Fidelity Connects

Live with Dan Dupont

Dan Dupont, 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.

North American markets have continued their turbulence of late, and with central banks trying to contain inflation and oil prices falling, market volatility is not out of frame just yet.

During this period of continued uncertainty, where can investors access downside protection and even potential for some upside with liquid alternatives?

Joining us today to offer his insight on today's market landscape, and to provide an update for both Fidelity Global Value Long/Short Fund and Fidelity Canadian Large Cap Fund is Portfolio Manager Dan Dupont.

On today's show, with host Pamela Ritchie, Dan shares that downside protection continues to be a main feature of his process, believing this provides the opportunity to outperform as compounding can happen from higher levels. Also today, Dan looks at oil companies, the macro picture, shares his thoughts on the overall economy and recession fears, and the state of U.S. companies versus global. Stay tuned for all of this and more.

Today's podcast was recorded on September 27, 2022.

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Pamela Ritchie: So, there's so many moving parts to the markets right now but the overall sort of concern is ultimately where you go to hide. It's sort of that question right now, where do people hide. Let's talk a little bit about how your style provides the capture of the downside because this really feels like a difficult time for many of those in the equity markets right now. How do you balance that out in your style?

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Dan Dupont: Well, my style has never changed. It was a little bit less in favour for a few years. It's the beauty of Fidelity. We have a lot of different styles and you can get forgotten for a few years and you keep grinding and you keep your head down, you work hard. With Canadian Large Cap Fund, for example, there's never been a negative calendar year but for a few years it was a lot of shiny objects out there with more growthy titles and that was fine. It was where the performance was and now it does feel like there's a lot of headwinds on the growth side and there's certainly a lot more tailwinds in the process that focuses more on capital preservation.

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Right now, it does feel like the economy is slowing down. It's not substantial yet because balance sheets of individuals and corporations have been enhanced significantly during the pandemic through monetary and fiscal stimulus. But now that's being reversed aggressively, mostly on the monetary side. On the fiscal side, eventually it might have to be, as we saw with the pound, the British pound just became super volatile two days ago as the market is finally telling governments that's enough. You can't really cut taxes more in certain instances, so we'll see how that evolves. But for sure, individuals balance sheets are still very good, but credit card balances are going up rapidly.

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Interest rates going up and the economy slowing down incrementally every month shows that people are just trying to keep the spending at the level that it was but it's tough, so credit card balances are going up and interest rates going up is certainly grinding things down everywhere and mostly in capital markets we can see it. There's giant losses being taken on investment banks balance sheets as they can't find buyers for the debt of private equity deals. These are the first signs of things getting worse. They still have the balance sheet capacity for now but warehousing of loans on balance sheets is what happened in '07, '08, when things were getting a little worse.

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So we're seeing signs. I don't know how bad it will get. It will be a slow down or tough recession. We've had 12 years of the NASDAQ going up. We haven't had really a recession that created bankruptcies in 12, 13 years, so we're certainly due for one. It would be, I think, good for everyone and everything to have a slight cleansing process because we've had money, we've had interest rates at zero for 12, 13 years. Science projects ... we call it science projects which are companies which don't have even a wish of ever making money ever, those are going to go away slowly and we're certainly making money on the short side, shorting some of those, some more aggressively than others. It does feel like it's not there yet. There's no individual bankruptcies or corporate bankruptcies that are close yet but we're seeing the first signs.

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Pamela Ritchie: Let's go to the Long/Short Fund as well. You mentioned Large Cap off the top. Give us a sense, actually, of your positioning on the Long/Short. I think you just mentioned a few there, the science project side of things. Are there other parts of the market that are of interest for you in that fund?

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Dan Dupont: That's evolved quite significantly since last year, although there are pockets that are similar. For example, software was a place where I'd say historically you have to be careful shorting that or not owning it because high cash flowing business, not a lot of debt, high return on capital. If you can find one that's growing rapidly and has a nice niche, you could probably make money and have a tough time shorting. But they got so expensive, 80, 90 times sales. We all remember Scott McNealy's quote 2002 that said, "What were you thinking? You paid 10 times sales for my stock and here all the things that needed to go right for that to be a price that's correct." So, we made money on the short side in software, for example, and we're pretty much not there anymore.

