Fidelity Connects

Earth Week: Hugo Lavallée on Climate Leadership

Hugh Lavallée, 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.

Joining the show today is Hugo Lavallée, Montreal-based Fidelity Canada Portfolio Manager, who joins host Pamela Ritchie for a portfolio update and a look at how he is applying his contrarian investing style to his funds in this year's choppy markets.

Hugo, who recently celebrated his 20-year anniversary with Fidelity, has long-managed Fidelity Greater Canada Fund and Canadian Opportunities Fund. He also manages Fidelity Climate Leadership Fund, launched in May 2021, which is a global equity strategy designed to reduce the risks and benefit from opportunities created by the global decarbonization trend.

As 2022 comes to a close, it's important to highlight and dissect areas of the market that gained momentum, and investor interest, to help shape the trends of 2023. One area that continues to gain traction is the ESG movement and investors continue to modify and evolve their strategies to align with today's fluid market conditions.

Today, Hugo and Pamela unpack what ESG strategies advisors and investors should consider leading into 2023. And look at what's on the horizon for climate leadership in the new year.

Reflecting on his current positioning, Hugo shares his European exposure is growing as there is an opportunity to create a double positive involving both capital gain on stocks and exchange rates. He also notes that he and his team look to find strong companies at a cheap valuation as the market dampens, sharing that when the market is uncomfortable it leads you to buy cheap stocks, and the stocks are cheap because they are uncomfortable.

Today's podcast was recorded on November 15, 2022, and for anyone interested in French content from Hugo, please check out our Dialogues Fidelity podcast channel. Hugo also spoke with Charles Danis, VP Regional Sales Quebec, and that discussion will be featured there.

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Pamela Ritchie: Let's begin with the markets. What does a guy like you – we know your approach is contrarian – what do you do with markets like this?

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Hugo Lavallée: I just feel like the market's been coming my way, right? It's been a tough year for the markets, a real bear market, and I try to separate the personal from the professional. There's all these reasons to be worried and negative on the personal life and war and it feels like the world's shrinking and interest rates but at work, what I really try to do and what I've done in the past is lean in with the analysts on cheap stocks. The market, until recently, the NASDAQ is down 30%. There's been some real pain out there. There's hedge funds going up. There's pain from higher rates. What can we look at, what prices can we lean in? That's really, I think, one of my strength is to look at we've got some situations, we've got some companies, we've got some compounders, they're having a really, really tough year.

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I think what we went through this earnings season has been really important because we've been talking for nine months that the market's falling but the earnings estimates haven't really fallen and they finally started falling after Q3. It's more like a regular recession because during COVID, the stock market was adjusting so much faster than the companies could but now it reminds me more of a garden-variety recession where the companies are coming in and saying, you know what, our revenues are under pressure, advertising's under pressure, our clients are a little bit more frugal and you're seeing margins compression. In a way, the negative earnings season for a lot of companies, it's good because it's part of that cleansing process. As prices fall, for me, it's just an opportunity to lean in.

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Pamela, what I'm really focused on with the analysts is give me a price where you think Company X, Y, Z, the stock can double over three to five years and if it can double over three to five years, we're going to beat the market, we're going to be fine. There's just more opportunities like that now than nine months ago.

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Pamela Ritchie: So tell me a little bit about how the market is doing what a market does really, rewarding and taking away. We are seeing that. There's been some sort of "wow" action out there in the market. What do you see sort of from your perspective? What are you looking at?

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Hugo Lavallée: I think simplistically the one thing I've been really focused on and the one thing I wanted to tell clients this morning was, I think the market's going to force behavioural change with the management teams and with some of the board of directors. All of a sudden, it's less fun and the market's sending different signals. Before, for a lot of companies, I'm not here to debate if it was right or wrong, but it was grow your top line, don't focus on profit growth, don't focus on cash flow. Those days are gone. We can look back at history in a few years how it was just a very special moment in time but everybody was trying to be like Amazon in the '90s. That ship has sailed. The cost of capital has gone up; the risk-free rate has gone up.

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What you're seeing is companies are being punished for keep on following that strategy. Eventually, especially in North America, people don't like losing. Your stock price is down 70, 80%. You're not as popular at the Friday cocktail party. When you're meeting a bunch of other CEOs, people mock you. If you're on the board, it's a cozy board and things are well and all of a sudden you've got angry investors calling in unhappy. That leads to change. You've got employees that are dissatisfied because their stock options are way underwater and you're starting seeing it now. I think the market's going to force companies to pivot and you're already seeing it.

