Fidelity Connects

Straddling Two Worlds: Low Volatility in the Canadian Market

Eddie Lui, Portfolio Manager

Brad Cose, Host

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Brad Cose: Hello, everyone. I'm Brad Cose, Investment Analyst with Fidelity Investments Canada. Thank you for tuning in. In this webcast, we'll be discussing a topic that continues to grow in popularity and that is low-volatility investing, specifically how low-volatility strategies navigate in all market environments and why these strategies could be a great fit in any portfolio.

In order to dive deeper into the world of low vol, we are joined by Portfolio Manager of Fidelity's Canadian Low Volatility Institutional Trust, Eddie Lui. Eddie has over 20 years of industry experience, 16 of which have been with Fidelity and he has been the Lead Portfolio Manager of the Canadian Low Volatility strategy since 2018. Eddie, thank you for joining us today.

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Eddie Lui: Thanks for having me, Brad.

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Brad Cose: Absolutely. Eddie, you've just surpassed your five-year anniversary of managing the Canadian Low Vol Strategy. Performance has been very strong. Now that you've managed the strategy for a full market cycle, how have you been able to outperform over the long-term period?

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Eddie Lui: Good question, Brad. It's not an exciting answer but I think it's the most honest answer. It's been over the years trying to build a consistent, disciplined, repeatable investment process that leans on our strengths which is our research. When I think about running our Canadian low volatility strategy, I try to manage the strategy through the cycle not for just certain periods of time. I care about downside protection but I also care about full-cycle returns. When I think about the markets over the last five years, I think the world has changed. There's been some seismic changes with some new megatrends from pre-COVID to now post-COVID. We've gone from a world of quantitative easing to quantitative tightening. We went from low interest rates/low inflation to higher interest rates/higher inflation. That's certainly changed the way that companies view their strategy and their capital allocation decisions. We went from globalization to deglobalization and I even think about energy. We went from energy abundance to energy transition to even energy security. Over the years more recently we actually now are looking at generative AI. When I think about running this strategy, it's been harder to rely on the past rather than to basically navigate us in the future. I think that a process that has as many forward-looking insights as possible helps you navigate the markets.

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Brad Cose: Absolutely. As you mentioned investors have faced a lot of uncertainty and volatility in recent years. Your strategies performed very well through these periods. What about your approach has allowed you to navigate these markets so well?

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Eddie Lui: When you think about our Canadian low volatility approach, it's really broken down into three components. One, it's fundamentally driven. What that means is what we're trying to do is optimize for lower volatility based off of our highest conviction ideas. We're trying to include our highest conviction ideas and exclude our ideas that we just don't have as much conviction in on. It's about building a better universe to optimize on and the alpha and the returns that we're generating is from that research.

The second part of our approach is using a minimum variance optimization approach. I do look at the volatility of each stock but I also look at the correlations of stocks. When I try to manage this strategy through the cycle, I think that it allows me to be more diversified and inclusive rather than exclusive because we will try to own any stock if it is a high-conviction idea.

Thirdly, I actively manage. I'm trying to be as nimble and flexible as the markets change. As the markets change and the opportunities change our strategy changes because our research changes. I think all three of those components really drive what we're trying to do in the strategy and I'd say overall I'm not necessarily just trying to capture the low-volatility factor but I'm trying to capture the alpha within the low-volatility factor.

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Brad Cose: Great. That's very interesting about the process because even today returns are quite volatile yet you're still performing very well. What are you seeing here?

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Eddie Lui: Markets are volatile. We live in a world now where it's higher inflation and higher interest rates. I think about the most challenging part of the investment cycle to run a Canadian low volatility strategy and that's in higher interest rates/higher inflation because in those periods of times you would assume that energy and resources, higher cyclical names are outperforming and that dividend-yielding stocks because yields are rising are underperforming.

To outperform in this type of tougher environment, I think you just need to be a little bit more selective in what you do own. The strategy owns interest rate-sensitive names that are impacted by higher yields but there are certain sectors and certain subsectors that are also dealing with more competitive intensity, more regulatory burden. You try to own less of those names. You might want to own less names that are tied to slowing economic growth. We've been positioning ourselves into more higher quality companies.

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I think as well when you look at our research what we're also trying to do is find names that might benefit from higher interest rates and higher inflation. Off the top of my head I think about the grocery stores. They're high-quality companies, they're defensive in nature but when you compare them to, say, a utility company you can think that they are less interest-rate sensitive. They actually benefit from inflation. The valuations of these stocks are pretty attractive and when economic growth is slowing they have trade-down benefits because their business mix has some discount banners as well. You try to add a little bit more on that end. It's about what you own versus what you don't own that helps.

