## Fidelity Connects

**Finding Quality Companies in Volatile Markets**

**Steve DuFour**, Portfolio Manager

**Pamela Ritchie**, 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.

Veteran Portfolio Manager Steve DuFour joins us today, manager of the concentrated Fidelity U.S. Focused Stock Fund, for Canadian investors.

2022 has been a turbulent year in equity markets and Steve shares with us today where he is currently finding opportunities using his rigorous stock-picking process, and he notes the key to his process is focusing on relative earnings growth during this time of bearish economic outlook.

Today, with host Pamela Ritchie, Steve also reflects on the energy sector, e-commerce payment companies versus the traditional payment companies, and healthcare among other topics.

One interesting note on healthcare is Steve sharing healthcare in the U.S. is moving towards small and personalized medicine for small subsets of the population.

This podcast was recorded on August 11, 2022.

The views and opinions expressed on this podcast are those of the participants, and do not necessarily reflect those of Fidelity Investments Canada ULC or its affiliates. This podcast is for informational purposes only, and should not be construed as investment, tax, or legal advice.

It is not an offer to sell or buy, or an endorsement, recommendation, or sponsorship of any entity or security cited. Read a fund's prospectus before investing. Funds are not guaranteed. Their values change frequently, and past performance may not be repeated. Fees, expenses and commissions are all associated with fund investments.

[00:01:41]

**Pamela Ritchie:** Steve, just when we say the title of the fund itself, it describes the fact that it's concentrated, there are not a lot of stocks, and I wonder if it sort of bears repeating a little bit, tell us a little bit about the fund itself.

[00:01:53]

**Steve DuFour:** Correct. The U.S. Focused Stock Fund and I try and keep the fund in roughly ... I can go as high as 60 but I own roughly 40 names. Over the years, I've been trying to control risk because when you invest in a concentrated manner you're taking on risk. I try and control the risk by owning companies with strong relative earnings growth, trading at attractive prices. That's what I've been doing in strong markets, weak markets, volatile markets. I'm a strong believer that over time stocks follow the earnings trajectory of a company.

[00:02:40]

**Pamela Ritchie:** Of course, we have had all of those markets as you've just described there. There's been a little bit of everything for the last two years. You, along with everyone, had to kind of bone up on viruses, on the health care sector, on various vaccine producers. Everyone needs to ramp up on that. What are you finding you need to sort of fine tune your skills about now?

[00:03:02]

**Steve DuFour:** You're correct. This all started with COVID and we're still actually still dealing with the ripple effects of COVID. So you're correct, we started off becoming amateur epidemiologists and now we're becoming amateur economists. It's kind of outside of our wheelhouse. I'm in my 30th year here with Fidelity and for 27 of them I spent most of the time talking with companies, figuring out valuations. But the market's being driven. It was first two years ago being driven by the magnitude and duration of COVID, and now it's being dictated by the magnitude and duration of inflation.

There's not a lot of tools to deal with inflation, and so raising interest rates by the Federal Reserve is a blunt tool that they hope can lead to a soft landing. It usually does not. So you're having to go back and what stocks worked last time we went through a strong Fed tightening to deal with inflation, does it result in a soft landing, a hard landing? You're basically doing a lot of history because history, it doesn't usually repeat but it does rhyme. And so you want to basically make sure you understand what happened before and what could happen in the future.

[00:04:36]

**Pamela Ritchie:** In reality, you absolutely are bottoms up in terms of your process. You told us about this before. You've mentioned now that you have to do a little bit of top down because that's sort of the economist hat you have to wear. Where does that take you? First of all, maybe we talk a little bit about the horizon that you're working toward. What are you looking at near term but also how far out?

[00:04:59]

**Steve DuFour:** It's usually about 18 months. The portfolio that's in the fund today is kind of mixture of how I was viewing things 6 to 9 months ago portion of the ownership and how I'm starting to get the fund positioned for the next 18 months. The fund is never, ever 100% positioned for the next 18 months. It's usually a transition of what we thought was working for 18 months, take some profits, rebalance and then get your next 18 months. It's usually a combination of two portfolios at any given time.

[00:05:38]

**Pamela Ritchie:** You used to describe it in terms of buckets, you probably still do, and also in terms of the fairway, which I love golf, not very good at it, but I know what you mean. What's on the fairway these days?

[00:05:50]

**Steve DuFour:** The fairway today is anything that is benefiting from inflation or the Ukrainian war, stuff like that. The fairway today has a lot of energy in it. It has a lot of commodities in it. It also has companies that are, I call "all-weather." There's a lot of problems in the world right now and we could spend the whole thing talking about problems but I'd rather talk about the bright future that's coming in about nine months.