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We're not long yet. I've looked at a few that were attractive, almost pulled the trigger, but definitely not there on the short side in North America. I'm still short one in Australia. I was short one in the Netherlands but, in general, software, the short trade is pretty much done and you might start looking on the long side. Hugo, for example, is really good at looking at software names that are really depressed in valuation, so it's starting to get more interesting. The clean tech...

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Pamela Ritchie: Okay, perfect. I was going to ask you about energy.

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Dan Dupont: Two sides to energy, right? So clean tech, environmental transition. That's been interesting to watch and it's still, because of the Inflation Reduction Act there's the second wave of overvaluation in what I call clean tech which is transition in fuel to something more renewable.

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Pamela Ritchie: Just explain that a little bit. Last year we saw them get just really bid up and then kind of the air came out of that.

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Dan Dupont: It did come out with kind of that bubble and the same with software names. The low interest rates really inflated that part of the market. There was demand also from the transition to funds that were more environmentally friendly. It was stronger in Europe, but it was also strong in North America. But certainly, there's a lot of pressure for money managers to go into more environmentally friendly way and that pushed these valuations up significantly. That includes electric cars, that includes manufacturers of equipment for solar and wind energy or even wind and solar energy companies. That deflated with interest rates going up and with this science project overvaluation deflating but with the Inflation Reduction Act it gave a second wind. So those came back up.

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There's a lot of, in my view, opportunity to short there. There's just massive overvaluation. Electric cars, still a little bit of opportunity there. It's less than it was. There's more and more opportunity for me on the short side with companies that are just structured ... the balance sheet is badly structured and/or they're going into this slowdown in recession just badly structured and badly positioned. It's been 13 years, so people don't remember how bad it can get. You can short a stock that is 8, 10 times earnings that looks optically cheap but that will get decimated in a recession. The easiest ones are the ones that are new industries.

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One that I've been short for a while so I can talk about, Carvana, for example, which is involved in financing of car sales online, used cars. They used to securitize that, but history does not repeat but it certainly rhymes. Companies that were involved in packaging mortgages in '07, '08 eventually blew up as they started warehousing those loans on their own balance sheet because they couldn't refinance them. Carvana now has a tough time refinancing and packaging the car loans, so it's warehousing them on its own balance sheet. You couldn't make this up. It's the exact same thing in a different industry. As this is happening, I think ultimately we're seeing the financing they're doing on their balance sheet with some of the Wall Street players that are not mainstream banks but hedge funds, for example, are financing them. It's clear, if you read the fine print, the odds that they end up owning the equity is very, very high.

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That's just one example out there of areas where we can take advantage of a situation because we have now the ability with the Long/Short Fund. We also have the analytical ability through our fixed income department. You don't talk to fixed income when times are good. I haven't spoken to fixed income in 10 years and about six months ago, I'd say, hey, remember me, and we started doing a lot of work. On Carvana, we spent a lot of time analyzing that one specifically. There's a whole bunch of them out there as well. Affirm, same thing. Buy now, pay later. Short now, cover later.

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Pamela Ritchie: It was very popular, maybe it still is.

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Dan Dupont: Yeah, it's still popular. People are using them more and more but, again, it's a new industry. They're lending $1,000, $2,000 to people through short-term payments. You can buy something in six instalments, you pay every two weeks for three months, for example. But there's no recourse. Everybody should sign up and borrow $2,000 from these companies because, for the most part, it doesn't go on your credit rating and they have no recourse. The odds that some of these companies go to zero are very, very high. These are the still the very attractive ones. I'm trying to diversify what I'm short, obviously, but certainly you can feel it, you can see it in the numbers and all taken together, to me, tells me that the odds of a recession are just going up and up.

