Fidelity Connects

Andrew Clee, VP, ETFs

Paul Ma, VP, Lead Portfolio Strategist

Glen Davidson, VP, Regional Sales Manager, Host

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

Today we welcome back Paul Ma, VP and Lead Portfolio Strategist for Fidelity based out of Boston and Andrew Clee, VP of ETFs for Fidelity Investments Canada, based out of Toronto.

Andrew and Paul are back for another conversation about Portfolio Construction and catalysts to watch for in 2021.

As a new year begins, what should investors consider for their portfolios in 2021? Paul, Andrew and host Glen Davidson - VP and Regional Manager of Sales in Ontario - go over many topics and trends including a new business cycle, the global rollout of a vaccine, cryptocurrencies, ongoing political issues in the States, and factors in equity and fixed income markets - this and many more catalysts to consider this year.

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[01:57]

Glen Davidson: So Andrew, let's begin with you. Welcome first of all and as we start 2021 what does the landscape look like today and where are you seeing flows?

Andrew Clee: Thanks, Glen. I actually think it's quite an interesting story. If we look at years past there tends to be some uniformity in flows where certain styles, whether it's passive, active, value, growth, momentum, they tend to flow together and it's more lopsided and concentrated in one style. That's usually driven by the consensus or what the forward-looking estimates look like. But I think December was quite interesting because we had two styles that are quite different than each other, both lead the flows positively. In Canada what we saw in the month of December is quality ETFs, so for example our International High Quality ETF had been performing very well all year, took in a tremendous amount of equity flows. On the other side of that is the value factor. Value investors saw a huge resurgence at the beginning of November following the election, and we saw it again yesterday. We saw value style taking a tremendous amount of outflows.

What does that say to the market? I think there's disagreement on what 2021 looks like. If I'm looking at the quality flows they're probably expecting volatility to pull back so they want to be in more defensive names, higher- quality balance sheets, whereas value is more correlated to leverage. So we're looking at highly leveraged companies here that have been beat up in 2020 and money's actually going there. So we're starting to see a bifurcation within the market in terms of where investors are taking their bets and what 2021 looks like.

[03:34]

Glen Davidson: For sure. Paul, welcome to you as well. We finally have a vaccine that's being rolled out obviously, and been a bit marred by confusion as cases continue to rise and everything. Has a new business cycle started, or has a late cycle been extended in this environment, and to what extent does yesterday's Georgia runoff impact market uncertainty right now? I see the VIX is down today, it's probably quite different than a lot of us thought might happen as the trading day opened today but please, those questions are for you.

Paul Ma: Yes, Happy New Year Glen. It's a great question. A lot of people have Georgia on their mind from yesterday and the consensus was that the market would go down 10% if Democrats take control of the Senate. Boy, was that consensus wrong because tactical short-term issues are very difficult to figure out. Instead of focusing on short-term issues like coronavirus and election, on Senate, you've got to focus on longer-term horizon like we've been talking about the last few sessions, like the business cycle. If you bring the business cycle chart up, let's refresh that a little bit. We are in early cycle right now. So what does that mean? That means that the green circle, U.S., Europe, etc. were early cycle. China's ahead of us because they're first in the coronavirus and first out. In early cycle you have a lot of stimulus from central banks, from fiscal monetary and unemployment rates are coming down a bit from the really high level and things are just recovering from recession. It's a great time to buy stock. Why is that?

So early cycle stocks really outperform bonds. In recession, you see the green, the stocks actually is negative, bond is positive. But in early cycle right now stocks really outperform bonds. So the number one thing you need to know is that buy stocks. So you have your bonds but really get out of [indecipherable] and cash and put it into stocks. On average stock market do really well. So that's the most important point. But even more important than growth versus value or small versus large.

