Fidelity Connects

Why You Should Consider a Long/Short Strategy

Brett Dley, Portfolio Manager

Rory Poole, Host

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

Today on the show, Portfolio Manager Brett Dley joins host Rory Poole to discuss Fidelity Market Neutral Alternative Fund. Brett talks about the diversification benefits that alternative investing brings to the table and why one should consider a long-short strategy.

Brett explains the way he invests in this fund is by relative value investing. He doesn't focus on the direction of the underlying market or asset class. Rather he focuses on identifying situations where there are discrepancies between valuations and fundamentals. The aim is to have returns to come *[inaudible]* strictly from stock vs. stock as they don't have any market or style biases.

Furthermore, he focuses on fundamentals and asks, "Has anything changed? Is my theory incorrect?" If nothing has changed, Brett maintains his conviction. In addition to his investment strategy, Brett discusses his thoughts on long and short positioning in 2023 and underlying themes and trends in health, tech, and consumer discretionary.

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Rory Poole: So, why don't we get started by you telling us a little bit about the structure of the fund and then we'll move on from there?

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Brett Dley: Sure thing. The Fidelity Market Neutral Alternative Fund is a true market neutral. What that means is the fund is managed with a beta of zero, which is another way of saying the correlation to the underlying stock market, bond market, commodities, Bitcoin, anything, you name it, is zero. So, the alpha is generated from pure stock picking, not from the direction of the underlying markets or asset classes.

The way that we run the fund is for every dollar invested, we go $1 long and $1 short for a net exposure of zero. That's what contributes to the, basically, no correlation with any other asset class. The fund is structured using a series of pair trades, so at any given time I have approximately 50 pair of trades on. That's about 40 to 50 longs and somewhere between 60 to 80 shorts. What the fund focuses on is trying to generate alpha from pure stock picking on a stock versus stock basis. We don't use indexes or derivatives. We use equities to construct the fund. That's basically how the fund is structured.

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Rory Poole: And when you say kind of pure market neutral, just to define that for folks out there, you mentioned kind of dollar for dollar equal parts long and short. So, this is not a product that is going to go slightly high in terms of net exposure, whether it be long or short. This is aiming to stay at zero at all times, correct?

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Brett Dley: That's correct. And so, we actually have restrictions. We keep the beta at + or -.01 so, effectively zero, and we keep the dollar exposure to + or -2%. So, this is truly zero net exposure.

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Rory Poole: Okay. Good stuff. I want to talk a little bit more about what we just discussed a little bit later in our conversation. But let's talk a little bit about maybe some more philosophical elements in terms of how you invest. I'm kind of curious, like, what do you think helps define this product and, more importantly, the way that you go about investing?

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Brett Dley: The whole premise of this product and the way I invest is what I call relative value investing. So, the direction of the underlying stock markets or asset classes is not important to me. It has no bearing on the performance of the fund. I'm trying to identify situations where I can have a group of similar stocks potentially trading at the same valuation but have very different fundamentals. We could be long a company that is growing faster, has a longer runway, better margins, better management team and short a company in a similar industry that has the opposite of those: slower growth, weak margins, poor management team. On the other end, we could have two companies with very similar fundamentals growing the same, similar margins, great management teams but trading at different valuations, in which case I would try and go long the cheaper company and short the more expensive company. These are the types of situations I'm trying to capitalize on.

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Rory Poole: So, factor exposure is probably something that you pay a fair amount of attention towards in that you're targeting these groups of stocks that try and exhibit a fairly high degree of correlation among one another. Is that fair to say?

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Brett Dley: That's right. One of the keys that we really focus on in this fund is we want the returns to come from stock versus stock. We'd have no sort of market bias, as we mentioned, by the zero correlation. But the other thing that's really important is this is not a growth versus value, value versus growth, small-cap versus large-caps. We try and neutralize all those factors. So, we don't want any style bias creeping into the fund. There's other ways that you can achieve that if that's something you're looking to try and find. But we make sure that all of the alpha comes from pure stock versus stock.

