Fidelity Connects

ESG Analysis: Considerations for the Year Ahead

Matt Egerton, Analyst and Portfolio Manager

Bryan Borzykowski, 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 we're joined by Matt Egerton, Fidelity Analyst and Portfolio Manager, for a look at investment opportunities with an ESG lens.

The 2022 United Nations Climate Change Conference is underway in Egypt with global policy makers coming together to discuss several key climate change issues, including how to reduce greenhouse gas emissions, reaching net zero by 2050, and the ongoing energy crisis. But the conference hasn't come without criticism of America's Inflation Reduction Act. So, what are the implications between the two, and is there a commitment from the U.S. financial community to fund the energy transition?

Matt unpacks this and more with host Bryan Borzykowski today. A few additional key topics include the role of oil and gas in the future, if rich countries should be compensating poor countries for the effects of climate change, how ESG ratings are created, and what is Fidelity's approach to ESG metrics and ratings?

Today's podcast was recorded on November 18th 2022.

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Bryan Borzykowski: So, obviously, the big news today is COP27 ending. It's been going on for a couple of weeks now. What have you been noticing from that? There was at the beginning, before this started a lot of people weren't sure how this would follow up the COP26. What are your observations?

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Matt Egerton: A lot of questions. I think in general this is all about implementation, COP27, COP26, more about target setting. There's an important difference there. I think it's critical that you've seen, obviously, Joe Biden there but President Xi as well turning in. I think all the big hitters on the same platform which is really important when we talk about implementation.

For Biden, I think it's come at a time ... you mentioned at the start the Inflation Reduction Act, the IRA, demonstrating the U.S. is back on the table, back in terms of thinking about climate leadership and that's important too. It's great to have the kind of momentum that brings to the party.

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I think, other than that, you've seen things like deforestation pick up from the COP26. That was a theme there and President Lula from Brazil promising to kind of end deforestation in the Amazon, or at least in the Brazilian Amazon. That's important as well. I think, for me, the bigger, the really high-level discussion point of observation is around what the UN would term loss and damage. That's the sense that rich countries should compensate poor countries for the impacts of climate change and help drive and help support that transition away from fossil fuel energy. There's not been a lot of progress on that, it seems like, in fairness. We'll see what comes out of today in some of the documentation but that seems like it's still something to be discussed over time. It's, obviously, a difficult topic.

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I think within that, some areas of, I guess, promise would point to the *[indecipherable]* Indonesian coal deal. There's a $10 billion transition package that seems to be supported or coming through as part of the discussions behind the scenes here. It's being supported by seven international banks which is kind of a new piece there. It's HSBC, Bank of America, Citi, have been named there as well. That's really important. It's really encouraging. It's modeled on something from the COP26 with South Africa, this $8.5 billion package to help support transition from coal in South Africa. So, that's important.

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In the last, I would say from a sort of financial industry perspective, people might be familiar with GFANZ which is Glasgow Financial Alliance for Net Zero, a bit of a tongue twister but it was set up by Mark Carney. That now has $150 trillion of assets sitting behind that. I think that's going to be a very important vehicle to try and encourage that flow of capital that you mentioned earlier.

I was at a dinner at an ESG conference over the summer and I was sitting by one of the GFANZ board members. We started there talking about some of the intricacies behind the scenes. He was making the point that you had all these sign-ups, it's fantastic news, great support, it's now about shepherding that. How do you kind of shape what's a massive and disparate asset base and a bunch of different interests into kind of action and transition action. I think what we've seen from COP27 is GFANZ committing to by next fall providing a kind of open-source database for different projects, transition projects, and spotlight progress so they can help dictate or help encourage capital flows into the areas most needed.

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Bryan Borzykowski: It sounds like some progress was made. I think there was some concern before would the momentum be there to see this through. Would people be excited about continuing the work that they did at COP26 but from your view, it sounds like there is that momentum to carry forward into the coming year.