As you deal with inflation, wage pressure, Chinese tensions, commodity costs, a strong dollar, a slowing economy, the list keeps going, there are companies that are better prepared to deal with that. Health insurers here in the U.S., Coca-Cola, companies like that. Those things are in the fairway today. They haven't been in the fairway for many years because, as we've talked in the past, the fairway used to be e-commerce, new types of SASC computing, payment companies, and stuff like that. This type of company is having its day in the fairway. The question is, how long will that last and how quickly do you have to go to a new type of stock?

[00:07:15]

**Pamela Ritchie:** When you're looking at the brighter future, hopefully nine months out, what's going to work and ultimately, the market view on that. Where's the theme of actually payments? You just mentioned there, I was thinking sort of finance generally but payments are still somewhat central to what you're looking at or less? Has it changed around?

[00:07:35]

**Steve DuFour:** It has changed around. As we were heading into the COVID shutdown there were types of payments companies that did very well because they enable e-commerce. They enabled person-to-person payments when we actually weren't in person. People were giving concerts and they were getting paid for giving a concert using Square Cash or Venmo. Their businesses did very well. As we reopened, the original payment companies, the Visas and the Mastercards are doing better because people are going and travelling again. They make a lot of money on cross-border transactions, so people going from the U.S. or Canada to France or Italy or Australia or wherever has picked up during this reopening. That type of payment does well. But as the economy does better, the payment companies usually see the volume through their, I call them their rails.

[00:08:43]

**Pamela Ritchie:** How does inflation, in fact ... not in fact, that's probably the wrong word, sorry ... affect the payments companies? Things cost more, basically. How, ultimately, does that come through on the other side for some of those companies you're looking at?

[00:08:59]

**Steve DuFour:** It actually is a benefit for Visa and MasterCard because as you go and buy something, whether it's a tank of gas or lunch, they get a percentage of what you spend. As long as you keep spending and you're spending higher amounts their take rate stays the same. But the payment to them actually goes up with zero incremental cost.

[00:09:25]

**Pamela Ritchie:** Interesting. very interesting. The U.S. dollar is also interesting. There's a lot of strength through, you know the story well, ultimately, what does that do? We hear about it from a multinational perspective, what companies have to deal with. How do you, if you will, get on board that trend in the same way as inflation? What do you do with that?

[00:09:43]

**Steve DuFour:** In the end its strong relative earnings growth, so if the strong dollar is affecting your earnings and you're taking your earnings down, as long as you're factoring in what the earnings growth is after the strong dollar and comparing it against the other field of investments, that's how I do it. I let the variables go in, go through the income statement and become earnings and then I look at the earnings growth and valuation, two variables, so strong relative earnings growth at attractive prices.

If you are being hurt by it and it's moving you down, you're not making the 40-person team because it is hurting you. I will look through some kind of real franchise businesses which is kind of where we're heading to in the next nine months. One of our larger holdings historically and currently is involved in the rating agencies and the rate of the bond issuances. In the month of July, high-yield bond issuances were down 93%. As you look out nine months from now, and they have comparisons, so I'm looking at the earnings growth currently but I'm also looking what could it be a year from now or 18 months from now? So I've got two stacks. How do you look now in the stack and how do I foresee you looking in 12 months? Because the market's going to pay for the second stack versus the first stack.

[00:11:18]

**Pamela Ritchie:** How, ultimately, does the fund ... would you rate it growth or value? Maybe you don't want to rate it that way but how do you look at that? That's the question.

[00:11:27]

**Steve DuFour:** I would rate it growth but I would tell you that right now ... the market is changing as we sit here, but if you went back kind of two, three months ago, I think growth in the market was the integrated oil companies, the E&P companies, the copper companies – and that was growth. Just because some agency from MSCI or SP said, no, it's Snowflake and Shopify, that's growth, but I'm going growth of earnings, not growth of revenues. I follow the growth in earnings.

That's why it's hard to characterize my fund ever as a value fund but there's periods of time where we're overweight what other people classify as value. We used to have a large integrated bank in our top 10, we had a large integrated oil in our top 10, we had a large steel company in our top 10, a large casino company. But those were for different markets.

[00:12:39]

As we went from the world being shut to the world reopening, as we reopened you wanted to own companies that got crushed during the downturn because their growth rate and their earnings was astronomical coming out. That's what kept our fairway moving towards that type of company. I try not to dictate what I want to own. I look at the earnings and I let the fund meander and meandering is probably not a correct word for the last two, three years. It's been hard left, hard right, hard left, hard right.

