Fidelity Connects

Introducing Fidelity SmartHedge U.S. Equity Fund

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

It's been a choppy start to 2023 for U.S. equity markets, as signs of cooling inflation and slower growth have left investors wondering: what's next? With recession fears still looming, investors may want to consider a defensive, options-based equity strategy that could hedge against potential market declines. And now investors have the opportunity to do just that, with the all-new Fidelity Smart Hedge U.S. Equity Fund.

Joining Fidelity Connects today to introduce Fidelity SmartHedge™ U.S. Equity Fund is Portfolio Manager and Derivatives Analyst Eric Granat and Investment Product Vice President Tim Callahan.

Eric and Tim join host Pamela Ritchie to explain how this fund may complement an investors existing investment portfolio and why might financial advisors want to consider this strategy now. Whether you are an investment professional or an investor, today's show will have something for you.

Fidelity SmartHedge™ U.S. Equity Fund aims to achieve long-term capital growth, investing primarily in equity securities of some of America's largest companies. The Fund uses an options-based derivatives strategy to hedge market exposure to help mitigate downside risk while providing upside participation. Eric manages the fund, alongside Zach Dewhirst, Mitch Livstone, and also leverages Fidelity's global research network and investment expertise.

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Pamela Ritchie: Tim, let's begin, if you don't mind, with you. Tell us a little bit about, outline some markets issues going on right now but why this type of strategy now?

[00:02:25]

Tim Callahan: You highlighted some very pertinent questions, Pamela. Just given the economic backdrop and the volatility we've seen in the markets in the last couple of years, this is the type of product that we think could be super interesting, additive to really any investor portfolio. We'll get into some of the reasons why we think that's the case moving forward.

Two or three years ago we really embarked on this project. It's been a little bit of a labour of love for us just trying to increase the number of sophisticated products that we have on offer to really solve some of the more vexing problems that investors face and that we think are going to continue to face into the future: higher inflation, more volatility, that kind of Goldilocks scenario we saw for more than a decade after the global financial crisis where stocks and bonds just kind of went straight up with no volatility every year. We didn't think that that was all that likely to persist into the future. Obviously, the last two to three years have borne that out. We've been hard at work here in the investment product group, working with our partners in asset management to bring more sophisticated solutions forward and we think this product is a perfect manifestation of that.

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Pamela Ritchie: That's great. Eric, how do puts and calls help, ultimately, investors in a market like this?

[00:03:43]

Eric Granat: Pamela, that's a great question. Puts and calls, and specific to this product, puts only really are the optimal hedging tool we have at our disposal. We have a strong bias towards centrally cleared exchange-traded S&P 500 put options. That's where the world really comes to hedge equity market risk. Those are the products in the security set we exclusively incorporate in this strategy.

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Pamela Ritchie: Tim, tell us a little bit about ... an investor might like to use this strategy because, I mean, that's what everyone joining us here today is sort of thinking. Okay, I've got clients with this type, these different types of portfolios, this is meant to complement, perhaps, an existing approach.

[00:04:26]

Tim Callahan: It is, Pamela, very much so. If you think about where you typically get defensiveness in your portfolio, there's a couple of different ways to achieve it. Obviously, a strategic allocation is the bedrock of any portfolio. Diversification across traditional asset classes, stocks, bonds, cash. That works great, and has worked great, for most of the time over the past century. It's certainly worked fantastically well post global financial crisis. For the most part a 60/40 portfolio outperformed pretty much any other approach and you really didn't want a ton of diversification because if you had too much diversification, you underperformed the market. That's certainly one way to do it.

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The issue with strategic allocations is that during times like high inflation that we saw over the last year, correlations tend to spike and that benefit that you traditionally get from a mix of stocks and bonds really breaks down. Folks have heard the expression, there's been nowhere to hide, that's certainly been true in traditional asset classes. Another way of adding defensiveness is to get tactical, to go to cash. We think that's really hard. Maybe some of the folks on the call are smart enough to do that but getting those inflection points right is really, really difficult, we think. So, this approach, which is more contractual, it's always on protection, we think it's the safest way to go about it and most consistent and most persistent in terms of protection that you get.