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Matt Egerton: I think that's right. The whole phrase of keeping 1.5 degrees alive was still thrown around. I think on balance, that was felt that that's still the case. Some of the wording, maybe it's been watered down. We're talk about two degrees again. Obviously that's a bit worrying but in general there's some areas of optimism I think we can point to.

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Bryan Borzykowski: Tell me a bit about the Inflation Reduction Act. That was big news for all sorts of reasons. Climate change was just a part of that. When you saw that getting passed, what are some of the key, I guess, areas that you're paying attention to from the IRA?

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Matt Egerton: I think in general terms, a bite of $300 billion package, roughly, you can slice it slightly differently, the biggest part of the plan, it comes in two parts.

The first is an extension of what was already existing, some energy credits that were already in the system so, it's an extension for ten years. Critically, it also includes a piece where the U.S. has to reduce its greenhouse gas emissions by 75% within the plan. As long as that's not the case, the plan is still live. What that means is that extension of credits could be way longer than ten years. This is something that I think has been missed a little bit in the documentation and the understanding. It's a complex document but I was speaking to a utility company few weeks back and they believe these credits to actually be in place till 2040s, even the 2050s. That's a hugely different sort of scale than the ten years that's kind of been thrown around. That's one kind of part of it.

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The second part of it is the credits they'll provide for domestic manufacturing and supporting localization of inputs across the kind of clean tech chain in particular. That's important for things like solar and wind where these are long-dated investments and having that kind of visibility on that funding, that support is really important and that should kind of catalyze local investment.

I think one of the high-level points here, and this is, obviously, still fairly new, but when we think about this as a longer-dated perspective, the competition for green dollar investment capital is a global story. Just as climate change is a global story, so is the allocation of capital. Potentially with this deal, it could really elevate the U.S. to maybe even above Europe in some of these decision points as to where do you put that dollar of capital.

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I think when we think about it much longer term, you could be optimistic. You could get to a point where there's a sort of flywheel where you invest today, you further bring down the cost of these technologies, clean tech technologies, and by doing that you have this kind of new – and this is very much the bull case – you have the situation where the U.S. industrial base and the residential base sits on this sort of low-cost clean energy and maybe even takes over the mantle from low-cost gas. You could get to that point eventually and it's all about this flywheel. When we try to think about the impact longer term, it's much bigger than the 300 billion we're talking about right now.

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Bryan Borzykowski: This legislation will have a real impact.

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Matt Egerton: I think so. I was at a conference last week, an industrial conference, meeting a bunch of companies right across the spectrum. All the companies, even if you're making some kind of widget or you're directly involved with insulation or you're making solutions to help reduce water intensity, whatever you do in an industrial chain, most companies have some exposure. There's this underpin here. It's in different buckets. There is something you can call out, relate to the IRA.

I think what that means is when we're, obviously, in a softer economic environment, we're all trying to work out are we in recession, are we not, how close are we. What you can, at least, say is over the medium term there's things that like the IRA, like the sort of things around support for electric vehicles, that exist that you can sort of point to and feel better about.

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In the GFC, looking through that, you couldn't say that there were things the other side. We're all trying to call in the immediate term, of course, but at least there are things to be constructive about. I think when I look at the U.S. industrial base as a whole, that's very constructive versus other geographies in particular. You think about things like reonshoring being a further tailwind. I think that's one of the messages that came from the conference certainly when I was there last week in Chicago.

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Bryan Borzykowski: Let's talk about ESG maybe a bit more generally. It's been an interesting year given geopolitical conflict, energy crisis in Europe. You have sort of people on one side saying, hey, no, this proves we need to have more oil and gas because of the energy issues that are happening in Europe. You have other people saying, no, this actually proves that we need to speed up the transition, that we can't rely on oil and gas, we need more renewables and other sources of energy.

I'm not going into the politics here but what do you see as sort of the future of ESG? Maybe it's not cut and dry, I don't know. How does what's going on now today kind of impact the market that you're paying attention to?