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Rory Poole: And it's a diversified product. When I look at kind of things like sector exposure and what have you, but I find that more often than not you tend to carry more gross exposure within some more growth-oriented sectors. So, I think of things like tech, health care, industrials, consumer discretionary. Is that more of a function of the product or is it more of a function of the way that you actually go about or your style of investing?

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Brett Dley: So I think it's two pronged. I think part of the reason that it's a function of the product is those sectors generally have higher dispersion among stocks. So, there's more sources of getting differences in relative returns. An example of a sector that I'm not particularly active in would be in Canadian banks. They tend to trade more as a group. There's some dispersion but it's not typically meaningful. The sectors you mentioned have much higher dispersion. They could be similar types of companies but very different outlooks and, hence, very different avenues for returns. And so you mentioned those four sectors, I think of those as stock-picking sectors. We actually label them here at Fidelity as stock-picking sectors. Before I was a Portfolio Manager, I was an Analyst at Fidelity, the same as basically every single person on our team who's a Portfolio Manager. The last three sectors I covered were industrials, tech and health care. So it's not a surprise that I focus on those sectors within this fund.

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Rory Poole: And correct me if I'm wrong, but with a product like this where you're running 100% long and 100% short, you have to think about things like dividends within the portfolio, especially on the short side because those are actually the property of the lender, if you will. And so, I would imagine, and areas like real estate, areas like utilities that tend to carry higher dividends, I'm assuming that's something that's thought of in the portfolio when it comes to kind of controlling cost.

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Brett Dley: Absolutely. It's part of the investment decision. And again, you know, I wouldn't have in the fund a high-growth tech stock that clearly doesn't pay a dividend against a value telco that pays a dividend. That's not the trades I'm trying to accomplish. That's not where we're trying to generate return.

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Rory Poole: Why don't we then walk through an example? I know we have one for you of one of these pair trades that you're alluding to. And I think that this one in particular is interesting because it is of two stocks that are of the kind of go-go-growth or higher octane type value. And I'm sure investors would be interested to hear how this kind of comes to fruition within the portfolio.

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Brett Dley: Yeah, absolutely. So, this is an example of a trade that we had on last year in the, as Rory mentioned, high-growth, high-multiple tech space. So, these are two stocks, we were long a company called MongoDB and short a company called Asana. Both were growing very, very rapidly, like 80%. Both were trading very, very expensive at the time when we put the trade on at 30 times EV/sales. So similar valuations, similar growth, however, the fundamentals of the companies were very, very different.

MongoDB is a market leader in a very fast-growing marketplace called Database Management. They basically have no real competition. So, the growth avenue I think is for years and years to come. Asana is a fast-growing company but they were playing in a very competitive space called Workplace Collaboration. There's three or four public companies that do the same thing. There's three or four multi-billion-dollar private companies that do the same thing. It's very competitive. So given these dynamics, the margin profiles of the two companies were very, very different.

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MongoDB had cash on the balance sheet and was basically at breakeven. Asana was burning about $150 million a quarter with no line of sight for this getting better. So let's think about what happened last year. These were high-growth, high-multiple tech stocks. They were bad. MongoDB was not a great stock. It went down 10% over the period that I had the trade on. However, Asana was a much, much worse stock. It went down 80% over the period we had the trade on. So, the net profit to the fund is the difference between the two, which was 70%. So again, I want to highlight these stocks were bad, they both went down, but because of the relative value and the hedging of valuation risks that we did, the fund was able to generate a profit from *[audio cuts out]*.

