Fidelity Connects

U.S. and Canadian Equities: Striking the Right Balance

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

U.S. and Canadian markets have continued rallying in February, continuing the green seen in January. With several large-cap companies continuing to cut their workforce, what could this signal about future earnings? And which sectors should you keep an eye on for further growth? Also, what is next for crude oil, copper and precious metals?

Joining Bryan Borzykowski today to explain his investing method, and where to consider your next position in North America, is Fidelity North American Equity Class portfolio manager Darren Lekkerkerker.

In addition to North American Equity Class, Darren also co-manages Fidelity Global Natural Resources Fund, and manages the equity sub-portfolio of Fidelity Canadian Balanced Fund, among others.

Darren shares today that he has a high-quality investing style, investing in companies that have the potential for a high return on invested capital, and rising return on investment capital. He'll also touch on the typical Canada/U.S. split in his fund.

This year, Darren is keeping an eye on good companies that under-performed in their earnings last year because of high inflation, as well as companies that are high-growth areas such as tech, who had large drawdowns and are ready to rebound after changing their business culture through restructuring or reducing costs.

Darren also notes that he hopes there will be more focus on individual company fundamentals overall this year, rather than macro headlines. Also, Darren and Bryan discuss opportunities in Canada's energy sector, the appeal of rail companies, and what he's hearing from companies in the many daily meetings he has, among other topics.

Today's podcast was recorded on February 9, 2023.

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Bryan Borzykowski: Darren, thanks for joining us today.

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Darren Lekkerkerker: Hi, Bryan. Thank you very much. I'm excited to be here.

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Bryan Borzykowski: Let's start off with your outlook for 2023. We've seen markets are doing well this year so far, but there's still a lot of economic volatility. Where do you think things, economically... markets could be headed over the next 11 months?

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Darren Lekkerkerker: Well, let's consider the path. Last year was terrible, and for a lot of good reasons. We had like high and persistent inflation, the Fed was raising rates, a war and a recession in Europe, and China closed. I would say coming into this year, things look a lot less bad. I think it looks like inflation has peaked last year and is coming down and that the Fed is much closer to —although while still raising rates— is closer to where the terminal rate will be in the cycle, and that Europe —with better weather and natural gas prices coming down— has avoided a worst-case outcome on a very deep recession, and that China has reopened. If we look at mobility data and early indicators, things look like they are starting to get better there. So, I think things look a lot less bad. I think earnings have come in. It's been maybe not as bad as some people feared. I think that sentiment was just terrible and so as a result, we've had a strong start to the year.

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I think for the rest of the year; it's hard to say. I think that it should probably be a choppy year, maybe a little bit flattish. I love that, as a portfolio manager and as someone who's focused on stock picking because I think it should be a year where it could be maybe a little bit less about the macro and more about individual company fundamentals. I think we're seeing that in the current earnings season; we're seeing stocks that are performing well and really cheap doing well. So, you can add a lot of value and alpha to funds through individual stock picking. I think that that theme should continue throughout this year.

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Bryan Borzykowski: It's great and lots to dig into here. One thing that's interesting about your fund, which we'll talk more about, is that you invest in U.S. companies and Canadian companies, it's a North American Fund and so you're watching the economics — I'm sure all the fund managers are watching the economics of both countries — but you're particularly paying attention to both as this is your purview. We saw the Bank of Canada say they're going to pause rates; we saw a big job gains in the U.S.. A lot of people think the Federal Reserve could increase rates. What do you think, based on kind of what you're seeing about the divergence of these two central banks, could that have an effect on companies in both countries?

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Darren Lekkerkerker: It's a good point. For me, I'm really focused bottom-up on individual companies. A lot of... even the Canadian companies I own do have a big U.S. business as well. I do think, though, you've got a good point that I would expect a stronger performance from the U.S. economy than Canada. Some of the reasons for that are it's less cyclical and they have less exposure to higher interest rates in terms of adjustable rate mortgages as we do in Canada.

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Bryan Borzykowski: What about just opportunities in 2023? When you're looking at companies, what companies —not necessarily specific companies, but sort of broadly— what kinds of companies look the most interesting to you in this kind of environment?