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Matt Egerton: It's a really important issue, as I said before. We'll get to the politics. Everyone has different views and that's totally fine. What I would say is in general terms, the time horizon matters. I think we can all agree to this – and I find this really interesting – this is a once in planet transition away from fossil fuels. In 200 years time, it's not even going to be a relevant discussion. It's all about time horizon, when does it matter? We say, generally speaking, maybe oil demand peaks in 2030 so it's still very much a relevant industry. It's still very much needed to support the transition whether it's oil or gas or the different facets of fossil fuel energy use. That's not going away.

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I think from an ESG perspective it's important to acknowledge that. I think it doesn't necessarily mean that an ESG fund has to invest in oil and gas. We need to protect client choice. Clients can allocate towards funds and mandates that can support that kind of thing. I think in general terms, it's important we remember that oil and gas companies, typically self-funded. It's not as if equity investors are injecting capital in these companies. That's not how it goes. The bond investors, that's a little bit different, supporting capital in different ways, so it's still an important point.

I think, in general terms, when I think about the way ESG interacts with this, one of the debates – and we've seen a high profile company in Canada, I won't name it, but investing in fossil fuel transition. So, you own a company, then you sort of say, okay, we're going to wind down this production or we're going to replace it with clean energy and we're going to manage it in a responsible way. I think that raises some interesting questions.

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Arguably, we all talked about the need to encourage change and engage with companies and make sure that we hold companies to account in those kinds of plans but there's a role to play. If a company can demonstrate that without their involvement this would not happen, then that's clearly an impact. I think we can make that case. I think it's nuance in the discussion. It's not about just bashing one side or the other. It's becoming a little bit more sensible and then making sure that the mandates are very clear. The portfolios that we all manage are very clear about what we actually invest in and what is the philosophy and where are the exclusions and making sure that's clear and consistent. I think that's what we hope to get to over time.

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Bryan Borzykowski: ESG, a lot of people do focus on the environment but what is the progress that you're seeing on the S and the G? Is that improving as well?

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Matt Egerton: I think the S point, I sort of invest in the U.S. entirely, the conversation with companies right across the industries about S is very much about data gathering. It's still a little bit early. They're saying, okay, to begin with, let's understand our workforce, let's understand what matters to them, let's understand kind of where we could work harder, where we've sort of dropped the ball, and then let's lay out a plan.

At the moment, I would say, yeah, most companies have got a good sense of their workforce and what matters. It's just now kind of integrating it into a thoughtful response. I look at the data across the different industries, I think in general, there's still limited progress when it comes to ensuring diversity exists right through the organization. You're seeing it at the entry level. You're seeing it in things like stats around application funnels, widening funnels to make sure that there's equal opportunity across different forms of diversity. You're seeing that but you're not necessarily seeing it translate all the way through to senior leadership, C-suite.That's going to take time. I think we all appreciate that.

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It's upon us, I think, through our engagement with companies to continue to further that and require disclosure. I think through disclosure, it means that within a company different ... HR team has to talk with the operational team, has to talk with different geographies across the organization, understand where are they falling behind, where they're not doing enough work, and where can they improve things. Disclosure is an important piece of that. It shouldn't be dismissed.

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On the G side, at Fidelity we have a voting policy where we want to see – it's sort of a G and S theme – but we want to see a minimum of 30% board representation by females. At the moment in the U.S., we're not always there. I don't know exactly the split as to what share of companies would fall below that but my guess is it's probably a quarter. This is a complete guess, just ballpark it, it feels like that based on my interactions. We're trying to encourage companies to improve their diversity of boards. If we don't see that, we will vote against the head of the nominating committee in the cases where that hasn't met our threshold. That's a new policy, base-level, that we are implementing across the across the group.

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Bryan Borzykowski: Can you talk a bit more about your approach. Fidelity's approach, to ESG, how do you incorporate different metrics and just ratings? You have your own proprietary ratings. How do you incorporate that into the investments that fund managers choose to put in their portfolios?

