Fidelity Connects

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Announcer: Hello and welcome to FidelityConnects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

Portfolio Managers of Fidelity Climate Leadership Bond Fund, Kris Atkinson and Sajiv Vaid, join today's podcast.

Russia's invasion of Ukraine has caused an energy crisis. As a result, countries around the world have significantly changed the way they're approaching energy. The European Union has made plans to increase its solar and wind power. Amidst this whirlwind of transition, how important is it for advisors to look at investing in renewable plays and why should they consider a fixed income approach?

Today, Kris and Sajiv share how they seek to identify leaders in global decarbonization to include in Fidelity Climate Leadership Bond Fund, which includes utilizing Fidelity research analysts from across the globe.

They note how this changing macro backdrop is the most challenging in decades, and also share thoughts on the expansion of EV charging stations, opportunities in South Korea, supply chains, and real estate, among other topics in today's 30-minute discussion.

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Pamela Ritchie: I wonder if we talk a little bit about the fixed income market just to begin with because we are in the middle of a rate hiking scenario. In our lifetimes, probably we won't see anything quite like this across the pond as well. Kris, I might put this to you first and ask Saj to follow up with just your thoughts on what kind of moment this is for fixed income investors, sort of, period. Then we'll break it down. Kris.

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Kris Atkinson: Excellent question. Obviously, it's been an extremely challenging year for fixed income investors and investors in risk assets more broadly. Clearly, the rate volatility has produced negative returns that, as you rightly say, where we certainly haven't seen in our investing lifetime. I think the last month was one of the worst on record for sterling and European asset classes. Really, that puts us in a situation where it's difficult to like fixed income; it's difficult to like risk assets. However, what I would say is that the resulting rise in yields and the yields that we're seeing today in investment-grade credit are higher than we've had in the past 10, 15 years. Therefore, I think for investors who are looking to sort of average into a higher yielding environment I think now is, potentially, an interesting moment.

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Pamela Ritchie: This is what we're hearing from a lot of different professionals in the industry. It's a fascinating moment. Saj, anything to add to that to set the table and then we'll go into the discussion of decarbonization.

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Sajiv Vaid: Kris hit on the main points here. I think, just from my perspective, myself and Kris have been doing this for some time. I think it's fair to say the macro backdrop has been, or is, one of the most challenging in decades. Just to put it into some sort of perspective, I just saw some stats today, global central banks year-to-date have increased net rates by 170 basis points overall, 170. Now, if you're to believe current pricing in the market of the four central banks, major ones, there's another 480 to go by year end. Now, that as a sort of backdrop may shy a lot away from fixed income, especially with the inflation backdrop that we've got. But as Kris said earlier, I think if we are nearer to the end. I'm not saying there's not going to be more volatility because that has absolutely followed us over the last 12 months, but the key thing here is that yield, global credit markets at 4.5%. The last time you got that type of yield you have to go back to 2009.

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From a macro perspective, it is going to be tricky for the next 3 to 6 months as we, in effect, have this tug of war between inflation and growth where central banks, in the words of this year pivot, have pivoted very much towards focusing on inflation and rightly so with inflation at multi-decade highs. It's fair to say if there's some criticism to be labelled at central banks, it's they were too late to the party recognizing this — and not just the central banks but a lot of investors. But I do think we have approached the point where they are now really addressing this issue. Now, the problem is, which actually provides, I think, the more positive backdrop of fixed income 12 months from now is if we do have half of the pricing that's in terms of rates, we are sure going to have a very deep recession in certain parts of the globe. Europe, U.K. and our own macro team say there's a 70% chance of a hard landing in the U.S.

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Pamela Ritchie: Interesting. This is sort of where bonds, ultimately, if inflation is down, can create that kind of ballast in that kind of environment. We'll sort of fold that through our conversation. Kris, I want to come to you, and we'll come back to you, Saj, as well for this but the discussion of actually where the decarbonization conversation – a lot of this is at policy levels … has changed over the course of – we could probably start the date at the Ukraine invasion, the invasion of Ukraine, but over the last year or so, how quickly has this discussion picked up pace? It has a real sort of highs and lows but there is change, is there not, in sort of the world's paying attention to this?