What we've seen is companies where I'm going to keep investing my business, my top line is going to go to the moon, and now the top line is under pressure. But they're still investing and the margins are compressing and those stock prices are getting really being punished. I think what you're going to see is behavioural change and you're starting to see it. The S&P 500 companies are starting layoffs because the world's changed and I think they need to adapt.

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Pamela Ritchie: The capex story in general with the rising cost of capital … that's not a new story, we've known that for months. Do you see there's sort of a rubber hitting the road at this point?

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Hugo Lavallée: 100%. So it's capex and opex. That's what the companies can control. They'll find their way but what I like to remind clients is, in general, it's been a tough earnings season where you're seeing margin compression. Eventually you see the opposite. You see companies, they've adjusted their cost base and all of a sudden revenues accelerate, whenever that is, and you see margin expansion and that's really powerful for stock prices.

For me, it's positive what's happened. We're seeing CPI coming a little bit below expectation. We're in the business of second derivatives. We're not in the business of absolute. The CPI on Thursday was the same it was earlier this year but it's …

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Pamela Ritchie: And today, the PPI, I mean, looking at that, that was…

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Hugo Lavallée: Exactly. But it's just perceived completely differently because we're in the business of second derivative. It's important to remind us and the clients that. What I try to do with the analysts … I'm in Toronto this week working with the almost 25 analysts we have here. What prices do we lean in? We're going through earnings season, what do we see? What do we engage with boards of directors know, try to have some changes. I don't know – it just feels it's a little bit right up my alley versus nine months ago. I'm working really hard to try to reposition the funds.

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Pamela Ritchie: Tell us a little bit about the global situation which maybe we should, on some level, ignore it. There's been a real focus on macro and that has sort of driven the markets, obviously, we know that. Which pieces of it do you look at? Do you look at the midterms? You, obviously, look at the Fed; everyone does. What are you trying to sort of block out and actually take from?

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Hugo Lavallée: It's always just how much is discounted. For example, I was noticing, personally, that over me doing some marketing with some clients over the last few weeks, there was just a lot of fear on the world getting smaller and political uncertainties. We've got the war on one end in Europe, we got China-U.S. And what I like to remind clients is I've been doing this for 20 years and there've been some really messed up times over the last 20 years. Working for a U.S. firm in a high rise post-911 wasn't super comforting. November of '08, Pamela, you'll remember that, when the Congress struck down TARP. You're wondering if we're going to have a financial system. I remember when my wife brought the kids early from school on a Thursday during COVID not really knowing what was going to happen. I made sure to open a nice bottle of wine that night, not a cheap one because I don't know what was going to happen. I'm not going to drink the cheap stuff now if we're all going to die. There's these moments in time that are really messed up and sad but you've got to push that aside and be a little bit optimistic. Obviously, we'll see this incredibly tragedy in Europe but we'll see what happens. But already this morning, we get a little bit more positive news on China-U.S.

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Pamela Ritchie: Can I go into the climate discussion just on that because there had been, a long time ago now, one of the threads of cooperation was actually going to be on climate. Then, of course, the world collapsed because of COVID. Is that back on?

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Hugo Lavallée: I think so. I think it's good to see the China news this morning. It's heartwarming on more collaboration with the U.S. but I think it's just on for three reasons. You've got decarbonization but more importantly, in a way, more importantly in the short term if you're a country, how do you control inflation? How do you separate yourself and control your own destiny from rogue nations, energy security. You can hit all three with renewables. That's what I tell clients. It's even more relevant now post February 24th. It's to each its own right; different countries have different solutions that they need to consider. For France, it might be nuclear. For Denmark, it's wind. You need all forms of energy and how do you separate yourself? How do you control your own energy security?

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We have these options that weren't there 50 years ago. We just have to use them. I think the war, unfortunately, put the spotlight back on, hey, you can't depend on these nations that marginalize women, marginalize minorities, invade other countries. Not every country is freedom loving, energy producing like Canada and the United States. There's very few of those actually in the world.

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Pamela Ritchie: I know, it's an amazing position that Canada finds itself and that works well.