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Brad Cose: Dig a little bit more in-depth with that. We as an organization talk about fundamentals quite a bit. How does that play into your portfolio optimization and what challenges do you face with that process?

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Eddie Lui: Well, Brad, I would say predicting and forecasting risk is really tough and I think that any portfolio manager that needs to optimize a portfolio by risk reduction needs to deal with prediction biases. What I mean by that is that, in periods of low volatility but rising volatility, volatility is underappreciated and in periods of high volatility but falling volatility, volatility is overstated.

What we try to do in the optimization process is certainly try to use the best quantitative techniques to help us minimize these prediction biases but we also lean on our research to help us basically avoid any of the blind spots that maybe the quantitative models or forecasting can't see as well. In general I believe that stocks still follow earnings and if you do a good job of forecasting earnings that will help minimize your volatility. Just in general, when you think about the optimization process better inputs means better results. In that regard those are some of the high-level techniques that we try to incorporate into the optimization process. I guess what I am saying to you is that we use a hybrid approach, a best of both worlds of both fundamentals and quantitative portfolio construction process to achieve goals.

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Brad Cose: Absolutely. I think the performance of the strategy really highlights the importance of the active management portion. Could you share maybe an example of when the process has worked for us?

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Eddie Lui: Yeah, good question. Off the top of my head I think about Dollarama. Dollarama is this great low-volatility stock that's worked very well. It's been a long-term earnings per share compounder and a great brand with great recognition. If you were to look at that chart from the IPO, it's been just up. The reality is it hasn't always been up in a straight line. I remember back in 2018 there was much more competitive intensity for a short period of time and what that meant was that Dollarama, their same store sales was getting impacted, their margin was getting impacted because of this competitive intensity. At that time, there were certainly investors that were concerned that maybe even the business model might be broken. If there was so much competitive intensity, what would be the impact to Dollarama? Over the next three to four quarters, the company has a great management team, they really needed to reinvest in their products, they needed to regenerate same store sales, make sure that their products are unique and differentiated, and that over time as those quarters started to progress itself it was very clear that earnings visibility was getting better. For us in our process, we were able to sidestep that period of uncertainty for a bit of time and then re-enter the position. When you look at that period of time since that 2018, 2019 time period the stock once again is a low-volatility stock. So, it's about, again, going back to just being nimble and flexible in the names that we do own.

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Brad Cose: That's very interesting, Eddie. Maybe shifting gears here, a common misconception we get regarding low-volatility investing is that they're typically over-defensive and they don't always show up during strong markets. Is that so, do you agree with that?

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Eddie Lui: Brad, I don't disagree that low-volatility strategies and my strategy itself is defensive. That's part of the investment approach and the investment mandate is to be lower volatility. One of the misconceptions I do think about is that you can't generate good value out of returns by being lower risk. For us in our strategy, what I try to do is just be the most efficient with the risks that I'm taking on in terms of generating returns. At a high level, I view myself as a low-volatility strategy but I also view myself as a high-Sharpe Ratio strategy. If we do a good job of generating returns for the amount of risk that we take on, I think we can achieve value-added returns.

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Brad Cose: Right, that's great. That leads me to think, just building off of that how do you become more risk efficient and how does that help you drive long-term performance while remaining defensive?

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Eddie Lui: I think that in general my strategy for the strategy is to win by not losing. I think that in general we all know that the more that you lose the more that you have to work on the way up, on the upside. What we try to do is have a very good downside capture. That means that when the markets are more euphoric or going up we don't necessarily need to outperform the Toronto Stock Exchange. We just need to keep up. It's this whole idea of the law of compounding. For our strategy, what we try to do again is to have a really good downside capture and have a reasonable upside capture. That's been able to, for us to be able to generate good value-added returns.

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Brad Cose: Thanks, Eddie. That just brings me to think of another misconception we commonly hear around low-volatility strategies and that is that they're primarily made up of the low-vol names. In your case, are there situations where you're investing in names that are typically higher volatility names and how does that work into your approach?

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Eddie Lui: I think what you're asking about is the minimum variance optimization approach. We do consider volatility and correlations of stocks. At any point in time I do own low-volatility stocks but I also own higher volatility stocks because in combination because of correlations we're able to have an overall lower volatility profile.

When I think back over these last five years or so, there's certainly been times where it's benefited to own higher volatility names, that sometimes like this most recent period sometimes low-volatility stocks are not low volatility, especially when yields are rising and that some periods of time high-volatility stocks are actually low volatility.

