stock managers. What do you make of the fact that when we have so many of our portfolio managers on this program, both value and growth, and what's really very interesting is that for years, we've sort of heard a theme out of the value camp, not a lot to buy, prices seem a little bit too high. But now not only are we seeing continued excitement from our growth managers, but I'll say new excitement from the value managers. What do you make of that?

Andrew Clee: Well, I think that's best of both worlds and kind of the stars aligning because when you hear across the board different investment style camps saying, "I love markets. I have tremendous opportunity," that's telling me that there's tremendous volatility in the market. It kind of gets back to the old adage that Warren Buffet would quote, saying "Rising tide lifts all boats, but who's going to be wearing a bathing suit when the tide goes out?" And I would almost akin that the month of March to one of the biggest tides going out that we've ever seen, and the active guys were sitting there wearing their bathing suits, where some of the passive strategies were not wearing their bathing suits, and significantly drew down with that drawdown that we saw in March and April.

[05:29]

David Bushnell: I like the analogy. I want to keep on the theme for just a second of the growth versus value. And I feel as though we saw spurts or green shoots for the value folks in Q4. There was a handful of days where we had big rotation to value assets, so I feel like the value train is trying to get started. Do you see it continually gaining momentum as we head into '21?

Andrew Clee: As long as there's volatility I think there's opportunity for all types of investment styles. I want to say the date was November 9th. I could be mistaken on that, but it was one of the first Mondays in November and we actually saw the biggest rotation in history as long as we've been tracking factors. We saw a huge mean reversion in the cyclical or the value names. The growth names gave a lot back and that trend's pretty much been in place since about November 9th. And what gets me excited is when I actually look at fund flows, there were some very interesting things that happened in 2020 that tell me that the market is divided in which way that it's going to go forward. If we kind of look at it, low-vol strategies have been in Canada for about 11 years. 2020 marked the first year that we ever saw net outflows in low-vol strategies.

So, I think that's an important thing to watch because A, a lot of them did outperform in the drawdown in March, but then they lagged on the rebound. So, they did underperform in the year. Where did that money find a home? Which I found quite interesting was actually high-quality mandates and then value mandates, and I view those very differently because value investing right now tends to focus on companies that may be more cyclical or more highly levered. And those are huge beneficiaries of the Biden win because there's a huge expectation that he's going to come with a massive stimulus package. That's in a sense very pro-cyclicality or high-leverage business. And on the other side, we see high quality which would be companies' strong balance sheets. They did tremendously well through the year 2020, specifically in the drawdown. It also tends to focus on technology names where we're actually seeing a bifurcation where we have two camps in the market that say, "Value is coming back." And then you also have flows supporting what's been working for the last three, four years, five years. So, it's interesting to see this division because I haven't seen it historically to this magnitude. It's something to watch out because I think there are two camps that are going in different directions.

And to your point, both active sides on those stock camps are excited. So, I think as long as volatility persists, taking a barbell approach to growth and value right now makes a lot of sense in the portfolio.

[08:12]

David Bushnell: Andrew, you've pivoted a little so let's continue with that into the ETF space. We've got some questions coming in. You mentioned about a rotation out of low vol. Will we see a rotation into value perhaps this year in the ETF world?

Andrew Clee: Yeah, we got glimpses of it in December. It was one of the better-selling styles within the factor realm. To be honest, the U.S. has jumped a lot more into the value space than the Canadian space. I think that's an interesting dynamic because when you look at the composition of the U.S. market, I think everyone immediately goes to energy as a Canadian as being a value sector. But when you look at the S&P 500 or the Russell 1000, the energy sector is pretty non-relevant. It kind of peaks at around 5 to 7%, got as low as 3% when we saw the energy blowout.