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Darren Lekkerkerker: There's been a few themes that I think are really interesting that I'd love to talk a little bit about. One of those themes is looking at companies that are good companies, but underperformed in their earnings last year because of high inflation. A second theme — I'll go into a little more detail on the first — but a second theme is companies that are exposed to China in/and the China reopening. The third theme is companies primarily in technology or other growth areas where the stock got absolutely crushed, down like 70%+, where they've actually sort of changed the business culture by restructuring, reducing the costs and maybe looking for some additional areas of revenue in certain cases.

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Let me circle back to the inflation theme. There's a lot of companies where they were hit by rising costs of goods, short supply chain problems, rising costs of labour, and they were unable to raise prices quickly enough and they saw their margins and their earnings compress. I think that, as we expect inflation to come down and we expect disinflation, the companies that do have pricing power are able to recover their earnings from this and I think you get a double win. You get a double win in terms of earnings going up and the multiple on the stock recovery. An example of this would be med tech. Think of companies that make implantable parts for people like hips and knees; the costs went up on them a lot. They weren't able get their pricing up, but these companies, there's strong demand here; they're secular growth and they should be able to increase prices this year. Some of the commodities will actually see deflation, meaning go down, and gross margins should recover. There's really nice organic growth outlook as a result of demographics and new innovative product cycles.

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Another area here is auto parts. Think about it; no one could buy a new car for the past couple of years because of supply chain issues, lack of chips. A lot of that is looking a lot better into 2023, and so we should see a recovery. Just to put some numbers on that, if we think about what's the normal amount of U.S. autos sold in a year in the U.S., is normally 17 to 18 million, and for the past two years it's been 12 to 14 million. So, there's a lot of pent-up demand where they can benefit here, the auto parts companies. I say the auto parts companies, not the car producers because the car producers actually really benefited in terms of pricing, stronger pricing because of the lack of volumes but the auto parts companies got hit because they didn't get that pricing advantage and actually their costs went up due to supply chain problems. The war then exacerbated it; commodity prices went up, and a lack of volume. So, we could see these issues improve a lot this year. Those are two areas that I find interesting on the inflation theme.

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On the China reopening theme, I think companies that make —in mining and metal, for example— copper or commodity chemicals are really well-positioned. The third theme I talked about was companies that have greatly improved their... one, the stock price is down huge and two, they greatly improved their cost structure and, as demand increases, we could see much better profits and management teams have more of a focus on profitability. It's more within software and media and communications.

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Bryan Borzykowski: Let's carry on the technology sector a bit here. IT is your biggest sector in your fund and that has been in the news: lots of cost cutting, slower growth. How do you sort of view the tech sector these days and is there an opportunity there? Just what you're saying, because they have cut costs already.

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Darren Lekkerkerker: I do believe there's an opportunity here. I would like to just point out, for me, the way that I invest in technology is maybe a little different than some people think about it. I'm not in the sort of very, very high-growth, unprofitable companies for the most part. Mostly what I own is high-quality, large companies that have nice growth, wide margins and generate a lot of cash flow. My largest position on my top ten is Microsoft. The investment thesis when I bought the company —and I've held it for several years— is the company is really well positioned on a number of key themes like productivity. Every company that we meet with today... and I was just in a meeting with a CEO right before this meeting, actually, of a software company —not Microsoft, but a different one. They're focused on productivity because they're getting hit with inflation; they need to improve their margins. I think Microsoft is very well positioned there in terms of cyber, in terms of the cloud, in terms of digitizing processes. AI is a very big theme, clearly, this week. So, here's a company that I really like. I think it continues to be very well positioned.

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Another one is Constellation Software, which is in my top ten. I had an opportunity to spend a lot of time with the founder and CEO of the company in the fourth quarter of last year. I'm really impressed with the company. One of the things I really love...I talked about alignment with management teams, and they have a policy here where 75% of their after-tax bonuses they invest in shares of the company for all the senior management team. So, I really like that. The company has historically grown at like 20 to 30%, top line and bottom line, primarily through M&A, through buying other vertical market software companies. So, these are the types of companies that I'm invested in. It's highly profitable, not as expensive. I think the more minority is what I just talked about, which is companies where they may have been previously in the high flyer camp that have seen their stocks go down huge and have made significant changes to the cost structure as a result and are better positioned going forward.