The second thing is that during recession growth and large growth did really well versus small and value names. We think about small and value should have a catch-up trade right now. That's, in terms of style, what you want to buy and equity, small and value should be getting some of your flows. Because recession in some ways is a great cleansing mechanism. A lot of small-cap and value names actually went bankrupt like Hertz car rental; it's much cheaper to rent a car from Hertz. It's a small company but just terrible. The paperwork … if I can go to National car rental and just get a car and go. So Hertz luckily declared bankruptcy during recession, so we cleanse it away so that National and Avis car rental, a small-cap value name can double its profit by taking over Hertz car rental's business, their clients, and then do really well in early cycle if they survive. So early cycle is when small-cap names and value names survive the bankruptcy, get to take the business from their peers and do really well.

So when your client's have Georgia on their mind, they're in tactical mode, you're thinking about early cycle. They're playing chequers, you should be playing chess.

[07:06]

Glen Davidson: Very interesting. What about the fact that there was so much focus on, in many cases, very little that we had some real interesting areas that ran last year and now you read more quotes from Greenspan from around '96 or '97 about irrational exuberance. Is that a reality we're in right now?

Paul Ma: Not right now. These cycles run a long time. They're not just a short-term thing. You'll see the business cycles going through maybe six years to a decade long. The last cycle from 2009 to 2019 is a decade long and then before the grey bar a recession happened. The one before that was from 2001 to 2008. So these are long cycles. We're entering a new cycle, it takes a while for the unemployment rate to go down, for GDP to go back up. We're still doing a lot of this recovery and that's early cycle. So we're not there. The exuberance happens when the unemployment rate is at 3, 4%. This blue line here is wage inflation, wage growth, which is how much you get paid. In 2019 I bet you got paid a lot of money, congratulation, but that means that a wage inflation got to 4%. People getting paid too much. So labour market is tight, unemployment is too low so conditions are very tight so that any small crisis can tip you into recession. So we're not there. Unemployment is much higher, people are getting paid lower, etc., so we have a way to go and it'd be many, many years before we're going to have exuberance where tight labour conditions happen again.

[08:54]

Glen Davidson: That's important to know. Andrew, just expanding on Paul's comments, what are some important factors we need to consider in this environment?

Andrew Clee: I think Paul touched on it. Early cycle is value, small-cap. But I think what's important to note is also you have some other tailwinds that are supporting these. Aside from a cycle we look at mean reversion, that's something that we look at quite frequently in the quantitative space, so I'm sure many of you heard Bobby Barnes, our quantitative analyst, design a lot of our ETF strategy down in the States. In August we actually started talking about how extreme the divergence between the value and growth stocks became. We were quite heavily talking about a mean reversion opportunity for the value stocks and we saw that through much of Q4 in 2020. But I think what's important about the Georgia runoff is the implementation it has for government policy because now Biden controls the Senate which is actually quite interesting because now there's the expectation for a larger-than-expected stimulus. If you saw the moves in the market yesterday, I think that was an indication where we saw the banks severely run higher. The banks were up about 4 to 6% and they look to be running again today. Also small-caps, the Russell 2000, emerge. So we see the early cycle tailwinds for value and small-caps. We see a mean reversion opportunity and now you actually have a government policy that's also a tailwind for that. So shorter term when we're looking at the investment horizon. This is really shaping up nicely for the small-cap and the value stocks base.

[10:29]

Glen Davidson: Interesting. Paul, from an interest rate standpoint does this change peoples' views on fixed income, and based on what your answer is, does it also alter the 60/40 that we've talked about so often?

Paul Ma: No actually. I think if you get too excited … right now, first of all, there's a lot of cash on the sideline. People use that as sort of a 60/40 bond plus cash. We need to get that into equity, more cash to equity, but that being said you don't want to give up on bonds. Even though interest rate goes up bond price goes down, that's sort of the normal path. But we've seen in the last few days crazy things happen, it's going to happen this year. We cannot predict that. When everybody is freaking out, and stocks and everything else goes down, bond goes up, or core bonds that are Treasury-based goes up. The only thing that sort of protects you from getting wiped out, to give you a smoother ride. So that 60/40 is still very relevant because … if you watch Game of Thrones, U.S. Treasury or Canadian Treasury are like House Lannister. We always pay our debt. For 200, 300 years since the revolutionary war so when people freak out they would go to the safety of U.S. Treasury to make sure they are fine so that you want to have some bond in your portfolio because we're not betting on world peace.