So, from a Canadian standpoint, I actually think U.S. value is an interesting proposition just because what you're able to achieve there is exposure to sectors that we're not heavily exposed to as a home-country bias. So, if you look at a U.S. value mandate it essentially has zero energy exposure right now, and I think as an American investor they've never had the kind of concentration that Canadians have in energy. So, they're more willing to jump into a value style from a domestic bias than we are. Similarly, if you look at Canadian value styles, that's where you're seeing the overweight to energies. It's been beat up. It hasn't really come back since the beginning of COVID. When we think about portfolio construction it's, well, how much Canadian equity exposure do I have for my clients? If the answer is, we do have that home-country bias, that's where I think you take a look to the U.S. flows and the U.S. value factor because it actually can give you the best of both worlds. You're looking at things like financials exposures which got fairly beat up, some of the more cyclical sectors with the X-energy bend on it.

[10:07]

David Bushnell: Andrew, keeping with ETFs, and you've mentioned a few trends, we did see a lot change though in the world of ETFs in 2020. Can you maybe highlight one or two that really stood out to you?

Andrew Clee: Yeah, and I think this trend is probably one of the most important ones to watch in 2021 and it sits in fixed income… the shift from passive fixed-income exposure to active fixed-income exposure. So, when you look at fund launches that happened in 2020 around the EFT side, so our ETF launches in 2020, two-thirds of those sat in the active space and the bulk of them came in fixed income. I think that's the nature of where we sit in the current market.

So just to throw some bond math to quantify the problem that we have with passive fixed-income investing is the DEX Universe Bond, which is now known as FTSE TMX Universe Bond, is probably the most widely tracked indice from a fixed-income standpoint in Canada. And we're talking billions and billions of dollars behind these types of strategies. Right now, what you're getting is a 1.25% yield to maturity, so you're not even covering inflation. Forget income tax if it's in a taxable account there. But then you're also running a duration risk of 8.2 years.

So just to put some numbers behind that, for every hundred basis point increase in yield, that means that that portfolio is going to lose roughly about 7%, which is pretty crazy to think if we're coming off the back of a 40-year bond market. And we've already seen it in the U.S., the ten-year yield on the U.S. Treasury is now back up above 1.1%. And then similarly in Canada we're hovering around 80 basis points. So, assuming that we are going to rescue the economy with more stimulus, and we see a pro-risk rally, what do bond investors do? I think this is now the environment more than ever where you do need active management.

Take for example someone like Jeff Moore and Michael Plage. Things they're investing in are not traditional fixed-income investments. It's not your normal investment grade corporate bond. It's not your Canadian government or your U.S. government. You're starting to look at sectors like asset-backed loans, floating rate income, high yield. These are the types of levers that you need to be able to deliver a positive return experience and a rise in yield environment. So, I think the industry is waking up quite quickly to the fact that passive fixed-income exposure could actually be a risk going forward rather than a tailwind.

[12:36]

David Bushnell: Interesting. It's interesting that we've obviously seen a resurgence of performance on the mutual fund side, but we're also seeing the demand of that to your point, that agile active on the ETF side as well. I was wondering if you could comment. You and I then were speaking about just the ETF universe. Do you see more entrants? I mean people always say, "My goodness, there's a lot of mutual funds in Canada," and there is. I've lost track of the number. But my goodness, there's a lot of ETFs as well. How do you see that in the coming year? Do you see more ETFs? I know we chatted about that you see a lot of ETF closures now. Can you maybe comment on how that will look for 2021?

Andrew Clee: Yeah, 2020 was interesting because it marked a record year for EFT opening, but it also marked a record year for ETF closing. What we're seeing right now is a lot of crowding in certain areas of the market. At the end of the day a passive strategy that tracks the S&P 500, I think there's probably about five or six of them that you can buy in Canada. They all do the exact same thing. They might have different features from a taxability or an MER standpoint. That space is incredibly crowded. I don't know how many more passive strategies to track the exact same underlying indices the Canadian market can take. Take a look there just because at the end of the day that's unsustainable given how crowded the space is.