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Pamela Ritchie: Maybe some parts of the world are already in it. We don't really know. I just want to go back to energy for a second because you were speaking a little bit about alternative energies is coming along quickly, lots of innovation, really interesting space. What about oil itself? We've obviously seen prices come down. We know that. Many will say that's been peak oil. But you look even further out and it's still ... there are question marks, aren't there, on the supply side.

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Dan Dupont: Yeah. oil is an industry I spent a lot of time in in 2020 because it was so cheap and I needed a very...

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Pamela Ritchie: It was zero, remember? The ETF went to 0.

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Dan Dupont: Yeah. I made a very large bet in Canadian Large Cap Fund and we were looking at it every day just to make sure that the thesis was correct and it ended up being correct. At this point I feel, based on our analysis, I feel like I really shouldn't be shorting oil. Gas is just, again, it changes every day, so I couldn't tell you where I was last week and next week. It's just Europe is evolving every day. There's new information coming in every day. In general, supply demand is still interesting to me, so I'm still long some pure oil companies in Canadian Large Cap Fund despite the fact that I think a recession is coming. It's not a huge position but cash flow ability, generating ability, is so gigantic that it's tough for me to see a short thesis. We own a little bit and in the Long/Short Fund as well I own some on the long side. We may have made money getting there on the short side with specific ideas but in general, I still think it's dangerous to be short oil.

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Pamela Ritchie: Going back to your process for finding shorts. I think you gave a great example just a couple of minutes ago. Can you give us the broader case for how you go about looking for ideas and the process that you use?

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Dan Dupont: If I can just take a step back to explain the fund in 20 seconds. It's a 150/50, that's the maximum you can go, 150% long, 50% short. So let's say if I'm aggressively positioned, I would be long 130% and short 40% of net asset value. The net long would be the difference between the two. So, 130 minus 40 would be net long 90. So pretty close to a typical fund. The short book, 40% of net asset value would be split half/half between arbitrage and outright shorts. The outright shorts, we made a decent amount of money there. About 60% of our alpha has been in that short book year-to-date, for example, and that would be the Affirms and the Carvanas, for example.

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Now, the arbitrage, that's very low volatility. It's a transaction where a company A is buying company B and there's a tiny spread between the two and we're going to make a little bit of money before the transaction closes. The biggest volatility in the fund comes from that 20% of net asset value where we have outright shorts. That would include things like Tesla, for example, that we've been short for a long time now. I'm not going to go into that specific name because it's a very controversial one and it's not an overwhelming position either.

Generally, I try to have a few buckets so you're well-diversified in the short book so that the volatility doesn't swing *[audio cuts out]* around too much. I learned my lessons. I really thought I knew what I was doing when I started that fund in the fall of 2020 and then Q1 of 2021 arrived and there was a lot of volatility, the meme stocks and all that, so I went from a novice to being basically an MMA fighter in the ring. The last lessons were learned there and now I feel like I really know exactly every move that's coming and I'm ready for anything.

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Pamela Ritchie: Some of the selloffs that we see, depending on the day, and, as you say, everything seems to change every day right now. There are some broad-based swings, so how do you work with the volatility? It can be across the sectors.

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Dan Dupont: Great question. I can adjust the size of that short book a little bit. If you take around mid-June where everything was going down and everything felt too easy, the size of that short book went down, so I went down to close to 15% of net asset value that was outright shorts and those were my highest convictions and I made them even smaller weights than they were a month or two before. Then when everything rebounded, we covered things in mid-June that went up 20, 25% in a matter of 2 to 3 weeks. So, you reanalyze them quickly, you know them well, you wonder why the big bounce and if nothing changed it was just a relief rally and then the expectation of a Fed pivot. You discount that, you look at it and you analyze all of it and eventually you might just reshort the same name that you were short before.

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The short book will move with the fluctuations in the market and since the start of this fund, the beta of the fund has been negative on average which is really a very weird environment. It's not my expectation that it will be for a long time. Ultimately, what this fund will become is something like Canadian Large Cap Fund which is lower volatility than an equity benchmark but hopefully better performance than the benchmark over time.

So, Canadian Large Cap Fund, since I've been on the fund it's been the same process where I try to have much lower volatility than the market but try to outperform. We've had effectively a balanced fund volatility in this product.