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Pamela Ritchie: Eric, just pick up on that for us, if you would. Protection, for instance, on the downside but what if markets go up?

[00:06:07]

Eric Granat: That's something that we always wanted to position ourselves so that we can cheer right alongside the investor for the market to go up. That's a great outcome for this strategy. I think, not to drill too deeply into our options overlay in the portfolio, we know that to provide a very effective downside hedge across market cycles we need to do two things well. We think about drawdowns not only in terms of the immediate spike in volatility, the sharp, sometimes painful drawdown in equity market prices and the loss of investor confidence but we also think about the second phase, and I don't think it gets enough acknowledgement, and that's the subsequent rebound. Investors come back to the market, volatility drops, prices rebound. So, it's very important for us to navigate both sides of those to really create a product that's going to perform well, not just for a specific 2020 drawdown event or a 2002 event, but a broad range of different market volatility shocks.

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Pamela Ritchie: Tim, if you would, just sketch for us how the team works together, the composition of the team running this fund.

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Tim Callahan: So, Eric is our primary practitioner here. He's got an absolute ton of derivatives experience. There's no one at Fidelity that has been thinking about derivatives and looking into these markets longer than Eric has. He's got a very strong investment team and platform behind him. We've been hard at work here at Fidelity investing in both the front, middle, and back office to support a full suite of derivatives products, to ensure best execution, to make sure that we've got the most sophisticated set of tools from a fiduciary standpoint that we can bring forward to help with strategies like this to really solve investor problems. Eric's got a very strong team behind him. We've got a CIO named Mitch Livstone, who's got a ton of experience in the liquid alts and hedge fund world as well, top-shelf risk management systems, and really the full weight and support of Fidelity fundamental and quantitative research behind it. Is there anything you'd add to that, Eric?

[00:08:11]

Eric Granat: No, I think that's fair. We've been building this team out in our internal processes for over 10 years and there's the right way to do things and then I'd say there's the Fidelity standard. We didn't move quickly into the space. We took our time building out the operational systems, hiring the right people, building the trading methodologies, the portfolio management tools, the risk management features that meet all of the criteria, the elevated criteria, of the Fidelity standard. That's a little bit about how we think about the product and the care that we put into it. I think that dovetails with how we've constructed our team.

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Pamela Ritchie: Eric, you can't go very far without hearing about headlines of different types of technologies that have improved across, really, every industry, particularly though within finance. Products like this that were thought of and came and were manifested years ago, how different would they be to creating a product today, launching it tomorrow? What the difference?

[00:09:11]

Eric Granat: That's such a great question. It highlights what's so fun about working in the derivatives space. If you win the clock back 10 or 15 years, maybe 20 years, not to date myself, in the S&P 500 option space we had one, maybe two

option expirations per month. We had a total of across the U.S. anyways, maybe four option exchanges. Fast forward to today, we have 18 to 22 expiration dates per month. We have over 20 option exchanges in the U.S. The market has matured at a rate that is just sometimes hard to keep up with but it's also that rapid maturity in the market has been a tremendous advantage for us.

We benefit in launching products today relative to our peers that launched maybe 5, 10 … we have competitors out there that launched almost 40 years ago. They didn't have the tools at their disposal that we have today. I don't like the term to say that we've developed a next generation product but we're certainly using these new tools to benefit the construction of this new portfolio relative to what our peers had at their disposal when they launched, again, 5, 10 years ago.

[00:10:18]

Pamela Ritchie: Tim, just keeping in line with a risk profile, for instance. I mean, every type of investing has some inherent risk in it, there's no question. What do investors, advisors need to know about the risk profile of this?

[00:10:32]

Tim Callahan: It's a classic defensive equity product, Pamela. It's going to participate in the upside, it certainly has beta exposure to the S&P 500, to the U.S. equity market, but it's going to have a muted volatility profile, which we think is really important for any number of reasons. If you think about it, it's a great behavioural finance-type product. A lot of folks suffer pitfalls and biases in the behavioural space. We're wired to not be great investors, particularly in times of stress and severe stress like we've seen in the market over the last few years. This is the type of product that really kind of mitigates some of those concerns and really encourages folks to stay the course, stay in the market. I mentioned tactical allocations like trying to go to cash. Again, that's really hard. Eric mentioned a little bit about market volatility events having distinct phases, the drawdown and the recovery. Oftentimes the recovery is as sharp as the drawdown.