[00:13:20]

**Pamela Ritchie:** I think you used the sailing term tacking. You've had to tack a lot, right?

[00:13:23]

**Steve DuFour:** Correct. The introduction of the virus to the world, followed by the shutdown, followed by the development of vaccines for the reopening, followed then by stimulus, followed by record inflation and soon to be record interest rate rises and potential recession. There's not been one type of stock that has been able to stay in strong relative earnings growth at attractive prices. It's been a lot of movement to keep it in the centre of the fairway.

[00:13:58]

**Pamela Ritchie:** What about the evergreenness, like the chairness, the evergreenness of healthcare? Healthcare means a lot of different things, we know. I know that you're very interested in certain companies that are doing incredible things in the fights against various diseases. Do they hold up going forward? Is it as evergreen as we think?

[00:14:20]

**Steve DuFour:** Evergreen is a tough word. It's kind of like how the Fed said inflation was transitory. Everything's transitory if you look out 100 years. Evergreen is a tough word. There are parts of healthcare that have very good franchises that should hold up better than others. The big, big pharmaceutical companies usually have one or two great new products that you go and meet with management and you're very excited about but they have three drugs that are coming off patent. So you're kind of adding two, losing three, adding two, losing three. If you look at their earnings ... we tend not to own some of the larger things because the earnings growth really is never that great because they're losing drugs that are in their 8th, 9th, 10th year with 90% margins and they're having to ramp up spending on new ones. The earnings never really show up in a way for our fund. The big companies, not so much.

[00:15:25]

There usually is a couple good in medtech, more the devices, and there's some great new things... We own a company that makes plastic bags that allow you to make the drugs in a plastic bag versus a metal container. Every time you make that drug you've got to pay them for the bag. It allows people to do smaller batches because we're headed eventually towards personalized medicine. The days of making something and making sure it works for everybody is ... it's not ending but it's slowly going to go away and they're going to be able to make smaller and smaller batches of things that are better for small subsets of the population.

[00:16:12]

**Pamela Ritchie:** Truly such a fascinating area of the market. It really is. Biotech has done incredibly well in the last ... that's not necessarily what you're talking about but we've seen certain areas do very well recently. This is a question rolling in. It somewhat ties back to some of your comments on the U.S. dollar though. Do you consider small-caps, more domestically oriented businesses?

[00:16:33]

**Steve DuFour:** I consider all caps. A stock is a stock. I do take into account liquidity. My first thing on a small- or mid-cap stock is I hit the HP function of my Bloomberg which tells you the average daily trades in the stock. I don't want to get into something I can't buy a good position in and I don't want to get into something I can't get out of. As long as it's fairly liquid, I will buy pretty much anything, anywhere.

[00:17:12]

**Pamela Ritchie:** Tell us a little bit about your outlook for, I'm going to say oil. I think we could talk broadly about energy. We've seen prices come down. We know the story. It's a little bit of a touch point politically and also very personally. Everyone feels it. It's a bit of a hot potato. That said, it seems to be kind of a different playing field. How do you look at the energy companies going forward? Are they important to you? Have they had their run or what do you see?

[00:17:42]

**Steve DuFour:** They are important to me. They have the highest relative earnings growth of any industry right now. The question is, are they attractively priced or not? It's a different world because a lot of them have single digit P/Es which you say, well, that's attractively priced, but the question, and very good question, is it peak earnings or is it the fifth or sixth inning of earnings and you're going to have higher highs? I was the energy analyst many moons ago.

[00:18:20]

**Pamela Ritchie:** You know all the Canadian companies. I remember because you used to come up for a rail company meeting, you know all of them.

[00:18:27]

**Steve DuFour:** The problem with energy is no one knows the future price of oil. The former chairman of Exxon, when I was very young I went down there and said, what's the future price? He looked to me said, "This is going to be our last meeting if you ever come in here again and ask me what the future price of oil is." He goes, "I don't know and all the thousands of people I've hired to predict the price have been wrong year in and year out. So, what's your next question?" I said, "Okay." So this guy has no idea and no one who works for him has any idea, so that's how I learned that no one really does know. No one could have predicted a year ago that oil was going to go up 100% and no one really knows where it's going the next thing.

[00:19:12]

For now, the E&P companies that I talk to, both in Canada and the U.S. and the big integrates, they have found some new religion which is we're not going to raise our capex and we're going to return our excess money to shareholders in the form of either dividends or share buybacks. If that holds, the world demand for oil will exceed production which will result in higher prices. That looks like the path of least resistance. But something always changes. So, you have to watch it and usually the price of oil does a pretty good job of reflecting the future. I punt on that question, but I actually talked for 3 minutes on a punting question.

[00:20:02]

**Pamela Ritchie:** It just goes to how everyone's trying to think through the future on this front because we know that change ultimately will come but at the moment we still very much use all of the traditional energy ways of providing energy to our homes and houses. It's a big question, obviously, in Europe.