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The main feature of the process that I follow is it's a downside capture which tends to be very low which gives us then the opportunity to outperform as we compound from a higher level. If you correct way less than the market, it gives you first, the ability to stay invested because it's much less stressful but two, mostly, you can compound faster by reinvesting when you have those dips. That's my job. I'm here for this which is a lot easier when you don't have a direct client.

On days when the market's down 4 or 5%, I have nobody to talk about other than my analysts and/or calling one or two companies but I can reinvest with confidence and with being aggressive and being decisive because I've been patient before, which is exactly what happened in March of 2020. Sometimes it's difficult to be that patient but ultimately, when the opportunities come very rapidly you can aggressively deploy that cash. When the Couche-Tard rumour happened two years ago, it was very easy. I'd been patient on the name, I knew exactly where I wanted to get in there and then it dropped massively.

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Pamela Ritchie: What rumour are you talking about?

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Dan Dupont: They were rumoured to buy something in France which the market hated. It was kind of warranted, that reaction. Probably it was overdone a little bit but it was somewhat warranted. We're up since then, I don't know, 50+% on that particular position. We haven't touched a share of it, you just sit on it. There's not a lot of trades but they can be quite bulky and we can zig when the market is zagging and that's what we've done in Canadian Large Cap Fund. That's what I intend to do with this Long/Short Fund as well, but it gives us more opportunities because you can short as well and you can position with more or less volatility depending on how many opportunities you have on the short side. The short side has been just, it's been fish in a barrel, honestly.

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The problem last fall in the short book was not finding out what the difficult part was managing volatility because you knew some of these stocks were 10 times overpriced. They were just super volatile, so you needed to size your position appropriately. Even a Carvana, for example, even if you truly believe it is going asymptotically to zero at some point, it did double at some point last month or the month before. You have to size things appropriately and you have to be really smart about the way you approach things. The more time I spend on the short book and managing this product the more familiar I become with all the movements that are possible and how to structure it. We have an internal risk management team as well which has been really, really helpful.

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Pamela Ritchie: From a macro perspective, walking in to, say, this year were you thinking, okay, there are going to be rate hikes in January? Many thought they were overdue even then but it got going in March, as we know. Did you kind of walk into the year thinking, well, this is the year where liquidity comes out of the market and it's going to be ... Did you know this was all going to happen, Dan, or no?

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Dan Dupont: I've been at this for over two decades. I'm more and more humbled the more time goes by. At the beginning of the year, I didn't really know what was going to happen. I try to be positioned to not get hurt too much. That's the first thing. You can't paint yourself in a corner. Inflation was higher than I thought, let's be honest. I think it was higher than a lot of people thought. At this point you just have to adjust to the data that's coming in. That's what I did at the beginning of the year and that's what I'm going to keep doing.

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Once inflation started to perk up then yeah, obviously interest rates were going to go up and the Fed was definitely behind the curve and there was a decent chance they were going to be more aggressive than they need to be just to show that they finally have what it takes to tame inflation. They don't want inflation to be unanchored. At this point now, again, we have to decide where we are and what's going to happen. Interest rates, mostly on the long end, certainly seem pretty high. You look at the 10-year, the 20-year relative to the amount of debt that's outstanding everywhere, governments and corporates, it does feel high.

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Pamela Ritchie: Well, that's the thing. The governments are going to get...

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Dan Dupont: I'm not a fixed income expert but it does ... if people were out of bonds completely at some point, it certainly does feel like it might be time to put the toe in the water back. From my vantage point, I do a lot of arbitrage and arbitrage returns have increased significantly. If you invest in an arbitrage deal that's going to close in six months, your alternative that has a little bit less risk would be to buy a six-month government bond. It's always a spread relative to government bonds and those have gone up quite significantly. The spreads on arbitrage have gone up quite significantly making arbitrage investing more interesting. You balance that with stocks going down, so on days when the market just has been down for a few weeks, you finally realize, okay, yes, I have a higher spread on an arbitrage deal but it's much more interesting to swing back the other way.