Similarly, the inability to raise assets is a major concern. ETFs don't break even at low dollar values. They're lower margin type products, so scale is an important aspect of ETFs, and that's where I think when you look to partners, what is the viability or the financial strength of that company, and what does the AUM look like from a total shelf standpoint? Because no one likes to have their money returned within one year of making investment, especially if it's a taxable account. So that's what I think one of the key themes is, is we'll continue to see more closures than we have historically. And I think the new launch window outside of nichier (sic) type spaces, whether that's disruptive, active management, that starts to slow because it's really hard to compete in categories that there's existing competition in.

[14:54]

David Bushnell: Andrew, you mentioned fixed income and it's a popular [inaudible 14:57]. Can you mention where did we see the bulk of flows in '20, and where do you see those continuing into '21 for ETFs?

Andrew Clee: Yeah. In fixed income specifically, it was mandates that have flexibility. So just to throw something off, FCGB or active Global Core Plus Bond was the 25th best-selling ETF in Canada. When you look at it from that standpoint, when you see an active manager come up and start competing with the likes of passive equity flows, that's a pretty important trend to keep an eye on. Short corporates. I think there's acknowledgement that interest rates fell very, very quickly in the light of COVID and at the same time government bond yields at the short end of the curve maybe get you 20, 25 basis points. And so, some of those funds aren't even covering their management fees when you consider how low the yield is if you're a short government mandate. So, we saw huge uptake into short corporates.

By way of background, those kind of yields, 2, 2.5% with a two, so a two-and-a-half-year duration. When I look at fixed income, the first question I always ask myself is, "Is the yield covering the duration risk?" And if the answer is, they're equal or close, that means it's a breakeven proposition when yields go higher. So, bond math again. Sorry to bore you with it, but 2.5% yield, two-and-a-half-year duration, if yields go up a hundred basis points, you lose 2.5%, all else equal on the pricier bond, but then the coupon covers that loss so at least it's a net zero proposition.

I think fixed income going forward huge, huge challenge for us to manage that and that's where innovation needs to come to the market. So that could be fixed-income liquid alts that kind of address the challenge that we have in fixed income. But even in MBA or business school, the first thing that any of those corporate finance guys are taught is issue as long debt as you can when interest rates are low because when we have low interest rates, we have companies that want to issue longer-term debt which pushes out the duration of the DEX Universe. So, you actually kind of have these counterforces that are acting in opposite interest of investors and better interest of the companies that are issuing debt.

[17:19]

David Bushnell: Interesting. Andrew, we got a neat question coming in here which says you talked about fixed-income risks going forward. What products is Fidelity offering that will alter this risk while keeping KYC compatible? Very important second part to the question.

Andrew Clee: Yeah. I think from a low-risk perspective the area you need to kind of be looking is short corporates. That could be on a mutual fund side, a short-term Canadian bond. On the ETF side it's short-term corporate FCSB. In the fixed-income space, I touched a little bit about it, the Global Core Plus mandate or the Multi-Sector Bond Currency Neutral on the mutual fund side. Those are the areas that I would be looking, and I think it comes down to the fact that volatility might be here to stay and that you need someone that has flexibility in the mandate.

So, when you look at a passive structure, there is no flexibility. It will track the index that it's designed to track. So, if a new issuer issues a bond, they are a forced buyer of that bond. If a bond gets removed from the index, they are a forced seller of that bond. There is no area for movement. Whereas if you go into the active space for example, these mandates which we rate low to medium on Multi-Sector and Global Core Plus, but at some dealers they may be medium. That's really giving you the best of both worlds, where they can go into high yield when it's opportunistic. They can go out of it when they need to and similarly, they can go for inflation hedges like real return bonds or floating rate if yields are climbing higher.

[18:58]

David Bushnell: We want to move on to ESG, Andrew. We're getting a bunch of questions in and the thing I was hoping you could reflect on for us, you spend a lot of time with our London office, and to paint with a big brush, the UK or Europe in general is very advanced in the ESG world. You spend a lot of time with our FMR office. Where do you see ESG? I think it's here to stay. We all know that. But is it coming with the force that it is in Europe? Is it maybe a little slower such as we've seen in the U.S.? Where do you see Canada falling in this ESG flow?