[11:54]

Glen Davidson: And Andrew, what about from a geographic allocation? There's been a lot of interest in going more overseas through 2020 just based on what's happened recently in the U.S. Does that bring us back more to the United States? What do you think geographically for an advisor creating portfolios for clients?

Andrew Clee: I think we all have addressed the home country bias that sits in the Canadian market before where the average Canadian is tremendously overweight Canadian equity and that's been hurtful over the last decade. If we rewind from 2000 to about 2009 that was the place to be. The TSX was one of the best performing equity markets around the world. I still do agree that, when you look at valuations around the world and how markets have behaved through 2019 and 2020, the laggards are sitting overseas. That's home bias, Canadian was a big laggard last year, specifically international was a huge laggard. So when we look at the asset class returns, I think the only two negative returns in 2020 is for European equity and then oil and gas stock. So when we look at it from that standpoint, I think there is a valuation argument.

Just to touch on Paul's point about fixed income, I think it is an important part of the portfolio but I also think it's starting to change. When we look back to where interest rates are today versus where they were, I think one of the risks that you could actually see coming out later in 2021 is the threat of another taper tantrum. If we rewind back to 2016, July was kind of the low of the U.S. 10-year yield and we're sitting below that or close to those levels that we are today, just below that 1% mark. If you look at the return profile of long government bonds that happened in the second half of 2016, they were a drag on the portfolio. This is where I think you need to start looking to active management of fixed income. Fixed income ETFs took a little bit of a foot off the pedal from a flows perspective this year. They were strong but not as strong as we've seen historically. This is where I think active management can prevail in a 60/40 portfolio. So take something like Jeff Moore, Multi Sector Bond or the Global Core Plus ETF, having mandates in a fixed income space that have flexibility to move between high yield, investment-grade credit government bonds will be more important going forward because if we are facing the risk of a taper tantrum, going purely passive in that space could present some tail risk if yields do start climbing higher on the back of an economic recovery.

[14:25]

Glen Davidson: Andrew, as you talked about, active management is so important in this. Paul, here's an interesting question that came in and it really has to do with … we've got Fidelity experts, portfolio managers that are looking at asset allocation. They're looking at all sorts of things within their portfolios every minute of the day, and an advisor is creating an asset allocation program, how does an advisor balance that between what the advisor believes? What's happening within those portfolios as well, to get the best outcome?

Paul Ma: Absolutely. Asset allocation drives 90% of your performance, so it's really important getting that right. That strategic horizon is the most important sort of driver. Your client's risk profile is one where they actually freaked out during last year's crisis, they probably deserve a 40/60 portfolio, that strategic allocation. But if they actually stay with you, no panicking, 60/40 moderate portfolio might be good. If they really can handle the risk 80/20. So getting that … because staying invested is more important than getting the nitty gritty right because people who pulled out during March and April stayed in cash and tried to get back in October, November, that's when they missed out one of the biggest rallies in history. So imagine the strategic allocation, 60/40, to a client's risk profile. We believe it's the most important thing rather than getting nitty gritty whether Fidelity asset allocation is better, or your asset allocation is better … no. Getting the behavioural aspect of the clients, how they react to risk and then adjust that … a smooth ride, 20/80 stock, bonds and getting that right the most important horizon we believe.

[16:11]

Glen Davidson: Really it's a balance of the advisor having their model and the portfolio managers adjusting and looking at what the client needs, but constantly monitoring that as well. That's something that is such an important factor in this. I've got to ask … crypto is something that's, I think for some people, becoming a bit of a distraction. It's rallying tremendously. I'd love your comments on it because I know it would be unfortunate if people just decided to go all in. We've seen manias before, is this a mania or is this just a prudent consideration for asset allocation going forward? Andrew, why don't you take that one?