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Kris Atkinson: Yeah, you're absolutely right. Obviously we had COP26 last year that was a catalyst for a rise in interest and focus on climate issues. But I think it's fair to say that those words weren't necessarily being followed up with actions. But, of course, what we're seeing this year with the Russian invasion of Ukraine and the focus that that's brought on the dependency of Europe in particular, obviously, on Russian fossil fuels that's really sharpened the pencil of policymakers. We have seen some very significant progressions over the course of the year. Obviously, the EU was already, I would say, sort of frontrunner in terms of the greening of its energy system but clearly they've had to really accelerate those plans quite rapidly in order to alleviate the shortage of gas and the shortage of power that they're experiencing currently.

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I think more encouragingly, given that Europe had already sort of got the joke, if you like, I think more encouraging from my perspective is that some of those other regions and countries that maybe have been a little bit slow to pick up on climate policy have also started to really run with it quite hard.

China has been making some good progress. We had recently a Climate Act passed in the Lower House in Australia. That's a huge development because Australia has historically been a bit reluctant to engage with the energy transition. And, of course, as you mentioned earlier on, the Inflation Reduction Act in the U.S. which, for me at least, is probably one of the worst named pieces of policy. It's essentially an industrial policy, good old-fashioned industrial policy, that focuses on climate in particular. That really sends a very positive signal that decarbonization has now moved right up the agenda and, of course, with it, energy security.

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Pamela Ritchie: Saj, did you want to add to that?

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Sajiv Vaid: Just on that, I think what is interesting over the last, say, actually since the beginning of the year, is there's been a constant which is at the company level where they are upping their sustainability bar. What you'll see as a result of the Ukraine crisis is governments accelerating that through regulation, as Kris said. I think what will be interesting over the next 12 to 18 months is how this incentivization leads to actually proper capex coming through from corporate.

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Pamela Ritchie: And that's what the bonds are for, right? These are companies that are needing to get themselves aligned in all different sectors in different ways and ultimately, this is the underwriting that goes along with it. Kris, I'll bring it back to you. What does this fund seek to do? It is a corporate strategy. It's looking to companies who are involved in the fixed income markets essentially for capex, is that right?

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Kris Atkinson: Well, exactly. The sort of genesis, if you like, of this fund, when we started to talk about this as a really interesting project because what we felt was a lot of the climate-focused funds in the fixed income market, not that there were that many but there were a few around, sacrificed some of those key characteristics of a fixed income fund, namely that they have an attractive yield and they have defensive characteristics with all of this sort of diversification across sectors, across regions, across issuers that you would want to see in a fixed income fund. And, of course, *[indecipherable]* climate impact.

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Now, so what we're trying to do is we're going to take this global universe of issuers of credit, something like 13,000 bonds, 2,000 issuers, and we identify which of those companies are most aggressive in decarbonization or have the most to win, to gain, from pursuing a transition strategy. On top of that, we're not just looking to identify the winners, the leaders and those who are transitioning but also those who can facilitate other companies and other countries as well in their decarbonization agenda. So we're looking for a positive tailwind, if you like. And of course, all of those things brought together actually results in a lower credit risk for these issuers going forward. For us, it just makes a lot of sense to factor in decarbonization to your fixed income investing. At the end of the day, it's just managing another set of risks.

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Pamela Ritchie: Saj, as Kris just pointed out there, companies that have to capex in terms of actual building or infrastructure, whatever they need to do, but also companies that are helping others with the transformation. Can you just sketch out for us a little bit more of the types of companies that … you don't need necessarily to give us names or anything but just to kind of dig into the types, maybe sectors, of how you're looking at companies.