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Hugo Lavallée: If you're Germany, you need to make a pivot. If you're a corporate German company, if you're BMW, you don't even know – it's industrial power base of Europe, Germany – you don't even know if you'll have access to energy and at what price this winter. You need, as a corporate, to pivot, find your own solutions and renewables are just part of that.

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Pamela Ritchie: Do you see that happening in Germany?

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Hugo Lavallée: Yeah, 100%. Some of the companies that I own in the solar space, they see such strong demand from their European corporate customers. It's just one of the solutions but you need these solutions to become more independent and control your own destiny.

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Pamela Ritchie: I wanted to ask you a little bit about small-caps because that's an area that you, obviously, excel and it's an area we always talk about, but actually small-cap sort of in light of maybe the clean energy side of things. You just mentioned that every country has to have kind of its own thing depending on what they need. What does that do for maybe smaller companies, not the global players but smaller companies that might be of interest to you?

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Hugo Lavallée: When you talk small-cap, it's very relevant to the Climate Fund but I think it's really relevant to all my funds. That's one area I've been leaning in. I do have a little bit of a small-cap expertise. Every time the market falls, the one thing that gets clobbered the most is the small-cap stocks. This earnings season has been a little bit unusual with the S&P 50 taking on the chin but small caps have been really tough. one area I've been leaning in for all my funds is small-cap technology. There's just a lot of cheap stocks there.

You've got to remember, one thing I do quite well is balance sheet investing. I consider it an area of expertise. Companies are cheap versus the cash on the balance sheet. A lot of companies raised capital last year when things were frothy and because of that, they have very good balance sheets. You've got excellent balance sheets, as a general comment, in technology.

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Some of these stocks have been absolute disasters, down 90% and *[indecipherable]* the cash on the balance sheet. In my experience, because I lived it through '02, '03, I lived it through '08, 09. Those are good times to lean in. The story sounds bad. They're not making money, but they have the balance sheet to survive and they have the balance sheet to pivot. Normally there's three things that happen. Management either figures it out or gets the boot, they start making money, or they sell the company. Sometimes they'll hit a product cycle and that'll take them ...

But I remember October of '02, Research in Motion was $8 a share with 6 bucks in that cash. It wasn't a really good sounding story. A year later, they hit a product cycle, the stock was a hundred bagger. You don't need a lot of those in your fund to make a big difference. I'm not predicting the next Research in Motion but what I'm saying is I'm really leaning in these small-cap tech that are just completely abandoned. We have the analysts focusing on them and I'm going to own a basket of them and I think some of them are going to be really good stocks over the next three years.

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Pamela Ritchie: Just following on from that and some of the things that you mentioned about management having to act if they need to. Your thoughts on the earnings season? We actually have seen some real action in some cases, haven't we, from management but what do you think about earnings overall?

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Hugo Lavallée: The earnings have come in pretty tough because managements were planning for ... they've been slow to react. They were planning for a continuation of post-COVID good times and investing in the business and we need to beat the competition and here and there. Instead, they're seeing weakness in their top line and it's leading to real margin compression. One thing I don't do is I don't focus on the next 12 months earnings because if you do that, often time the stocks will go down but they look even more expensive, so you're never going to buy them. One tool that I use is, what was the previous peak earnings? Can they get back to that? Can they surpass...

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Pamela Ritchie: We're talking pre-COVID in some cases?

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Hugo Lavallée: For some it's pre-COVID, for some it's actually COVID, like late 2020 or early 2021. For some companies their peak of earnings was 2021.

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Pamela Ritchie: Do you have clarity on the ones that just won't get back to...

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Hugo Lavallée: I think that's the magic. You've got to use your brain and some of them have such strong COVID sales and earnings that they're probably not going to get back there. But some of them, there's no reason why they won't.

It's just another tool in the toolbox. It's not the end all but to know that, hey, the stock is eight times. There's one, I can't name it because I've been active in it, but there's one name that stock's been clobbered, the company's pivoting, they're cutting opex, it's eight times their COVID peak earnings, it's cheap. If you're in that eight to 15 times previous peak earnings and you think you're going to get back there, it gives you a framework, okay, I think I'm going to compound my capital here and I can lean in, especially if they have the balance sheet.

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The other thing we're doing, Pamela, that I think is more than six, nine months ago, we're talking to boards. We're expressing our disagreement or discontent with some board of directors and I'm very proud of that.

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Pamela Ritchie: Not just listening but talking to. Really interesting.