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You really saw that post-COVID in March and April of 2020. If you went to cash and missed those first few trading days when the market rebounded, you missed a lot of upside. There's a big opportunity cost potentially, especially if you're wrong. The market doesn't send you an all-clear memo. The market leads and the indicators lag. This is really a product that insulates us from our worst tendencies, to a degree. That's one of the primary use cases, Pamela. Why we would recommend putting it at the core of a portfolio, why we think it's a terrific add to a core of a portfolio, is it really mutes the volatility of the equity portion of the portfolio while still giving you that equity market participation on the upside.

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Pamela Ritchie: Eric, how, ultimately, do you look at how much of the portfolio is hedged at any one time? Can you give us any detail on that?

[00:12:27]

Eric Granat: This is a systematic rules-based strategy. We do actively manage it day-to-day but the level of protection is we target 100% at all times. We're not looking to toggle the level of protection based on volatility levels or our own appetite for risk in the marketplace, we're targeting 100% hedge at all times, and that will vary time-to-time but the safest way to think about that is, generally speaking, we have 100% of the equity exposure hedged at all times.

In very rare periods where we see the cost of put protection go up dramatically, those are environments where I'd say – if people are familiar with the VIX index, or maybe in Canada, the CVIX index, in U.S. terms – once we see VIX trading

above 0.5, 0.6, we know that those puts are incredibly expensive, at which point we do have a floor. And no matter what, at least 75% of the portfolio is hedged. But I have to say that that's such a rare event. I think for the sake of this conversation, we target 100%, that's generally where we land 90+% of the time.

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Pamela Ritchie: Are there costs that advisors want to know, investors would want to know, associated with buying and also selling certain types of options contracts that you manage, but that people might want to be aware of?

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Eric Granat: Yeah, sure. As far as implementation costs, it's important to note that there are two components to this strategy. We're passively replicating the S&P 500 with a quantitative process. Our portfolio rebalancing is based just to track the index, so we're not making any bets there. Our implementation costs are very low. From the option side of things, we're trading at least every month but it's important to note that we're only really trading about a third of the portfolio every month. Those implementation costs, we find, are far lower than many of our peers that have a very active strategy where they're moving in and out of positions based on either a model or some other factor. We're maintaining these positions and we have a systematic *[indecipherable]* strategy that, again, particularly with the heyday of electronic trading and how prevalent it is in our exchanges, our implementation costs remain consistently low on the option side as well.

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Pamela Ritchie: Tim, tell us about a collar strategy of competitors, how this works. Take us into this conversation.

[00:14:43]

Tim Callahan: There are some terrific competitor products out there in the marketplace that are more like collar strategies. Your last question about costs is really germane to the discussion here. Eric talked about the explicit costs of trading options. Some of the competition, they kind of market the strategy as costless from a defensive standpoint in that they're paying for the put protection on the downside by selling call options. So, they're harvesting premia associated by writing calls and then buying long puts with those premia and kind of calling it a wash. That works great if the market trades within a certain range. But if the market goes up, which it sometimes does as we talked about here, what you're doing is you're selling your upside. The explicit costs may be low but the implicit or opportunity cost is very high.

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That's something that we've thought a lot about and Eric and his team have done a ton of research on. We're really trying to stay out of the way of market rallies. The market goes up a lot more often than it goes down from a frequency distribution standpoint. If the market goes up violently enough, happily, we don't want our equity upside to get called away. We want investors to participate in that upside because that's where the compounding really kicks in. We've designed the product in that way to really stay out of the way when the market is rallying. We think that is a very important and differentiating feature of our strategy relative to some of the other ones.

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Pamela Ritchie: Does this product address currency risk in any way?

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Eric Granat: No, we do not perform currency hedging in the strategy.