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Rory Poole: Which I think kind of really highlights the fact that this is more of an absolute-return-type strategy. As long as your longs outperform your shorts, if you will, irrespective of them going up, down or sideways, then the fund has the ability to generate a profit. That was, obviously, a very lucrative trade and that's fantastic for the fund but that's not always going to be the case. You're going to go through periods where your short position potentially outperforms your long position which, in this example, that was happening. How do you kind of manage through those types of scenarios or what potentially goes through your head as a portfolio manager in terms of controlling risk in that sense?

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Brett Dley: Yeah. So there's two parts to that. The first is focusing on the fundamentals. Has anything changed? Am I wrong? Is my thesis incorrect? And during the period in November where this trade was upside down, I kept focusing on that and nothing had changed. So, I didn't lose any conviction in the fundamentals or that I was missing something.

The other part that I think is maybe even more important is controlling risk. And the way I do that is with position sizing. So, I mentioned earlier the typical long book is about 50 stocks, the short book is a lot more, say 60 to 80. So that leads to more, smaller short positions which allows us to, in these periods where there's maybe some irrational exuberance, which if we look back, November was the height of that, it's not super detrimental to the fund and we can make sure that we can wait this out, time is on our side, and assuming we have the fundamentals correct, it will come into fruition. And that's what happened on this trade.

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Rory Poole: Good stuff. Let's maybe transition now to talking a little bit about last year but also talking about 2023, which I think folks are, obviously, interested at this time of year to hear about. But if we're reflecting back on last year, like as I mentioned in my intro, your product did very well, both on a relative basis and on a risk-adjusted basis last year. What worked for you?

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Brett Dley: The start of the year was a lot of what I just mentioned, sort of the MongoDB, Asana type trade. So that was really focusing on hedging valuation risk, making sure that I was able to buy the best-of-breed companies, the ones with a more durable growth runway, better capital structure, and just give it time and let that play out. In the latter half of the year, I would say more towards the summer, I started thinking a little differently and I started thinking about the market is down a lot, we know there's all sorts of bad things going on. Inflation's high, interest rates are going higher, comps are tough, stimulus is gone. But I began to think about one year from now, is the world better or worse? And I came to the conclusion, I think we're in a better spot. I think inflation will at least have slowed. Interest rate raises will ... I don't know if they'll stop, but they'll slow. Comps get easier and we're either in the middle of a recession or on our way out. So, what I began to do is I began to use the tools that the market neutral strategy provides, begin to play offence but in a risk-controlled way.

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Rory Poole: So, almost like a bit of a contrarian type of approach towards what was going on in the market. Not that I would label you necessarily as a contrarian investor but in terms of looking at areas to kind of buy into those stocks where expectations are low and potentially short sell some of those stocks where expectations are high, that obviously paid off. You made money in 7 of 11 GIC sectors, I believe, last year in terms of positive attribution to the fund. Why don't we talk a little bit about the elephant in the room last year which were interest rates. Obviously, that impacts heavily kind of your approach towards valuation, the sheer math that goes into discounting stocks but how else does it impact your product? And more specifically, how does it impact the cash within your portfolio as interest rates go up?

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Brett Dley: For the broader market in general, bonds, obviously, stocks as well, you know, raising interest rates was bad. We saw that. We know what happened due to the valuation multiples that contract because of that. However, for the fund specifically, higher interest rates is actually a very good thing. And so when we short a stock, we are actually selling that stock. We get cash proceeds from that sale back. Those proceeds stay in the fund and they are invested in super safe, super liquid, Government of Canada, overnight securities. So, for the first few years of running the fund, the yield on that cash was effectively nothing. We weren't really making much money on that. However, things changed dramatically in the second half of last year and now and now we're actually making a fairly meaningful yield on this cash. So, when I think about the fund as it stands right now, we're generating alpha from the stock picking and we're also getting a yield pickup from the cash proceeds from our short sales.

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Rory Poole: So it's accretive to, and material to that of portfolio performance at this point in time.

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Brett Dley: That's right. It's a good thing for shareholders.