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Hugo Lavallée: We're talking to them and we do that in the background. I think it's important. I'm not going to name any names but I think it's important that the clients know that. There's one Swiss company that we've been talking to the board. There's a Canadian company, we're talking to the board on Monday. There's a U.S. company, a name everybody knows, it's been a real underperformer, we're talking to the board. We're talking, we're engaging, we're trying to affect change a little bit. It's good, it's good. We're rolling up our sleeves, try to create opportunities, try to focus on some opportunities. We're not just sitting there being passive, we're trying to find new opportunities, try to talk to companies. You know what, sometimes just engaging in the board, that's the catalyst because you might have a board member who's very qualified but maybe he or she is semi-retired. They thought it was a cozy job and all the sudden investors are telling them, hey, it's not great.

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It's not fun. People like to be liked. People like to win. It's human nature. Sometimes that just leads to catalysts down the road. We won't know these catalysts because they're not going to tell us that's MNPI, but us engaging, expressing our views, sometimes that leads to change and change can be good in our business. I think we've got to stay positive in these moments that ... People sometimes, they just extrapolate the status quo. This company has been losing money. If they're never going to make money, it's not going to be a good investment. But if a company can go from not making money to making money, just like the famous Peter Lynch Chrysler story, that's very powerful. Those are like the best, the absolute best stocks like RIMM or Apple are the stocks that go from not making money to making money. That's super powerful. That's what I'm trying to focus on.

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Pamela Ritchie: It's such an interesting time. It must be absolutely fascinating for you right now looking at some of these. A question has come in and asking you to talk more about any kind of repositioning, trying to get a sense of what that means. Can you give us some more broad strokes or more specifics?

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Hugo Lavallée: Names that everybody knows that have had a tough earning season, I can't name them but focused on those. Small-cap tech, we've talked about that. There's a lot of cheap stocks, even in Canada, a ton of orphans, orphans, small-cap tech stocks, 100 million market cap, 150 million market cap, 200 million market cap. Focus on those. Focus on industrials. Some of them, you're buying them because you think, well, we're in a recession, eventually they'll come out of that. Some of the companies that I own, they've actually had a really tough COVID because they've had supply chain issues. They've had labour issues and the recession is making it a little bit easier for them. Their second derivative is actually inflecting, so focused on that. Consumer discretionary, which I always do a lot of...

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Pamela Ritchie: Travel, are you still looking at travel? Travel, the reopening discussion? Anything left in there?

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Hugo Lavallée: Travel is not too contrarian because everybody's focused on more like goods. It's been a great year to be in consumer staples like safety, like grocery, Dollarama. I think it's not a bad time to start focusing on the opposite. What's brought down their earnings? What has brought down their earnings estimates? I do own a little bit of travel but what I'm really focused on, who can win now and who can really win in the future and which stocks are discounting enough bad news. There's so many stocks in consumer discretionary that have been cut in half this year. It's right up my wheelhouse. It used to be X and it got expensive, now it got cut in half and we think there's a path to making really strong returns over the next ...

So, the money's been invested, there's less safe stocks, safe meaning consumer staples, in my fund than before. There's a little bit more cyclical. There's a little bit more risk, cyclical risk, cyclical stocks. You're seeing it, you're seeing it in the funds. If you look at Greater Canada, if you look at Canadian Ops, if you look at all my funds, how they reacted on Thursday, on Friday, just that CPI being a little bit less than expected makes a really big change to a lot of stocks. That's how I'm trying to position the fund.

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Pamela Ritchie: Just remind us a little bit on ... It sounds like how good Canada looks right now but also what is your universe in terms of where you can go outside of North America if you want to?

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Hugo Lavallée: Every place is a little bit different. Canada, I think we still create these great companies and I think Fidelity's really good at finding them. I am worried about Canadian consumers. Everything that's ... I'm really scrubbing the Canadian consumer. I tend to have not a lot of those in my fund. I just think we're just a little bit exposed to higher rates.

In Canada, everybody, rates reset after five years. We've had expensive real estate. We'll be in a great place over 10 years. We've got a great immigration policy. We're seeing a lot of great companies being built in Canada. That's not the problem. It's not a secular problem. It's just cyclically residential construction has been a really big part of our economy and that ship sailed a little bit. Home prices are under pressure and that's going to challenge a little bit of our consumer.