Andrew Clee: I think we're somewhere in the middle Dave to be honest. Scandinavia was the hottest out the gates with it. You saw Norway ban investments on the pension plan side and energy-related companies. Surprisingly enough it's almost table stakes in Europe now across the whole region if you will, and that comes from an institutional standpoint but also a retail standpoint. So, we're already seeing regulatory reform at the UK regulator level that's going to mandate that each fund discloses where it sits on the ESG spectrum regardless of whether it's a dedicated ESG strategy or not. That's from an investor awareness standpoint that they're starting to ramp it up there.

If I look south of the border, while the dollar values are significantly higher than Canadian dollar values, on a per capita basis we're punching a little bit above our weight compared to the U.S. So, where do we fit in it? I think we're somewhere in the middle. Ahead of the U.S. as a percentage of flows or opportunities standpoint. Whereas we're still far behind Europe. But when you and I were talking about this, I think from a demographic standpoint we're a little bit closer to the European mentality than we might be to a U.S. mentality.

What did we see in Canada? Just on the ETF side alone we had never broken a billion dollars in ESG flows prior to 2020, and they posted 2 billion out of a 40 billion yearly flow in ETF space. To put that in context to percentage of total flows, ESG is starting to really pick up and when you include mutual funds in that space, I think Canada is well on its way to a trend more similar to Europe than what we're seeing down in the States.

I think that's probably one of the hot trends for 2021 is I think you'll probably see explosion in new mandates across mutual funds and ETFs. But I also think that the flows are starting to go there. And then when you look at the policy that Biden is putting forward, green energy was one of his platform mandates. I think that's going to continue, and we'll start to see a lot more talk of it even south of the border than what we've seen historically.

[21:45]

David Bushnell: Andrew, I'm curious. Do we look as a leading indicator to the institutional markets? It seems when we look at Europe that the ESG really started with institutions going that way and more worked its way to retail. Do you see the same thing happening in Canada?

Andrew Clee: Yeah, and I think that can be safe to say for any asset class. I call it the institutionalization of retail portfolios. And I think A, it's almost table stakes that you're getting reporting. Even if it's not an ESG mandate, they want to now understand what the carbon impact is. They want to know whether they're investing in ESG leaders or laggards. So, there's an awareness increase there, and then we're also seeing big dollar values in the institutional space. But I also think it's important to think about other categories which is liquid alts.

So, institutions and pension plans have been investing in alternative strategies for decades, and that was largely driven by the fact that we had a low-yield environment and they manage money very differently. They have liabilities that they need to meet in the future. So that means they have certain return targets that they need to hit. And when your universe bond is giving you 1.25% gross of tax, that's where alternatives came into the institutional space and then I think that's supported by regulatory reform when POSC said, "Hey, we're going to introduce a liquid alternatives category," and that's when we kind of democratized it to the retail investors.

Just to throw out some numbers behind it, 2019 liquid alt mutual funds sat at 6.5 billion. We ended 2020 at 13 billion, so they doubled in just one year. I think that's another major trend that we're going to see in 2021.

[23:26]

David Bushnell: I want to keep with that trend which is again that of liquid alts. To your point, very topical. I find it interesting that like Jurrien Timmer the 60-40 portfolio that we've all been brought up with and educated on there's now conversations of is there alternatives in there? Is there crypto in there? We'll come back to that question because we definitely want to hit on that before we close. My question to you Andrew is, how do alts grow, and where do you see them fitting into a portfolio?

Andrew Clee: I find it interesting because there's all types of alts and I think what we need to do a better job as an industry is educating. Where are we funding this allocation from? I broadly break it down to, is this a diversifier or is this an alpha generator, and is it correlated to the markets and is it not correlated to the broad markets? For example, there's something like market neutral and its job is to run a forecasted beta of zero. That means looking forward we want to forecast a beta of zero. You can't invest to a beta of zero historically because we can't go backwards in time, but the goal there is to let stock selection drive the return profile and nothing else. The goal is not to be correlated to the equity markets and run a beta of zero, meaning whatever the equity market does is irrelevant to this mandate. They tend to be less volatile than strategies that are correlated to broad markets. That's an area that you can look at funding from a more conservative area of the portfolio than a higher risk area of the portfolio.