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Matt Egerton: The key thing there is that this is done by the analyst team, the research analyst team. We have a sustainable investing team which is about 30 people globally dispersed all over the map but the investment team does the ESG rating. What that means is the analysts might cover 30 companies. They're responsible for putting that rating, an A to an E, on a company. It's very much trying to be forward looking just as the investment recommendation would be, using the data that's presented but thinking about where's the appetite to change or improve that. That's an important part of the engagement, that slots in there. It's all very much thinking the next year ahead.

It's also about thinking about appetite for change. What is the openness to improve, that is important. We have a fixed score, A to E, that's aggregated across three pillars, the E, S and the G column, three separate pillars, and there's also a trajectory score. It's improving, deteriorating or stable. Again, we're trying to make sure that we have a dynamic score and that can be updated any time by the analyst.

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In terms of the PM involvement, just like the funds, you have all the ESG ratings, the fundamental ratings available to all PMs on our central insight system. The PMs can look at the research behind the ESG rating and they can probe it further with the analysts, back and forth, what do we need to do to see this rating improve, let's understand that. It's not about leaning on the analysts to encourage that change risk but understanding how can we work with the company to improve that. That's kind of how it's integrated.

Again, it's with the analysts, the analysts and the PM are having a conversation, the sustainable investing team can come into that conversation and certainly inform things like thematic engagement … talking about the fashion industry. I supported that with some of my budget allocation to do a survey on U.S. fast fashion and that was part of the same investment team and they worked with us on that. That kind of comes in as well. The conversation between analysts and the PM, that's where it should be and that's where we've centred the ESG rating and I think that's the most important part of it.

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Bryan Borzykowski: What about these Fidelity ratings that you have developed, what does that look like? Is that in response to the fact that there is a lack of common standards across the industry at the moment? I know people are trying to change that but there is no real sort of standard that everyone's following when it comes to investments.

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Matt Egerton: There isn't and what I ascribe to – and I love to make this argument – is that just like you have a buy, sell, hold recommendation on a stock, you have different views on the ESG credentials of a company. It all comes down to materiality. We can disagree with that, everyone has a different view on that. We think the person with the best, or the member of the team with the strongest view on what is material when it comes to value creation but also impact or risk, is the analyst. What we do is we let the analysts dictate the materiality score. When I talk about those three columns, the E, the S and the G, overlaying all that is a materiality assessment that's been set by the sector team. I was in the bank's team at the time. We sat down in a room, we compared notes there, I think there was 99 different ESG options we had or things that we scored each company on.

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Of these, what are the key things for banks? That's going to be different for oil and gas, it's going to be different by consumer companies, by tech, but for each analyst group let's agree on that, commonly, globally. With that, we can measure companies and benchmark them on the same basis. Banking in the U.S., we compared to a bank in the U.K. and that, I think, is the right way to do it. When we think about the different scores out there with third party rating agencies, we do pay attention to that, it does matter. It's important we get our homework marked by a third party, absolutely, but for us, in terms of thinking about the engagement, thinking about where to drill down further, where to do more work, the Fidelity rating, we think, is a really good place to start.

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Bryan Borzykowski: Do you think there will be common standards that everyone can follow at some point?

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Matt Egerton: I'd love to say so. I think, in reality, there's two ways to take that. I think the first one is there's going to be a disclosure standard, a common disclosure standard and there's going to be a common investment standard.

The first one, the disclosure standard. I'm talking about things basically like an accounting standard, like an IFRS that the U.S. [GAF?]. I can see a world where that exists and that's going to be very much about disclosure and I don't think that's too high a hurdle. The U.S. regulatory framework and ESG in general is based on disclosure. It's about asking companies or making companies disclose a common set of data points that the investor or the market can then take and incorporate as they wish into the investment allocation or into the assessment of risk or reward. That's the way the U.S. is doing it. I think other countries, other geographies can get to that. I think that makes sense.

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On the second part around a common investment framework, I think that's going to be very difficult. I think you've seen the EU kind of forge ahead. It's very detailed, it's very thorough. It's difficult to kind of comply with all the different pieces of it. Obviously, we're working very hard on that behind the scenes. I can't see other geographies having the appetite to be quite as prescriptive as the EU has been. So, I don't see that's going to be the case. That does change where the assets are managed in different geographies. I think that will be the case for some time.