When I think back of 2021, there were certain days and certain short-term time periods where large-cap IT names were the only names that were going up on a down day, and that in 2022 after the Russia-Ukraine war energy, which is like higher volatility, was a lower volatility area to invest in. I think that through the cycle there are certain periods where owning higher volatility names have been beneficial.

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Brad Cose: Absolutely. Eddie, we've talked about your performance, the process, some common misconceptions, and I can see how these all kind of fit together. When I'm looking at your strategy it really does seem like this could be a standalone Canadian equity mandate. Do you have any thoughts around that?

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Eddie Lui: Brad, full disclosure, I'm not a consultant or an advisor but I do think it is a strategic allocation to invest in Canadian low volatility. I think that it is a risk-efficient way to allocate to Canadian equities. I think that when you look at our strategy in particular it can be a standalone strategy for institutional investors to consider. When you look at it from a performance perspective, certainly the behaviour and profile is very good downside protection but okay upside capture. When you start to roll over rolling four-year time periods the performance has been quite consistent. From a holdings perspective, as I mentioned to you, we're trying to be inclusive rather than exclusive so I will own a variety of different names, high-vol names and low-volatility names. I think that in general even though my beta is less than one I am owning some higher volatility names that help me keep up on the upside.

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Brad Cose: That's great. It does sound like it could and should really be considered as a standalone mandate but at the same time how does this fit as a complement in a well-diversified existing portfolio?

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Eddie Lui: I think just in general my investment objectives is dual. I'm trying to remain lower risk but also generate alpha. The strategy is benchmark agnostic, so when you're creating a portfolio that's benchmark agnostic I would say that my strategy looks very different than your typical Canadian large-cap mandate. When you start to look at the top holdings, the top active weights because of the way that we construct our portfolios they look very different. In my view, whether you're looking at a value manager, a growth manager, a high-beta Canadian equity strategy, if you include a Canadian low-volatility strategy, I think in general you can get better risk-adjusted profile.

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Brad Cose: That's great. Maybe just taking a bit of a step back here, it's pretty clear that low-volatility strategies work in Canada. What are the unique challenges that you face when investing in Canadian markets?

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Eddie Lui: A very good question. I think that every market is unique. I think when you think about Canada and what the challenges are with running a Canadian low volatility strategy, I point to three things.

One, TSX 60 which is our larger cap names are very large and so when you're benchmark agnostic and you don't care about owning all of the large-cap names in proportion, you will gravitate your portfolio towards mid- and small-cap ideas. For me, I like the fact that we have research and analysts following these companies looking for opportunities.

The second thing to think about is that Canada has a lot of commodities and a lot of interest rate-sensitive names, so there are going to be periods of times when energy is in favour and maybe dividend-yielding stocks are out of favour. It's good to be diversified and try to find those names, those self-help stories, those idiosyncratic ideas that aren't so skewed to those two particular factors because you do run the risk of concentration risk.

I think the third thing to think about is market breadth. Relative to global markets in the U.S. market, there are only 250 names. When you're trying to construct a portfolio and you're owning a little bit more mid-cap and small-cap names, you do take on a little bit more stock-specific risk. I think all three of those key factors are things to consider when you are running a Canadian low volatility strategy.

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Brad Cose: That's very interesting, Eddie. You've provided us with a lot of information today and it's been great. Maybe just before we wrap it up, can we get a few high-level comments of what you're looking at going forward?

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Eddie Lui: Thanks, Brian and thanks for having me on this program today. In general when I think about the markets and the market outlook I think about the job of inflation not being done yet. I think that there's still a lot of debates on the path of interest rates, whether interest rates stay at these levels or perhaps in the near future if there's market stress that we're able to cut interest rates. There will be still much debate around a soft landing, a hard landing. I look at the unemployment levels and rates that continue to be low and I do believe that economic growth is slowing. I think that stocks that demonstrate good durability, good stability are valued in the marketplace today. For us and our analyst team, we're constantly focusing in on forecasting revenues, margins, valuations. I think that an area that we look at for 2024 is just making sure that we don't have any negative earnings surprises because negative earnings surprises for a portfolio in a particular stock would mean negative returns and probably it's bad for your volatility metrics. In general, the process and the focus still remains the same in trying to help clients achieve outcomes for their portfolios and I think that we've got the right tools and the process to be able to navigate what may come in the future.

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Brad Cose: That's great. Thanks, Eddie, insightful as always. Thanks for joining us today. Thank you, everyone, for joining us today. See you next time on Fidelity Compass.