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Sajiv Vaid: I think one of the things, just picking up again from what Kris said, what this fund is not about is exclusion or taking the easy route out by the hard-to-abate sectors. That's not *[indecipherable]* the portfolio and appear that we have the good carbon credentials. What we are aiming to do, and we passionately feel about this, is if we are to achieve net zero and get Paris aligned, we will have to bring these sectors along. We identify that as the built-in environment. Think about real estate, industrials, mining companies, transportation. Obviously, we think about EV cars but it's not just about cars. It's thinking about shipping and supply chain. What we attempt to do through our analysis is look at all these subsectors and identify, as Kris said, not only the leaders but the transition helping with them. I think what's key and why we're very excited about this fund is the engagement part of it, all you can really do realistically if you have the resources. At Fidelity, we have 184 fixed income equity analysts helping along this engagement, engaging these companies and these subsectors and not just at a regional basis but a global basis. To address this thing, it's going to be a global problem.

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Pamela Ritchie: That's exactly … I was just typing away, "Ask global next." Kris, over to you. The scope of the fund is, in fact, global. Just tell us a little bit about what's of interest at the moment in terms of the regional story. Obviously, some governments are further ahead and some perhaps look good because they have farther to go. I don't know. Tell us about the global story?

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Kris Atkinson: I think probably where I'll start off there is really with that Inflation Reduction Act that we talked about earlier. That, for me, I think is going to create all sorts of opportunities within the U.S. I'm not going to go over the details and I'm sure you're all very familiar with the details of that policy, but one of the things that we think it will do is make certain subsectors more interesting.

For example, as you're probably aware there's various tax incentives on all electric vehicles. Now, the problem with EV production in the U.S. at the moment is that 70% of them don't qualify because of the local content restrictions on that policy. One area that we've been looking at is actually a number of the South Korean companies that we follow have been establishing local U.S. battery production and have been developing that over time and they've been raising debt, actually labelled green debt, in order to finance the construction of those battery facilities in the U.S. We can actually lend money directly to those issuers. They will definitely benefit from the IRA because they will be classified as local production. Things like that, this is what Saj was saying about having that extensive network of analysts. You dig down into the details. It's not necessarily the first derivative of the policies, it's the second derivatives, it's suppliers *[audio cuts out]* into that business that make it more interesting.

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Pamela Ritchie: That's fascinating. Saj, another piece of the Inflation Reduction Act which, again, is a terrible name, I agree, is the idea of where are we going to plug all the cars in? We're still grappling with that. I was in London not so long ago and you do actually have them on the streets. Every second street light is a plug-in which I thought was quite brilliant. We don't have that here at all. We're speaking about Canada but the U.S. as well. The idea, I think, within that act is that it would open up sort of areas that are already either federally or, I guess, state controlled like inter highways where you could have things. You don't have to buy the land, for instance, to do some of these things. It's opening up networks that are already there right next to the pipeline that's already doing something. They'll run whatever type of electric line right next to it. That, to me, strikes as sort of a second derivative as well. Is that moving something for you, Saj, at this point in terms of investment opportunities?

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Sajiv Vaid: I think, Pamela, maybe coming back to an investment that we have in the fund. It's a German service station where what we're doing, encouraging in terms of capital is putting more EV battery stations in there. You talked about ... I was this summer been away in Majorca and I was just fascinated to see the lack of EV stations there. It is a global problem. I think, again, coming back to what Kris said, the incentivization by governments is what's going to encourage that and also to get that unit cost down. Talking about this German service station that we've invested in the fund, that is one of the key criteria that we have engaged with them that we want to see and progress made in order for us to be satisfied that they are part of that solution that we're looking for in companies.

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Pamela Ritchie: Kris, maybe I can put this to you, we'll just stick with the EVs just a tiny bit longer here. What will the service station of the future look like if we all maybe have to line up along the highway, along our road trip to plug in and will there be some games for the kids as they hang out for the 40-minute charge? I've actually heard some podcasts saying that they'll become sort of half, like a tiny little Disneyland or something, something to do while you're charging. Is that real? Are we going to be thinking about travel in a different way? We have to stop for the charge.

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Kris Atkinson: I think that's a really good question. I think you're right. When we speak to the issuers that are slightly more forward thinking in that respect that's exactly where they're going. Saj made that point about the German service station operator. That's the route that they're taking.