And then we have what I would call as alpha generators and so take a 130-30 strategy, so like David Way's Alternative Long-Short for example. What 130-30 means, he was just recently on our webcast this week, but just as a refresher, what it means is he's going to be on average a hundred percent long exposed to equity markets. So, for our investors out there that means there is a correlation to the broad market and there is a beta to the broad market, but what we have done is given him additional tools to add alpha. So that means 30% leverage, so he can now lever up on his best ideas. We've always rated stocks fundamentally. There's certain stocks we don't like as a company. A long-only manager all they can do is not own them. I don't like that stock; I'll have a zero percent weight in it.

Similarly, now what he can do is he can actually short that name, so that's another lever that can add alpha. When I look at a mandate like that, that's almost replacing a core equity mandate in the sense I wouldn't go all in. It should be kind of like 5%, 10% of a portfolio, but you're going to take funding from an equity manager there because he will run a beta between 0.8, or 1, or 1.1 at a certain point in time depending what he's doing. But it's important to remember, when you're running a beta of 1, there is market exposure. So, if the equity market is falling, there would be an expectation that that could drop with the market but the additional levers such as short selling should buffer that volatility. So, I kind of view that as equity market exposure with a smoother ride and enhanced alpha-generating tools.

[26:39]

David Bushnell: Andrew, I've left I'll say the most topical for last and that you can't pick up a newspaper or look at any social media without seeing that Bitcoin, I'll say, is back. My goodness. A very turbulent year in 2020. It is roaring this year. What do you make of all this?

Andrew Clee: Dave, did you learn about Bitcoin in your MBA?

[27:00]

David Bushnell: No, I most certainly did not, but mine was quite a while ago. Maybe it's on the new curriculum.

Andrew Clee: What I will say is it's an emerging asset class. You saw Lagarde from the ECB this morning say it's not a currency, and it's a security that's speculative in nature. We've heard camps that akin it to digital gold. I think at this point it's going to be a headline throughout the entire year. Am I willing to bet on which direction it goes? I'm absolutely not, but we do have a webcast coming up on the 28th where Jurrien Timmer is going to lay it out.

So, from a property standpoint, it does share some similarities with gold in the sense that there is a finite supply of this. A lot of investors are starting to view it as a hedge against inflation. Where I think it differs from gold is the fact that there's no tangible thing that I can actually put my hands on. At the end of the day, gold is used in catalytic converters. It's used in HDMI. So even if the gold price drops, I know there's certain industries that will continue to use gold from a processing as a raw material input, and then there's also jewellery. So, I think from a tangibility standpoint it lacks those traits. But there is a growing camp that's arguing that this is a great hedge against inflation and it is digital gold, but the volatility profile is quite different than what we've seen in gold. Just for example this week we saw it shave off $10,000 in Canadian dollar terms in one day, so it went from $50,000 to $40,000. I don't remember the last time I saw gold drop 20% in a single day, but it is a growing camp. We're starting to see closed-end funds launched in Canada. I think that the finite supply and the market manipulation aspect in an inefficient market prevented any open-end funds from coming to the market, so remember, closed ends can trade at premiums, but they can also trade at discounts.

I think that's an important thing to watch as this continues to grow, and I think a lot of fund manufacturers there's a lot of filings with the SEC down in the U.S. to launch ETF structures. The more that you see come to the market, there is a finite supply of this, so it's one of those unique circumstances that I can't give you a great answer, but if the demand keeps going, that's supportive of prices. Jurrien is going to do a whole webcast on this coming up on the 28th of January to lay out the argument for both camps from a pros and a naysayer standpoint on the currency itself.

Ending: [29:36]

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