Andrew Clee: I think it's interesting. Classically trained investors would always say that gold is your inflation hedge, it's also a great hedge, it's a cash replacement, it's a store of value, it's an alternate currency that fits in your portfolio to hedge against recessionary risk and whatnot. Then we see the new wave of investors that are saying, okay, this is digital gold. I think it's important that we draw parallels between the two because when we look at the volatility between gold and Bitcoin, they are not similar in that sense. When I look at what happened in the month of March, Bitcoin did not behave the same way that gold did. It was actually down quite heavily in the month of March before rebounding into the end of the year. But where we are today, it's sitting at almost $50,000 Canadian. We're starting to see manufacturers scramble to launch closed-end funds. We see a couple of them here in the Canadian market. We see ETF providers down in the States that are lobbying the SEC to allow them to open Bitcoin tracking exchange traded funds. I think it's still a young asset class in the sense that it's tough to say whether this is a digital gold replacement, whether it can compete with bullion and time will tell whether that strategy is true. But it is important because I think this will be a main talking point of 2021 and a catalyst that a lot of clients will be talking about.

As you know it is a store of value and it's an acceptable form of currency in some institutions and some do not accept it, but where does it fit in the portfolio? We actually have a webcast coming up on January 28th where our very own Jurrien Timmer is going to do a tutorial and a deep dive into the asset class and whether it is in fact an asset class fitting in a 60/40. So I would say let's defer to Jurrien on that topic because I think it's still an emerging space, but it's definitely something that we do need to keep an eye on because it is going to start moving quite significantly through the year 2021 as we hear more about it.

[18:56]

Glen Davidson: Paul, let's go back to you just from a style standpoint. From an equity purchase growth, value there's a lot of talk about small-cap value going into 2021 and so on. Is it prudent for a portfolio to go specifically that direction, or what about a barbell? What about a bit of a blend [audio cuts out]?

Paul Ma: We're not recommending people go … it's just like driving, you drive slowly when you change lanes, you don't just jerk really quickly changing lanes. We want you to overweight a little bit small-cap value just to catch up to what happened early cycle, but it's a time horizon question. Over a long term horizon, 10 years, we believe technology will be a bigger part of the S&P 500 for example. So that growth we think will win out over value for the long horizon. Therefore underweight, over, you want to have a tilt to here and tilt there but not all in small value or all in large growth. Sorta tilt to small-cap, now you're here, but then have that growth because we're sitting at home talking to you from home, this is not a normal early cycle. I'm watching Netflix movie tonight, I'm ordering Amazon packages, so these large growth names of Netflix and Amazon should still do okay. Make sure that you have a little bit of both as Glen said, barbell, but tilt here and there, maybe small value tilt, but at a certain point when wage inflation starts going up … remember we got the chart with inflation, very important … as wage inflation was squeezed restaurants, factories are value names, but it wouldn't hurt the tech names. Those tech works are going to pay a lot already so therefore when that happens, when wage inflation starts going up, maybe switch back from value and small-cap back to large growth in the mid-cycle.

[20:54]

Glen Davidson: Of course, that's for an overall construction of a portfolio or as simple as certain funds that you can select like Global Growth and Value which we offer blending two different managers and also CanAm. So worth exploring those as well. Maybe a question for both of you. We'll start with you Andrew, as we look further out into 2021 and beyond, what are some of the signs in '21 that you're looking for that might indicate a rotation?

Andrew Clee: I think we need to start with the central bank activity. They've been pouring, pouring liquidity into the market. As long as that printing press is going, I think that's pro risk. It's very supportive of equities in that environment. I touched on it a little bit earlier that the risk of a taper tantrum and that kind of brings me back to nightmares of 2016 because it actually coincided with the Brexit that the taper tantrums started. So this can come out of anywhere and the market is a foreword mechanism of pricing and expectation. So it's important to remember that the yield curve will move far before the Fed makes an announcement of a rate hike or that they're withdrawing liquidity. So it will be very important to watch what's happening in the yield curve in 2021 because that's likely to be the first signal that the Fed's going to start pulling liquidity out of the market, and that's when you would start to look for rotation towards more defensive names and potentially a risk to the long bond government market in that environment. I think from an indicator that we will be closely watching it's going to be the yield curve in 2021.

Glen Davidson: I can tell you're a new father by the fact that you said temper tantrum.