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Rory Poole: Good stuff. How long would you wait for each pair trade to potentially pan out? We talked about it a little bit in the example. And, I mean, I think it's probably fair to say, correct me if I'm wrong, that each situation is different but at the same time, I mean, are there any kind of numbers, whether it be soft stops or anything that you think about thresholds that you do not want to cross when it comes to particular pair trades?

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Brett Dley: Yeah. So, I think firstly in terms of time horizons, I try and think about the fund on a 1.5- to 2.5-year basis. And so over the next few years, you know, where are the areas of the market that look cheap, where are the areas of the market that look expensive? And how can I capitalize on that? Typically, when you have that view things actually happen faster than that, especially in growth tech. But that's the framework I use.

And so in terms of time horizon, I would say somewhere around a year and a half but typically, it happens sooner than that. In terms of lost thresholds on a pair trade, that's all about has the thesis changed? Has the valuation changed? Has there been some incremental news that was better for the company that I'm short or, worse, for the company that I'm long? That's no different than any other sort of long-only fund that we have here.

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Rory Poole: Do you have a batting average at all that you strive for in terms of profitable versus unprofitable trades within the portfolio? In an ideal world, is there a certain number of trades that you're looking to get right versus wrong that you think will help the fund break even, if that makes sense?

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Brett Dley: Yeah. There is and, again, let's put numbers around this, right? And so on average I have about 50 of these pair trades on. If I can be right on 55% of them and make 50 basis points per trade over that year-and-a-half- to two-year time horizon, that results in a sort of high single-digit return to low double-digit returns for the shareholders. That's what we're trying to accomplish and that's how we go about doing it.

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Rory Poole: Right on. Let's talk a little bit about looking forward now in 2023. Before I get into some minutiae, first off, any broad thoughts around your outlook and positioning moving into 2023?

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Brett Dley: Yeah. And so kind of akin to what we kind of touched on briefly before, I'm a firm believer that stocks price in what's going to happen about a year in advance. So, I'm trying to think about not where we are today but where we are when we're talking one year from now. And as I mentioned, I think the world is in a better place at that point in time. So, what I'm trying to do is play offence but in a risk-controlled way. The way I'm doing that is I'm thinking about stocks that have gotten beaten up, that are really cheap. And so a lot of these kind of tend to happen in consumer discretionary right now and some in industrials. There's a bunch of stocks trading at, let's call it, seven-times earnings. We know the earnings estimate is far too high but let's say it's 50% too high. That means the stock is trading at 13, 14 times earnings at the bottom. So as long as it has a clean balance sheet, I think over two years that's a great way to make money.

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On the other side of the book is stocks that I think have held up really well. They're typically more defensive. A lot of these are in the staples, some are in utilities. They are trading at all-time high valuations still, they grow like 3% and so I think that if market sentiment turns at some points, these stocks will underperform. And so that's kind of the big focus of the trades I have on right now.

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Rory Poole: Yeah. And that's, again, speaking to that kind of contrarian notion, if you will, that we talked about before. I want to dive into a few specifics on a sector level, in particular kind of going back to what we talked about at the start with some of those sectors that you tend to be more heavily exposed to on a gross basis. Those that kind of stick out to me being tech, health care, and consumer discretionary.

So, why don't we start with tech because, I mean, that's probably the sector that has been the most exposed to these interest rate moves that we've seen over the course of the past year or so. But again, a sector that you generated a positive return in 2022. So, are there any kind of underlying trends or themes that you're seeing within that space moving into '23?

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Brett Dley: Yeah. And so, again, the direction of, let's call it the NASDAQ when we're talking about *[inaudible]* is not particularly relevant to the performance of this fund. It's the dynamics of what I own versus what I'm short. And so within that, there is a continuation of the cyclical trade. There are parts of tech, specifically semiconductors, that are trading at, in some cases, high single-digit multiples. They are growth stocks. We are in the middle of a semiconductor slowdown, but these things tend to correct over 4 to 6 quarters. We're four quarters into this, so I feel pretty positive that things get better a year from now and the stocks before a year from now will be up a lot. So those are examples of stocks that I own.