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Pamela Ritchie: Tell us again a little bit, if you don't mind, Tim, let's come back to who this is for. I just want to sort of sketch out. You've got people invested in this market, they've looked at last year's concerns in the market, it was a complicated year, there's no question, walking into this year who, again, would be taking a look at this and how would they apply it, the application question, really.

[00:16:48]

Tim Callahan: Yeah, sure thing, Pamela. That's a really interesting question and I'll share a little bit of some of our thoughts on that. Our thinking has evolved on it based on some feedback we've got from our distribution teams with whom we started working.

We launched this product in the United States a few months ago and we've started to get some terrific feedback from advisors and some use cases that we didn't even think of in terms of applications for the strategy have come forward that I'll share with you because I just think they're super fascinating. Our core thought on this was, there were kind of two primary use cases that we had in mind was for folks that are just maybe really nervous about the market and under-allocated to equities, maybe too much cash on the sideline, this is a terrific product for them because it gives you equity market exposure with a muted volatility profile. You're not going to experience the rollercoaster ride that the market can take you on, particularly on those down days that folks get really nervous about. That was our primary use case, was to try to coax maybe some cash off the sidelines into a product like this as a way to dip your toe in the water for equity exposure.

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Another one was just maybe you're overallocated to equities or you're concerned about equity market valuation, the fact that equities have run so much over the last decade, you could substitute a portion of your equity portfolio into our defensive equity strategy here to take some of that market risk off the table.

Another use case has kind of developed from talking with some of our internal asset allocators who build solutions here, packaged solutions for clients both in the United States and Canada, our asset allocators are interested in investing in this strategy as a way to express an overweight to equities. If you want to overweight an already fully loaded equity portfolio but maybe wanted to dial down the risk a little bit of that overweight, this is another way to do it. There's kind of myriad use cases here. It really depends — I hate saying it depends — but it really does depend on the situation of the individual investor. This strategy can really be implemented in a number of different ways and complement an existing portfolio in a number of ways.

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Pamela Ritchie: Eric, a couple of questions, just wanting to go back to the bare bones of taking a look at derivatives, put and call options. You're using puts, but if you can just sort of do a starter, people interested in this strategy, ultimately, how it might work, but they need a reminder.

[00:19:20]

Eric Granat: Yeah, definitely. It's a great question, Pamela. This strategy, as Tim highlighted, we're focused on explicit costs, right? We're competing against quite a few competitors out there that deploy either a collar strategy where they're selling an upside call to help fund their puts, or in many cases a put spread collar. The feedback we received for the market was that there was a desire for explicit cost. People like strategies that are rules-based and we want to produce a strategy that's going to work across a wide array of market events. To get into the details of how we deploy the strategy, we basically at any one time always hold at least six different expiration dates in generally six different strike prices. We don't have a specific view on how high or how low the market might go in the future, but we do know that we want to diversify our puts across time so that we can hedge the widest swath of potential future market downside events possible.

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The other thing we want to take out of it, and we see this as an opportunity...we see actually two opportunities. The first is that we don't want timing risk into this. We don't want timing risk in the product. What I mean by that is options are incredibly unique instruments. They expire sometimes on a weekly, monthly or quarterly cadence, and oftentimes many of our peers will go ahead and purchase options at a specific cadence, whether it's every single month or every third month, but that can introduce market timing risk that is not beneficial to the strategy.

We need the ability to provide a solution that is going to offer investors a very, I want to say equivalent, that's probably not compliance approved, but very similar risk attribute, the same risk attributes relative to the investor that joined on day one, day 15, day 60 of the quarter. That's really what we're trying to do and why we so broadly diversify not only our expiration dates but also our strike prices.

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Pamela Ritchie: Let me just sort of add into there, for instance, we're hearing about the U.S. debt ceiling right now. We hear about it often, many people don't worry about it but it's a big headline event and so on. You don't want to walk into it timing that, but the talk about it today might be quite different from the talk about it, say, in the spring, for instance.

Tell us just how, ultimately, investors can walk into this product at no specific time but be able to get some of the advantages, just sort of expanding on what you're doing but there are events that people are aware of out there that may become greater or lesser fears going forward.