What can you tell us about, essentially, what you think might move a little closer? What it will take to move some of the stocks that you've got not on the fairway onto the fairway? What are the pieces? This is sort of going back to the economics question but I'm curious what you need to see in some different, more sustainable way to move certain stocks into more focus. What are you watching?

[00:20:50]

**Steve DuFour:** I am watching the direction of interest rates and all of the other variables that are determining the cost of goods. For most large-cap items, people do not pay cash. They take out a mortgage or they have car payments and stuff like that. So, interest rates have gone up, that stuff is slowing. A lot of industries that are interest-rate dependent, I'm watching to see if it looks like we've reached a peak in the cost of borrowing. That's one thing that whole sector to be there. But also, if interest rates can stabilize, growth stocks are two things. One, they are the growth rate of earnings and two, they are the above-market P/E rate. As interest rates have risen that above-market P/E rate has contracted. I'm spending a lot of time on growthier stocks that have been crushed because as we get past the contracting of the economy to, which I think we're going to have a pause, and I think we'll probably lower interest rates and we go back, I think there's sectors that could not only have higher relative earnings growth but actually have expanding P/E. So I think I can get paid twice. I'm spending a lot of time on that type of stock *[crosstalk]*...

[00:22:18]

**Pamela Ritchie:** You said sectors. Can you tell us the sectors? I won't ask you about the stocks but can you tell us about the sectors?

[00:22:23]

**Steve DuFour:** A lot of it is in software. A number of them are in the chips, in semi equipment stocks, they've all been crushed. A number of e-commerce stocks have been crushed. Most things that you've seen get crushed, at least I've tried to form an opinion on it because I'm looking at going, alright, just because the stock's down 60, 70, 80% doesn't mean it's a buy but I want to make sure I understand what variables took it down and, as you said, what could happen in the next 18 months? As we talked at the beginning of this thing, we've had quick tacks which means we're going to have a couple more tacks because that's what usually happens. I just want to understand, if things do tack back what is the magnitude change in their earnings and what would the market pay for it? So change in earnings plus change of P/E and how much we could make and if things stay the same, what is my downside? That's what I'm doing with a lot of companies and most companies that are down a lot, I'm spending time on.

[00:23:34]

**Pamela Ritchie:** We're glad that you're at the helm doing that, too, because that's serious work. Couple other questions on ... this is coming back a little bit to the way we started but let's dig into it for a minute or so that you've got left here. Can you expand more, Steve, on the type of investment market you see potentially sort of 9, 12, 18 months? You mentioned that generally you're looking 18 months, but do you want to just provide a little bit of perspective on the nearer term and then a bit further out?

[00:24:02]

**Steve DuFour:** I'll do six months out. I think we're still just going to kind of meander along here. I think that the earnings growth of these companies, most everyone's reported their second quarter numbers, which were fine. They weren't great, they weren't bad, they were fine. But they took their third-quarter numbers down. I think third quarter they're going to be fine to miss and then I think they're going to take fourth-quarter numbers down, so that gets us to year end. The good thing is, as we get into next year, and I think during this period there's one fly in the ointment, is midterm elections.

Without midterm elections, I think the Federal Reserve, they know they got behind the eight-ball and they basically have got to crush inflation because if it spreads, if the dandelions spread to the whole lawn, you're not going to have lawn left, you're going to dandelions. They are going to have to crush the dandelions and get it under control. They may or not pause during the midterm elections because some of those states, political not political. During that period, you're going to have okay earnings, rising interest rates, and we're probably going to be in a defined recession. That's what's happening then.

[00:25:33]

The market looks out, the market looks out 12 to 18 months, and so I think people are already looking right now in January and February and that's why on these days when it looks like things *[indecipherable]* things, they go like that. But a year from now I see people moving back to growthier stocks and I think that the days of hanging out in a lot of all-weather stocks will change. I think that people will look for strong relative growth and that'll come from new sectors which are yet to be determined.

[00:26:10]

**Pamela Ritchie:** Happy that you're at the helm of that 'cause that is a tricky one to stickhandle through. Steve DuFour, it's always a pleasure to see you. Thank you for joining us and we look forward to seeing you again soon, perhaps in the fall.

[00:26:23]

**Steve DuFour:** Thank you, Pamela. Have a great day.

**Announcer:** Thanks for listening to the Fidelity Connects podcast. If you haven't done so already, please subscribe to Fidelity Connects on your podcast platform of choice, and if you like what you're hearing, leave a review or a 5-star rating.

You can visit fidelity.ca for more information on future live webcasts, and don't forget to follow Fidelity Canada on Twitter. Thanks again, see you next time.