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Bryan Borzykowski: You mentioned China and commodities potentially benefiting from that. When you look at Canada's energy sector, are there opportunities there? Maybe you can speak to your thoughts of positioning in that sector.

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Darren Lekkerkerker: I'm really excited about the China reopening. China was shut down for a long time now. As they're starting to reopen, I think that we could see economic activity pick up. I'm excited for companies that are leveraged to that. What's most leveraged to that? It's actually copper. I'm more excited, probably, for copper than I am for energy. I've talked in the past about longer data demand for copper from the energy transition. As we transition to a low-carbon economy it's very, very copper intensive to produce electric vehicles, to add renewable power, and then supply is really tight. We see that today in terms of extremely low inventories of copper, but also it takes forever to build a new mine. One of the big mines that's supposed to come on this year is by a Canadian miner called Teck Resources. The mine is called Quebrada Blanca 2; it's in Chile, and they bought a company in 2007, Aur Resources, when Teck Resources was called Teck Cominco, and the mine's just going to come on this year. It just shows you how long it takes to bring on new supply. It's very tight and with China reopening, there could be higher cyclical demand. I think that's really attractive.

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You mentioned energy. I think with energy, the supply is also extremely tight. Last year we had the SPR —the U.S. Strategic Petroleum Reserve— releasing barrels; that has ended. I think Russia still could potentially have supply disruptions. We need to also think about what happens — do we have a recession, which would certainly crimp demand a little bit?

Having said that, I do think supply is tight. I think that the companies, the energy producers are not expensive and are returning a lot of cash back to shareholders, which is attractive. But I would place copper as something that's more levered to the China reopening theme as more attractive.

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Bryan Borzykowski: Any other sectors that you're — you're keeping an eye on all sectors, I'm sure — that look attractive in the months ahead?

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Darren Lekkerkerker: Another one on that China reopening theme and within resources is also commodity chemicals. They're focused on specific companies and I'm looking for companies that have sort of idiosyncratic drivers to increase their cash flow and where I think there's asymmetric sort of upside, much higher upside than there is downside, and there are some individual company catalysts that I'm focused on that can increase the cash flow there. Some of the other sectors... I'm interested in rails. I've talked about rails in the past. In particular, I prefer the Canadian rails to the U.S. rails and here's why: Structurally, I think they're superior and that is because they have a longer length of haul. That makes them have less competition with trucks and so they have better pricing power. The other thing is if you think about their end markets in the U.S. Class 1 rails, a portion of their volume is for thermal coal which is used to make power, and that's being kind of phased out as people move more towards renewable power and worry more about carbon. So, I think the Canadian rails are attractive. I also think for CP Rail, they have a proposed merger with Kansas City Southern, which, if it closes, would be extremely attractive, very accretive to increase earnings for the overall company. So, I think Rails is another sector I find attractive.

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Some of the other big sectors, I would say... China reopening, technology, what have we not talked about? Consumer, I think within consumer there are some interesting consumer products. I think the sector was actually just really beaten up and left for dead and I think you can buy some of these companies where they're already pricing in a recession. We're doing a lot of due diligence. We're looking at the company; we're meeting with management and trying to decide which companies will do really well and, especially if we can buy them really cheaply, we think that's very attractive. Also, within health care, I mentioned med tech earlier, but I also like life sciences and tools. So, there's a few more and with that we can get into your next question.

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Bryan Borzykowski: You mentioned meeting with management and you had a couple executive meetings with tech companies, I wonder how many executive meetings do you have in a week? It sounds like you meet with a lot of management teams.

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Darren Lekkerkerker: I think in a good week you're doing anywhere from one to five meetings per day, depending on the day. Sometimes you could have a really heavy day where you're maybe doing eight meetings per day. But, listen, I really enjoy it; it's an interesting aspect of this job and it's a really important part of my investment process. My investment process, just to review, is meeting with people who run companies, CEOs, CFOs, and speaking with our analyst team a lot upstairs who are experts in their field. That's primarily the biggest part of the investment process. I kind of think of it as a continuous learning process. You're learning something about an industry, a company every day. We just met with this

big software company that just completed a big acquisition and we had a chance to talk with the CEO about what's the integration plan over the next short while and ask them some bigger picture long-term questions about the business.