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On the other side of tech, there's a portion of tech stocks that are still very expensive, that are often seen as darlings, safe havens. And I think that those, if the market turns and sentiment changes, will underperform. They might not go down necessarily but they won't go up as fast as the stocks that I'm long. And that's how we're going to generate a positive return.

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Rory Poole: Why don't we move to the second most beta-heavy sector, if you will, being consumer discretionary. Do you kind of see any changes from the perspective of the consumer moving into 2023?

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Brett Dley: Yes. The consumer is in trouble. The outlook is not great. I think that's very well understood. There's a debate, are we heading into a recession in 2023? I think we're probably already in one. And so we're seeing it across the board, the numbers are too high. But, like I mentioned, there are parts of this space where the stocks have already more than reflected that. And those are the stocks that I'm starting to buy. On the other hand, there's parts of the space where the earnings will be probably okay. They'll go down a little bit but not too much. But again, they're at all-time highs. These are what I call expensive defensives. It's not an area of the market over two years that I think can outperform.

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Rory Poole: Last but not least, health care. I mean, obviously, we're going through a transition period right now, if you will, where ... I don't want to say we're fully through the pandemic but we're certainly in a different place than we were, call it, two years ago. Is there anything within health care that's kind of sticking out?

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Brett Dley: Yeah. So, I think on the short side within health care there's still a number of companies that had huge benefits from COVID. So, a simple example of that would be a company that their base business is flu tests and that's a fine business and it grows slowly over time. But however, during COVID, they pivoted to COVID tests and their business grew rapidly. That's all coming to an end and I think that earnings will disappoint meaningfully and margins will disappoint meaningfully, too. And it's not in the stock yet. So, within health care, I think are still some COVID winners that will revert back to the norms and the market is not anticipating that.

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Rory Poole: Can we kind of talk a little bit about the broader notion of shorting. I mean, I know it's a huge part of what you do within your fund. It's half of your product in terms of the gross notional exposure that's in there. But I feel like there's still this kind of misconception out there nowadays that short selling is reckless and risky. I personally don't think it needs to be but I'm just curious, as a portfolio manager, what your thoughts are around that.

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Brett Dley: So the Market Neutral Alternative Fund is a true hedge fund. It is a hedge fund. We hedge out risk, we focus on risk. It's one of the most important things we do. So especially on the short book, risk control is very, very important and there's numerous ways we do this.

Number one is we all know what happened with some of these stocks that squeezed two years ago. GameStop is kind of the classic example. We monitor the cost of borrow, which is something we get every day. The higher the cost of borrow, the more shorted the stock is, the higher the risk is that it could squeeze on sort of no information or Reddit or something random. We have specialized software that tells us these buckets of stocks have higher squeeze risk. And, of course, like I mentioned before, we have portfolio sizing. So more bets but smaller bets, which means that if there is a period where there is some sort of squeeze action, we can withstand, it is not going to be detrimental and we're not going to be forced to *[inaudible/cover a?]* position that we think is overvalued.

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So when I think about that and the way that we use short selling to control for risk, especially when we're talking about hedging valuation risk which is something we did within growth tech last year, it can actually be beneficial to your risk metrics. It can actually be used to help control risk. And that's something we demonstrated last year by having a volatility profile much lower than the underlying markets and a positive return profile in a year where basically every asset class was down.

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Rory Poole: Yeah, obviously, very additive towards your process last year and I'm assuming will aim to be kind of in years to come. When it comes to that short side of things though, I am curious a little bit about how does your team play into this? Because everybody talks about the Research Analysts at Fidelity and what goes into stock picking on the long side but how do you kind of capitalize on value or create value when it comes to short selling within your product?