Now, obviously, I think that the first hopeful iteration is that those charging times come down so you won't be standing there for 40 minutes waiting for 80% charge. It will be something significantly lower than that. But over time, I think you're absolutely right. There will be reduced charging times; there will be additional facilities that will allow you to keep the kids quiet while you get yourself a cup of coffee or whatever. That's the sort of opportunity that really presents itself for many of these service station operators.

What we're seeing in Europe, I don't know if it's started to spill into North America, is that actually a lot of the utilities are starting to encroach on some of these service stations because that's how they can generate additional margin is from having a joint venture with perhaps traditional fuel station operators and offering a much more extensive charging network.

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Pamela Ritchie: I wonder if we can go back to the global element a little bit. In the introduction we were just talking about companies having to completely rethink their energy, their strategy for energy. A lot of countries within the EM universe, simply unattainable energy bills and there may be a greater urgency just because there's the sustainability of energy situations that they won't be able to sustain them for long. Do you see opportunities in some EM markets where, in fact, they have to accelerate the decarbonization, move, perhaps, even faster out of necessity?

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Kris Atkinson: I think the question is absolutely correct. Obviously, decarbonization of developed markets is only part of the problem. There are some extremely large markets, India and China obviously being the two most obvious ones that spring to mind, whose populations, rightfully, would like to move up the income curve and, obviously, the consumption curve with that. That, of course, is energy intensive.

If we have 1.3 billion Indians or Chinese consuming more energy and that is derived from fossil fuels, that's going to have a massive impact on carbon emissions. What we need to do is to provide low-cost renewable generation to these emerging markets. As Saj says, we'd be looking at some opportunities, in particular in India where there's a combination very attractive yields relative to European assets. For example, they are either state owned or state backed revenues. There is a huge amount of policy support to drive the growth of those assets. That's something that we find really interesting. It's also a market which has been historically – never say never – but historically has been relatively investor friendly as well. It's an area that we feel quite comfortable in deploying a modest amount of capital in the fund to those sorts of opportunities.

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Pamela Ritchie: Some will argue that this is sort of broadly across markets, across credit and equity markets globally, not specifically zeroing in on anything to do with decarbonization, but things are, like a recession, much more priced in in Europe, for instance. Do you find actually quite attractive ... you mentioned India but I'm wondering also in Europe, Saj, if there are more attractive looking opportunities because perhaps the recession has been priced in further.

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Sajiv Vaid: I think if we take a step back, just generally going back to the comments we made from a macro perspective, where we are in terms of bond spreads, we are at 5-year wides. But actually when you break that down, Pamela, actually the cheaper market at the moment is actually Europe and UK. They've only been wide at this level 20% of the time. Definitely we see value creation. I think one of the things that is maybe a perception that the sustainability area of the market has taken a back water to this. It hasn't. It's still very much front and centre where capital is still going. What is really interesting is that sort of extra premium you were paying for buying those assets is no longer happening. They are part of the normal market, so you're not paying up to have these assets. I think that is what's creating our opportunities and we've actually been very conscious of just because it has a label bond, why should you pay up for that because you're subject to the same amounts of default risk, same volatility in the balance sheet. That ability to step back and look at it has actually served us well. Now we can look at some of these label bonds and treat them like we would any normal bond. I think that's where the opportunities are coming.

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Pamela Ritchie: That's so fascinating. Saj, I'll come back to you in a second because I want to get on the positioning, if you can go through that for us in a second. Kris, one thing I wanted to put to you and ask you for a little bit of an explainer, I need a cheat sheet on this, when we hear hydrogen, when we hear fusion is the future, when we hear nuclear is involved within that story, I wonder if you can break that down for us. Does nuclear absolutely need to be involved in the story of fusion, the hydrogen story, or can it not be? There's a lot of different stories rolling around right now.

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Kris Atkinson: It's a pretty thorny subject, actually, because, obviously, nuclear is somewhat controversial pretty much globally. If we start off with sort of a cheat sheet, if you like, the way to think about nuclear, obviously we have existing fission reactors. They are, relatively speaking, a tried and tested technology. Obviously, they have some concerns about waste at the back end that need to be dealt with. I think where the nuclear industry is moving towards is more towards these, what they call small modular reactors which are supposed to be easier to build, quicker to build, basically almost like a factory process so that you could have a capital goods company that would produce these SMRs almost on a conveyor belt.