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Bryan Borzykowski: That's a lot of meetings with executives and companies. What are you hearing from companies whether it's about earnings or just kind of the economic picture? What are they more generally talking to you about?

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Darren Lekkerkerker: One of the big things we're asking about is demand right now; how strong is demand, are you seeing any sort of drop off in demand, any weakness? Most companies are saying "we're not seeing anything yet". Also, we're talking a lot about inflation, are you seeing inflation and if so, are you able to raise prices, or do you see deflation and how is that going to impact the business? As we've come through earnings, a big part of fourth quarter earnings is companies set their guidance for earnings for 2023 to the market. Here is the revenue we expect and here's the earnings we expect. For the companies we're interested in, we follow up with management teams and we ask them "what are the assumptions that you're putting in your guidance?" It's really interesting, there's big divergence now in those assumptions. Some companies are assuming that there will be a recession in the U.S. in the second half of the year and others are not. Some companies are assuming that they will see revenue growth benefit from China reopening and others are not because they're seeing it now. On balance, we prefer to be invested in the companies that have more conservative or more achievable assumptions in their earnings because companies go up when they crush those earnings expectations and that's an attractive area for investment.

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Bryan Borzykowski: Let's talk about the fund itself for a bit. It is an interesting fund because you're combining Canadian and North America into one. How do you split those two? Do you have allocations that you try and hit for both? How do you approach both markets?

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Darren Lekkerkerker: We started the fund in 2015 and we wanted to start a fund that was both U.S. and Canada, but primarily U.S. The target over time is 70 U.S., 30 Canada. For me, the way that I approach it is I don't stick right to that target, or I don't adjust it based on my economic projections for different countries. It's more based on best ideas. I want to own the best ideas in each country, so that's what's driving it. That's what I think's interesting about it. The other thing I think that's really interesting, I think North America is a super attractive place to invest versus the rest of the world. The U.S. has been the best place to invest throughout history and I think North America continues to look good. Why is that? I think in terms of energy self-sufficiency and food, I think North America is independent and extremely well-placed. I think in terms of history of innovation, look at Silicon Valley and look at all the big tech companies in the U.S.; it's outstanding compared to any other region in the world. Also, I think look at the politics. Even though people do get upset over politics, politics is pretty stable, considering what's happening in the rest of the world. Last point I'll mention is demographics. The demographics for U.S. and Canada in terms of number of workers and growth and that, is actually much better than Europe or Asia, so that's also attractive.

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Bryan Borzykowski: I think you mentioned something earlier when we chatted before this that was interesting that I think is worth mentioning. You actually have a big portion of your own retirement and your own investments in this fund. Maybe talk a bit about that and why.

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Darren Lekkerkerker: Thanks for that question, Bryan. Last time I checked I was the second largest owner of the fund. I used to be the largest owner, so I like to say that, not just to say the second largest owner, but I'm the second largest owner of the fund so, for me, it's like by far and away my largest personal financial investment. I don't do it for a marketing point because it's hugely material to me; it's more to save for my own retirement and for my own family's goals. I've got two young kids and at some point, they're going to go to university — I hope so — so that's why.

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Bryan Borzykowski: That's great. And, within the way you manage the fund does currency impact how you look at U.S.-Canadian companies or are you more focused on the prospects of the individual businesses?

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Darren Lekkerkerker: Definitely the latter. I'm more focused on the bottom-up prospects. Having said that, in terms of the currency the fund's 62% U.S., 38% Canada today and tends to be more U.S. than Canada. I think that's good over time. The U.S. currency is less cyclical and more stable than the Canadian currency, so it has the impact of reducing volatility, so I like that. Then just thirdly, just on that point, I think that, for me, I'm really focused on bottom-up stock picking. Why is that? I think it's because one, I think that I can have more of an edge on bottom-up stock picking than I can on consistently calling the macro. For me, I really want to have an investment process that one, that works and two, that is repeatable, so I can have repeatable investment performance. Again, that's why I focus more on the micro than the macro.

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Bryan Borzykowski: Another question is about AI. It's been in the news a lot. Do you see more opportunities in AI at a general level or is it something to monitor?