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Bryan Borzykowski: I just want to clarify something on Fidelity's approach. There's ESG funds and then there is incorporating ESG factors into all the analysis. What do you do, is it ESG funds or do you incorporate into kind of every stock choice that fund managers and analysts look at?

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Matt Egerton: It's actually a good clarification. Every analyst has to provide ESG ratings of all the companies that they cover. Whether they cover companies for ESG funds or for global funds that don't think about ESG or local Canadian funds that may or may not incorporate ESG to different extents. The analysts serve all the funds. That's the model that we have and there's different PMs that absorb the information. Every company has an ESG rating and a fundamental rating. It is then up to the PM, depending on their mandate and how they communicate their mandate, obviously – it's very important that they stick to that –how they incorporate, how they take into account those factors that have been discussed in that rating. I hope that clarifies that. It's everywhere but then it's up to the PM and what they would deem to be important for their specific mandate. That protects the client choice.

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Bryan Borzykowski: Great. Back to climate change, much of the narrative has been on replacing fossil fuels, do you see more conversation in the future on land and soil management, repairing the water cycle and other areas that might have a greater impact?

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Matt Egerton: It's interesting. Biodiversity loss is a big part of that, too. I think at the moment, when I think about my engagement with the companies, they are razor focused on the scope 1, scope 2, scope 3, and I think that is somewhat seen for them as a sort of low hanging fruit. I think it's just the reality of where we are right now in the U.S. where they sort of start to catch up, I think, with some of this. At the moment it is very much a case, how can we get to net zero, let's set a target and then we can fill in the gaps. That's kind of where the workflows are. In terms of the conversation, I think what's difficult for companies, U.S. large companies, is setting a global target on that. Certain geographies, obviously, have more work to do with regards to some of these considerations.

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I used to cover emerging markets back a few years ago and obviously some of the challenges there are different and we have to acknowledge that. It doesn't mean they're not important. It doesn't mean that biodiversity and soil management, water quality is not important issues, they obviously are, and they're starting from a point much further behind. I remember a meeting last week with a water company, 80% of waste water in emerging markets is not treated. That's a huge issue.

I think, for companies at the moment, when it comes to the non, let's say, within environmental, the non-climate piece, they're taking it on a plant-by-plant basis and they're probably, frankly, starting with the U.S. That's not a scientific point but anecdotally I kind of get that sense. They start in the U.S., what can we do to improve our water management and our waste management, which has a direct impact on soil management. They'll start with the U.S. Hopefully, that means we can roll out some of these solutions more globally. I think it feels a little early. Not that it should be but it does feel a little bit early in terms of the list of priorities that the companies are taking, to be honest.

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Bryan Borzykowski: Another question from the advisors is, what could a recession's impact be on ESG investing? Also, does the energy crisis in Europe mean more investment opportunities there?

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Matt Egerton: I think in general terms, the IRA, it shouldn't be that recessionary sensitive, which an interesting part about it. These credits are going to make sense kind of regardless of recession or not. You're going to see that kind of plough on anyway, I think, which is an interesting dynamic.

In general terms around options within in green investment, I think at the moment we're still a little bit ... I'm probably making it sound that the IRA is very clear and obvious and it's open field and let's go. In reality, there's still a piece to kind of iron out. Things like local content inclusion in the U.S.. What do you have to do to qualify for a credit? What sort of types of things qualify? What does not qualify? How do we set up supply chains to make sure that it's a robust assessment? These things are ongoing. While I probably make it sound a bit too straightforward, there's still some working out to be done.

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From my side, from the analyst side, it's very much working out within the supply chain, the value chain, who's going to benefit, who's going to share the credit more or less with the end consumer, whether it's retail, residential consumer or a commercial client, that's still to be done. The direction of travel is there but who wins and who loses is still a little bit to be to be determined. That's where the opportunities lie, ultimately, but we're still working through that.