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Brett Dley: That's right. And so the job of a analyst at Fidelity is to cover a certain sector and rate groups of stocks or different stocks in that sector along a scale of buy/sell. So that, to me, sounds exactly like a pair trade. It is exactly what this fund is built around. And so over a long period of time, our buys have outperformed the market by approximately 9% and our sells have underperformed by approximately 7%. What the Market Neutral Alternative Fund allows us to do is, given the new tool of short selling we can capitalize on all the things we've been doing for 20 years: rating stocks, research, visiting companies, understanding the fundamentals. Make money on the long book by owning our buys and actually make money on the short book by selling our sells. So, it's not particularly different than anything we've been doing for a long, long period of time. It's just another tool to capture all the value that we can provide.

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Rory Poole: So you rely on the analysts a fair bit, and I'm a little bit curious then kind of if you can walk us through, we've talked about pair trades a little bit, we've now identified the fact that the research processes is pretty important with regards to this product as well as all of our others.

How do you think of a pair trade? Is it the type of thing that really is kind of your brainchild, if you will, or do you utilize the analysts? What are some of those instances or can you give us a few examples of how Brett Dley thinks of how to pair stock A versus stock B?

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Brett Dley: Absolutely. So again, my whole framework is thinking about relative value. It is not about is this stock going to go up or is the stock going to go down? It is about is this stock going to go up more than another stock or down less than another stock? And so an example, we kind of talked about industrials, but let's talk about airlines as an example. So airlines, you know, some people will never buy them. They're not great businesses. All these things are pretty well understood. However, the way I try and think about the airlines as a way to make money is an example would be last spring, the airline industry was obviously in a tough spot in COVID, it had started to bounce and everybody had booked their leisure trip, right. If you haven't seen your family in two years, you went you booked that trip. If you haven't gone to Disney World, you went, you did it, you went to Vegas. And so that kind of played out. And we're heading into a recession, so we don't have unlimited money and we don't have unlimited time to keep going on those types of trips.

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What was still lagging within the airlines, however, was business travel. And for me, particularly business travel really ramped up sort of in the fall, late summer and I suspect this year it's going to be very, very busy. And so what I try and do within the airlines was I thought about, okay, there are some airlines that are much more exposed to business travel and this is an area that I'm positive on and hasn't recovered. And there are other airlines that are much more focused on leisure and this is an area that heading into a recession doesn't seem so good. So that would be an example long the airline that focuses on business travel, short the airline that focuses on leisure, where we can make some money based on different fundamentals amongst a group of stocks that are typically seen as being very similar.

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Rory Poole: So maybe an analyst takes that airline and they go to a conference and they interview two companies and they come back and they say, hey, Brett, I like company A and I'm not as fond of company B. Is that the type of scenario that can potentially pose a trade for you?

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Brett Dley: That is absolutely, that is something we've been doing for 20 years and that's just something we keep continuing to do in this fund.

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Rory Poole: Great stuff. We've kind of talked about a few things of what this product is today. It's a fund that does not rely on correlation or sensitivity to that of broader markets. It's a fund that strives for, call it, a mid to high single-digit type return profile, consistency, low volatility. How do you want this fund to work for investors?

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Brett Dley: So it's all of those things that you mentioned. We're striving for mid single-digit type returns, maybe a little better with a low volatility profile. But most importantly, we want to have no correlation with the underlying asset class. And so what that can provide, the market was down. The volatility profile was, I think, a third to a fifth of the underlying markets. So putting that in context, that means higher reward with lower risk. So that's the benefit of having a non-correlated asset within your portfolio to diversify, help add to reward and lower risk.

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Rory Poole: And in a year where everything is carrying a correlation of one, or at least it seems, those are the instances where this product can, obviously, be very beneficial for that of investors.

Brett, I want to say thanks so much for your time today and we'll probably hear from you a number of other times within 2023. So, I want to say best of luck and, again, thanks so much for your time today.

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Brett Dley: Thanks for having me.

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