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Last Friday, for example, it was kind of the best of all worlds in some of these arbitrage positions because a lot of them are in U.S. dollars. The Canadian dollar was coming down, down, down, down, so in Canadian dollars you made a lot of money owning an arbitrage deal that was getting close to the end date of the closing of the transaction. Spreads are getting really tight as you get close to the transaction.

On Friday, if you owned an arbitrage deal you were able to sell it, which we did, for example, in some of my funds, with a .05 or .1% spreads, a gigantic amount to a U.S. bank that knows there's practically no risk there. Then you turn around and that was in U.S. dollars, right, so in Canadian dollars even if you gave the bank a spread of .1%, you were still up 0.5%. It's all complicated.

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Then you turn around and you buy something that's down 5% on the day, like a great company that you were just patiently waiting to get to your price. You just zig when the market is zagging, I guess, is what I'm saying and I'll keep doing that. The size of the short book will keep moving up and down when I talk about targeted shorts and if I find less targeted shorts, there's less opportunity there, we'll go more into arbitrage. The long book, it's around 65% of net asset value is invested in typical long stocks, stocks that are high quality, that were cheap enough when I bought them that I want to own over the long term and that's going to go up and up and up and up.

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Pamela Ritchie: So, tell us what you think is priced into the market. Could earnings be a catalyst for getting things priced into the market? There's a question of that. But I guess all of those questions with the overall question of the downside capture, it's hard to know what comes next but earnings is one question rolling in. What do you think of this earnings season?

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Dan Dupont: Well, earnings is kind of the question really, as usual. In the medium to long term what you have to think about is where are profit margins going. Profit margins in the U.S. have been really high. There's more higher quality companies in the U.S. market than elsewhere. Probably part of that is warranted, probably not all of it. The thinking has to be, where do I go once we have a recession, where do I want to do the homework? For me, it might hit my target prices a little bit quicker in some parts of Europe and even, you look at emerging markets. But I want to be patient. I learned my lessons.

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Pamela Ritchie: Can you go there, globally can you...

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Dan Dupont: Emerging markets, it has to be really, really attractive for me to go there. It's mostly a developed market fund in Global Value Long/Short and Canadian Large Cap Fund is a large-cap product, so I typically don't go in emerging markets. I'd say in developed markets, the U.S. has outperformed the rest of the world massively over the last 10 years and at some point some of that is going to come back and it's a question of when and how much and where do you want to position. I want to do it gently, I want to do it slowly but I do know that and I can see that there's some really attractive valuations. For now, we have some positions there but it's hurting us slightly on the performance side, also slightly on the currency side.

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I've learned to respect momentum. I'm not going to go one direction and aggressively into Europe and Asia but I think it's certainly one way to look and global funds for the next 10 years if we look at history, should have a pretty good performance relative to the U.S. although on a stock-by-stock basis, sometimes you look for stocks globally and you always end up back in the U.S. because the higher quality one is in the U.S. It's a balancing act.

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Pamela Ritchie: What about within a sector. Sorry, I just have a minute to ask this question. Within sectors, the discrepancies between companies, ultimately, within the same sector. This seems like a very interesting moment. Can you comment?

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Dan Dupont: Sometimes it's easy, you're correct. Sometimes the internationally based company will be in the same industry, will have the same kind of global footprint and it will be cheaper. That's one hint to us that going global is probably not a bad idea at this point. It's been really painful, though. I can't talk against that. We've lost some basis points owning European-based companies just on the currency or the U.K. The U.K. was volatile like an emerging market currency a little earlier this week. So it's being careful, it's balancing things and it's pouncing when something is really cheap enough. I think we're getting closer to a moment where you should probably tilt to global.

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Pamela Ritchie: Fascinating. Dan Dupont, it's been amazing to speak with you. Thank you for joining us and we look forward to catching up with you soon.

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Dan Dupont: It's been my pleasure. Thanks, Pam.

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Pamela Ritchie: Thanks for joining us. I'm Pamela Ritchie.

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Thanks again, see you next time.