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In the U.S., the U.S. consumer's a little bit in a better shape but they've done really well. The U.S. dollar has been really strong. I'm buying some U.S. stocks that have been out of favour but in general, one way I've been pivoting is a little bit more towards Europe, which, historically, I haven't done a lot of. If you're thinking from a Canadian perspective, Europe is really taking it in the teeth. They're going to face a really difficult winter. Everybody knows that. There are a lot of cyclically depressed stocks over there and as a Canadian consumer, Canadian investor, I can buy stocks in euros, in British pounds that have fallen versus the Canadian dollar. I'm thinking that if I'm buying a European cyclical today, I might get double positive. I can get currency plus the stock going up.

So, definitely a little bit more European exposure than before, not the majority of the fund but definitely more than I've ever done. I think it's just the right thing to do. I can lean in on Fidelity over there. I think we think we've got over 50 European analysts. We've got a European trading desk in London. We got Shauna, who does a great job on everything like private placements in Europe, IPOs in Europe. We've got a lot of resources there and I'm just trying to lean in on that a little bit more.

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Pamela Ritchie: Is there a particular criteria that you're looking for in companies and that might be thematic or maybe not? Has anything changed there in terms of criteria that you're looking for for Climate Leadership now?

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Hugo Lavallée: Climate, I think I've been very consistent since the launch of the fund last 18 months. It's Climate first, so I really try to build a fund that respects that. I leave a little bit of leeway for contrarian investing that are not climate negative. I take all the Fidelity research, put it to a climate lens and it's the one fact I focus on. Decarbonization, that's our north star.

The one thing I've changed a little bit running the fund is instead of trying to predict the next big business that's losing a ton of money and "oh, don't worry, they'll make a lot of money in the future, there's five," to be honest, there's five or seven stocks I'd like to get back. What I've tried to do, I need to do a better job stock picking is instead of trying to predict the next big thing, let me look at good ROIC companies but I think there's a climate tailwind. I'm trying to look more like industrial companies. Instead of trying to reinvent the wheel, there's some, if you look at, there's so many companies in industrials, there's so many companies in consumer. A lot of them are good businesses. Some of them are going to face a climate headwind. Some of them are going to face a climate tailwind that's going to add to their revenues.

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Transportation, railroads, for example, I think they're going to take share for the next 20 years over trucking, because if you're Nike, for example, and you've got a really strong move to zero in 2035, one way you need to decarbonize is how you bring goods to customers. One easy way to cut your carbon footprint is to move from trucking to railroad. These small things, think about all scope 3 emissions, it's a small change. I think it's an important one, I think, in the fund but the decarbonization trend, and it's even stronger like we talked about, Pamela, post February 24th, post invasion, that energy security puts it even more on the spotlight. The trend is as full as ever; I just need to do a good job on the stock-picking side.

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Pamela Ritchie: Would you say that you're getting aggressive at this point in some of the moves? Are you really moving?

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Hugo Lavallée: I'm trying to be and I think you see it. Last Thursday, you saw in the funds. At some point you've got to feel uncomfortable. At some point when stocks are cheap enough … I was telling … I don't know if that's going to come out the right way but I was telling one of my really good PM friend that I exchange with every day, Connor Gordon, I was telling him two weeks ago, I'm starting to scare myself a little bit. I'm leaning in in risk so much that it's starting to feel a little scary. But scary is okay. You've got to feel a little bit uncomfortable. At the bottom, it always feels uncomfortable. I'm not saying we've seen the bottom but what I'm saying is during COVID, it felt uncomfortable, during '08, '09, it felt uncomfortable.

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Uncomfortable leads you to buying cheap stocks. They're cheap because they're uncomfortable. If they sounded amazing, they're going to be expensive on a relative basis. So, I lean in, I do what I … I'm not … just do what I always do and hopefully that leads to strong returns when things get a little bit better. It's just part of my style, it's part of who I am. I think it just comes to me a little bit easier than most. Dealing with uncertainty, dealing with being uncomfortable. I'm very comfortable in my skin and sometimes you've just got to be a little bit different. It leads to a little bit of a different fund than others but that's how I've been able to be successful.

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Pamela Ritchie: Great to see you Hugo Lavallée. Thank you for joining us today.

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Hugo Lavallée: Thank you, Pamela. Thanks, everybody. Good to see you.

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

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Thanks again. See you next time.