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Bryan Borzykowski: Back to the ratings for a minute, Fidelity's ratings. Do all PMs have access to the ratings or is it on a mandate-by-mandate basis on how they use those ESG ratings? Maybe talk a little bit more about that.

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Matt Egerton: Yes, all PMs have access. I can open the inside tile. I've got it in front of me here from earlier on today. You can type in the company name and it comes up with the all the research that we've had over history at Fidelity. You've got over 30 years of equity research history in that insight portal. Same with ESG. The ESG is, obviously, a lot newer than that, so we have we had a V1, version 1 system, we rolled out version 2 last year. I've talked about that a few times on different calls here. That V2 system is live and it's available for all PMs at their fingertips and they can drill down. I can open up a company, pick your company, I can open up the E, S and the G column, I can click and see what the analyst has written, all the data is integrated into that as well, so it's all brought in there. It's all in one place.

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For me, the biggest use case ... maybe it's interesting to folks on the line ... is engagement. I say, okay, I'm going to meet with a company, what are the most pertinent issues, what are the most material issues that we think need to change or could see improvement, let's pull that down from the rating and we'll go from there. That's kind of an important part of the workflow that wasn't there historically. While we integrate a lot of these factors, maybe the formalization wasn't quite there and that is important when you're trying to have a more robust conversation with the company. You need to be informed. You need to understand where this is coming from. They need to know that you understand the issues or you understand the companies in the sector and the considerations when they try and make targets. That makes that conversation much more fruitful, I think, for all of us. I think it's much more useful all round.

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Bryan Borzykowski: You cover U.S. financials, too and I want to get a quick overview of kind of what you're seeing there. Before that, just to connect these two themes, ESG and financials, where do you see sort of the role of the financial industry when it comes to funding the transition? There's lots of technology, lots of physical assets that need trillions of dollars of investments. Are capital markets in the U.S. coming up with innovative products? Are they there to help fund the transition? What do you see from that part of the market?

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Matt Egerton: We talked about GFANZ earlier, GFANZ is a part of that and signing up for these agreements to try and move capital around, that's absolutely part of it. I think, as well, you have to acknowledge that you still need fresh IPOs in the space to provide opportunity, greenfield opportunity to deploy finance. We're talking about private markets as well. Private markets will play a role in funding, particularly, earlier stage investments in the space around the impact area. In general, I think with sort of public markets, it's very much about how do you support various M&A or how do you encourage kind of capex allocations when you engage with companies? How do you kind of respond to different ideas that they may have to decarbonize? How do you respond to trade-offs that they might have in their business and provide encouragement? I think that's the way I would sort of phrase it.

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It's a little bit more about rewarding the companies that are making these investments in a sensible way and demonstrating transition. I think by doing so protects, whether it's protecting their earnings base, reducing the business risk or whether it's growing a new franchise, I think it's incumbent on capital markets to identify that and then support those kind of transitions and support that higher growth or whatever it be, higher margins, whatever the attribute is. It's that combination of engaging with companies and then kind of making sure you identify the opportunities where the most attractive returns or growth opportunities come from as a result of those transition investments.

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Bryan Borzykowski: Just quickly, we have a minute left, U.S. financials more broadly, not necessarily ESG-related, what's the health of that market like? Where are the opportunities that you're seeing?

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Matt Egerton: In one minute, the last time I was on Fidelity Connects was in August, we talked then about [indecipherable] the playbook would be. Early in the cycle you buy financials, typically that's the playbook. Back in August, they weren't valued for that, I felt. Right now in Q3 earnings, we've seen a few … the tree has been shaken in some areas and some of these names have fallen from grace. Maybe it's a difficult quarter, one particular issue, and that, I think, has opened opportunities. So, you're starting to see that valuation marry up with where it probably should be at this point in the cycle. That makes the space much more interesting than it was when we spoke in August.

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Bryan Borzykowski: Great. I will leave it there. Lots more to talk about, obviously, but I'm sure you'll be back soon and we can dig into all these issues again. Thank you so much for joining us.

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Matt Egerton: Thanks, Bryan. Thanks, everybody.

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