Andrew Clee: Yes.

Glen Davidson: Paul, go ahead.

Paul Ma: Fed is making jobs to fight inflation, and unemployment, but fight inflation so the number to look at is really inflation number. Wage inflation, where's your CPI, core inflation … if that's going up taking out 3, 4% Fed has no choice but to raise interest rates. That's when rotation will happen as Andrew talked about to more defensive names. Absolutely that's the case. The second thing you have to watch out for is all the stimulus coming from the Biden administration, $2000 cheques or more spending infrastructure, it's not free. There's no free lunch. You're just going to pay for it with taxes. Going through the budget reconciliation process in [indecipherable] means that you've got to pay for whatever you're spending which means that taxes coming in 2022, 2023 … when that tax starts hitting, I think market will react to that as well.

[23:41]

Glen Davidson: Paul, the fact that we're Canadians … you're in the States, we're Canadians, we've got to think about what the U.S. dollar is doing to our investments right now as well. Quick comment on the U.S. dollar, please.

Paul Ma: I think all the spending means that when you print a lot of money, the money becomes less valuable. That's what inflation is. You've got to take more dollars to buy a gallon of milk or to buy a Canadian dollar. So that's really favourable to euro, for example, and yen. But Canadian dollar relies on energy, banks, those are big sectors, so you have to have those sectors do well … oil prices go up for Canadian dollar to recover its former glory, so to speak. That's sort of how Canadian dollar versus U.S. is. But definitely U.S. dollar, all this printing's not going to be good for its value, but euro and yen's the main beneficiary of that.

[24:38]

Glen Davidson: Thank you. Andrew, where do ETFs fit into all this discussion?

Andrew Clee: I think it comes back to how we construct portfolios for 2021. I like to always talk about environment [indecipherable], low cost or half the strategies do well and what active environments are favoured. If you expect a year of volatility you can just look at some of the returns that we saw from our active managers. Global Innovators posted 95% in 2020. That's largely driven by sector dispersion and stock dispersion [audio cuts out]. If you own the winners and avoid the losers you can add alpha in excess of 50% versus the benchmark. Similarly, if we expect to chug out of this recession in a fairly stable fashion, which I don't think is necessarily the case, you just want to own the S&P 500. That's when sector leadership is non-existent, rising tide lifts all boats, that's what they call it. I still think that 2021 has a fair bit of volatility ahead of it, and that's driven by the fact that we have a new White House coming in. They're talking about corporate tax reform, they're talking about stimulus packages, we have a risk that the Fed could withdraw liquidity from the market if the economy starts improving.

So that's where I look to ETFs if you are going to take a look at the smart beta or the factor space, and I think the market showed you in December taking a barbell approach between quality/momentum and value is a great idea. But I also think it should be married alongside active management because I think every CIO that we've had come on here is saying timing the market is almost impossible. So am I willing to bet my entire portfolio that I want to be 100% in ETFs? Or 100% in mutual funds actively managed? I'm not willing to make that bet, so that's where I think it makes sense that you should be considering a barbell approach because it brings the best of both worlds where you can lower the cost of the portfolio to the client experience, but you're also not putting your eggs all in one basket trying to time the market and guess where volatility is heading.

[26:36]

Glen Davidson: Thanks Andrew. And Paul, concluding comments from you.

Paul Ma: Help your client to get off the sideline. Cash in bank accounts are at a record high, at least in the U.S. So it doesn't matter if it's small-cap value … just by [indecipherable] S&P 500 or global indices, you really need to get the client comfortable to get off the sideline from cash into hopefully stocks because early cycle stocks outperform bonds by a lot. That's sort of the base case we're working off of.

[27:09]

Glen Davidson: Thanks very much, Paul. I do want you to know that the viewers do love the travel books behind you. It kind of brings us all back to a better time and that will come … one of these days we'll be able to travel again, but I appreciate both of you being here and your comments. As always to our advisors we hope that this conversation and the perspectives that you got from the conversation provided you with insights you can use in your client meetings because I know you're going to have a lot of those meetings coming up.

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Voiceover:

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