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Eric Granat: Yes, that's right. Boy, there's just an infinite number of risk events out there that we have to think about. The debt issue is certainly one of them. So, diversifying, again, strike price but also expiration date allows us to achieve a couple of things. There's no one period of time where we know we only have a day or two or five days until all of our protection is about to expire and then we have to go ahead and refresh it. Avoiding that monthly or quarterly refresh of our put protection allows us to create a smoother downside dampening profile in the portfolio so that whatever event's coming our way, we're going to have a level of risk mitigation in this strategy that is commensurate or consistent with our objectives.

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Tim Callahan: Just picking up on that, Pamela, because I think your last question really hits at an important differentiating characteristic of our strategy. We've talked a lot about the upside advantages of this product where we're really trying to stay out of the way when the market rallies. Eric just, and you hinted at these exogenous shocks that happen from time

to time, these kind of black swan-ish events, you don't know when they're coming, they don't happen all that often but when they do, they do a lot of damage to portfolios when you get these really severe drawdowns. Our product is really protecting against that left tail event. We've got a little bit of a barbell put option portfolio where we're trying to protect in more moderate drawdowns but some of the allocation on that explicit cost that Eric mentioned is really those longer-dated put options that are much further out of the money with more of an explosive convexity profile.

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So, when you do get one of these events, like you mentioned, we know the debt ceiling debate is coming but we didn't know that, for instance, Russia was going to invade Ukraine. Some people may have thought that, but these events happen in the world that we don't anticipate, that we're not prepared for, and when they do that tail risk protection that we bring to the table with this product can really kick in. Again, you don't need it all the time but when you have it, you're glad you do.

[00:24:13]

Pamela Ritchie: Tim, I might just ask you to kind of add on to a comment you made about asset allocators. Actually, I think our Fidelity Connects, Fidelity Canada, quite familiar with David and David and Geoff Stein also. Do you want to just tell us a little bit about how you work with some of the asset allocators? I think you've had some conversations, certainly, with Geoff.

[00:24:35]

Tim Callahan: Yeah, sure thing. Pamela. My team is responsible for harnessing the great investment capabilities that we have at Fidelity, like Eric here and his team, and creating both products that can be sold direct to consumers and customers, institutional, intermediary clients, but also creating building blocks for internal solutions. They're one of our primary constituents and we feel like they're true institutional investors, so if we're meeting their needs from an investment requirement perspective, they're very likely meeting the needs of external investors as well. That's an input that we take very heavily into our product design and portfolio construction is the needs of our internal asset allocators.

Geoff Stein's a great example. He manages tens of billions of assets up in Canada. He is invested in our hedged equity products. These liquid alternative products that I mentioned at the top are building blocks to our solutions that we provide for our customers both in the U.S. and Canada. It's really nice to have that interest from our internal asset allocators because it makes us feel like we're bringing the right solutions to the marketplace.

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Pamela Ritchie: Eric, any final thoughts? There is one question coming in on back to the defensive nature of this: what is the kind of risk rating ultimately? Do you want to just finish out with some comments on, broadly, what you're trying to accomplish here?

[00:25:54]

Eric Granat: Yeah, definitely. I think many of the advisors in this discussion or that are watching today are accustomed to hedged equity strategies out there in the marketplace. I think what I would like to tell them is that this strategy is a little bit unique relative to our peers. We're focused on outperformance in the tail. The protection that we have embedded in this strategy is really going to kick in, it's really going to add value in the highest volatility drawdown events. Those are the markets where we really worry about the investor making a bad decision and saying, that's it, I've had enough. So, how can we keep investors in the markets when things get scary.

The other part is the right tail. It doesn't get enough attention. How do we allow investors to participate in a hedged equity strategy without totally throwing away their upside in those just momentous, awesome years, 2013, '19, '21? How do we get that as much participation as we can? That's how we stack up and that's probably how I would, in a nutshell, compare our product to what else is out there in the marketplace.

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Pamela Ritchie: Tim and Eric, I want to thank you both for joining us. It's been a pleasure to speak with each of you.

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Tim Callahan: Thank you. It was fun. Thanks, Pamela.

[00:27:06]

Eric Granat: Yeah, thank you, Pamela.

[00:27:08]

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

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