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Darren Lekkerkerker: I think it's something to monitor. I think it's a positive for some companies. I think one thing that's really interesting that's early to say is could this be the start of a new investment cycle for computing? Every company has to think about this because I think every CEO is going to be asked by their board about AI given ChatGPT in the news, given the Microsoft demo that was this week. I think that could spur additional investment in AI and I think that will be good for those companies that have leading investments and leading offerings in AI, as well as cloud offerings because that's where the AI will run off, the big cloud platforms.

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Bryan Borzykowski: Another question is, what is your sell discipline?

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Darren Lekkerkerker: My sell discipline is primarily and hopefully one... whenever I buy a company, I have an investment thesis. It should be one or two sentences; it should be very clear and easily communicated to a lay person. So, one, if that investment thesis is correct —and hopefully it is and the stock goes up— then I sell, or two, if I receive new information where I think it invalidates the investment thesis, then I sell. Sometimes three, if I just find a much better company with a more attractive investment thesis, then I might sell it to buy that one. But in that case, typically it needs to be much better because I tend to know and understand better what I already own than what I don't.

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Bryan Borzykowski: Just on your investing style, do you consider yourself growth or value or a combo? How would you describe yourself?

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Darren Lekkerkerker: I call myself high-quality. What does that mean? That means investing in companies that have high return on invested capital and rising return on invested capital. They have a competitive advantage that's sustainable and, ideally, growing. I talked about railways; that's a monopoly business with high return on invested capital. I talked about software, so I would say same thing, monopoly business, high return on invested capital. Secondly, I focus on the management team of high-quality. I kind of outlined this a little bit earlier. I think it's different than growth or value but if you had to bucket me in one it's closer to growth than it is to value.

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Bryan Borzykowski: I think what is also interesting about this fund is that it's pretty concentrated. North America, Canada and U.S., there's a lot to choose from yet your portfolio has something like 60 stocks, 50, 60. Why take that approach when you have this entire universe in front of you?

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Darren Lekkerkerker: I think you can only have so many great ideas. For me, one of the things that I try to do is periodically think what are my top three ideas that I'm most excited about, where we see the highest return potential and the lowest downside potential, and make sure that I have large positions in those funds. Generally, the top ten names in the fund are between 30 to 50% of the fund. As you mentioned, today it's a little bit more than 50 names, so I think it's a little bit higher name count than I would like. There's a few names in there where there's a smaller position where it could be sometimes I may be picking an initial small position before I get larger in that name or wait for an opportunity.

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Bryan Borzykowski: Do you tend to turnover during the year or did you do more of that last year? How do you approach turnover?

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Darren Lekkerkerker: I generally think lower turnover is better because there is a cost to turnover. Having said that, I think some turnover is healthy because it means that you're refreshing your best ideas. For me, I think ideally a good number for turnover is probably somewhere around 50/15% during the year. Although I would say that the actual turnover of the names, or the top ten names would be lower than that. In terms of the trend of it, I would say that 2020 was a high

year for turnover. If you think back to that year we were going into a pandemic and the lockdown and towards the end of the year we were coming out, so there was some opportunities. It was a really attractive year for absolute as well as relative returns for my fund, so I used that higher turnover to take advantage of that. I would say that it's fallen off and normalized lower.

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Bryan Borzykowski: Just maybe the last question —we've only got about a minute left— I'm wondering why a North American fund? You can buy a Canadian fund; you can buy a U.S. fund. You can have them in the same portfolio. What is the benefit of having a fund that combines those two versus getting them separately?

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Darren Lekkerkerker: They're two attractive places to invest, but I think this way I can own the best ideas of Canada and the best ideas of the U.S. and I'm not forced to be in either market if I don't like the set-up for either. We have gone through periods where, as I mentioned, the U.S. has historically been the best, but there has been periods —for example, like the 2000s— where Canada was a much more attractive place. I think that should give... ideally, my goal is for it to have better returns and more smooth returns over time. I think that should be the advantage.

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Bryan Borzykowski: Awesome. I'm going to leave it there. Thank you so much for joining us today.

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Darren Lekkerkerker: Thanks.

Ending: [00:28:01]

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