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Pamela Ritchie: I almost think of them as like cubes that you can put on the back of the truck and roll them somewhere else. Is that actually what they're like?

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Kris Atkinson: Exactly. The problem with fission reactors over time is that they start off and they say, yeah, we'll have this thing built in 10 years and it turns into 20 or even longer. We've experienced a number of those delays in the U.K. and across Europe. So that sort of delivery that time to market, if you like, has always been too long. That's why it's a problem for low carbon, it's a problem for addressing climate change because the timescales that we're talking about are just not compatible which is where SMRs would come into effect. We just haven't had that technology tested yet. Fusion is another matter altogether. Obviously, that is the holy grail of nuclear power. We are not at a stage where fusion has been commercialized or is even close to being commercialized as far as I'm aware. Now, of course, if we get there, then that will be a game changer. With regard to hydrogen, there are, again, different sorts...

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Pamela Ritchie: There are many different colours. It's like a rainbow.

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Kris Atkinson: There are many different colours of hydrogen. We have just conventional hydrogen which is produced often from hydrocarbons. You have grey hydrogen where basically the carbon is sort of stripped out of that production process. You have green hydrogen which is produced from electrolysis and that is usually ... the power that feeds that is renewable power, that's why it's called green, so the idea being there that you basically have a zero-carbon fuel that can replace things like gas in certain situations. And then we have another one which is called pink hydrogen. That is hydrogen that is derived from nuclear generation. So there are all sorts of different shades of hydrogen.

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The one that is getting the most attention is green hydrogen for very obvious reasons. Part of the advantage of green hydrogen is, as we all know, the sun doesn't always shine when you need the power and wind doesn't always blow when you need the power, so you need a way of taking that energy and storing it. Batteries is one solution but hydrogen is another. Basically, the idea would be you have an excess of power because the sun is shining far too strongly and you just convert it into green hydrogen, then you can stick it on the back of a lorry, stick it in a pipe, and you can move it to where it's needed. So actually, green hydrogen is a really exciting technology. It's something that we have invested in the fund. There are a couple of very large industrial gases players that are quite well advanced in their development of green hydrogen. That's where we see really exciting opportunities. That's the sort of thing that we were talking about earlier. They decarbonize their own operations, they're really focused on sustainability, but also they're providing new technologies, new opportunities for other businesses to decarbonize, so they have a revenue tailwind there as well. That's the sort of sweet spot, if you like, from a credit investor investing sustainably.

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Pamela Ritchie: Tell us a little bit, Saj, about the positioning at this stage. There's a time and a place for everything. What does this moment in terms of positioning represent in terms of opportunities and kind of how are you set up right now?

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Sajiv Vaid: Definitely we have a more defensive mindset at the moment, very much focusing on high-quality assets. From a duration perspective, which always sort of is focusing given the back-up in yields, we have been shorter duration. This rise in yields we've somewhat mitigated that. However, having said all of that, myself and Kris do feel there's a point in time where we will be, I reckon over the next 12 months, going longer duration because we believe there's a peak in yields.

The focus for us very much now going forward is about stock selection and focusing on what I think will start to happen as a result of the energy crisis and the growth scare that we have, is greater dispersion in markets which is a great time for active managers such as ourselves with the depth of resources we have from analysis to take advantage of those opportunities.

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Bottom line is cautious, high quality, but one of the things, again, just as a reminder, this is a high-quality, investment-grade fund with really good sustainable characteristics. Fixed income, for many, hasn't quite done the job for providing the ballast but I think over the next 12 months, one thing I'm fairly confident is you're going to get positive returns from here on from fixed income given what's happened in yields and given what's happening with spreads. For us as managers, what's focusing is that bottom-up stock selection to ensure that we mitigate to any sort of issues going forward.

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Pamela Ritchie: That's fantastic. It's such a pleasure to speak with both of you and to have the conversation evolve with you guiding us through that. We look forward to speaking to you again. Thank you, Kris and Saj.

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