Fidelity Connects

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

Darren Lekkerkerker, 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.

Portfolio Manager Darren Lekkerkerker joins the show today. For Canadian investors Darren manages Fidelity North American Equity Class, is Co-Manager of Global Natural Resources Fund, and manages the equity sub-portfolio of Canadian Balanced Fund, among other mandates.

Today, Darren joins host Pamela Ritchie for a look at North American equities, including where he is seeing opportunities and which sectors he is bullish on for the months ahead.

The Bank of Canada raised its benchmark rate to 3.25%, which means Canadian monetary policy is now in the restrictive territory, meaning the range in which the interest rate will begin to suppress economic activity. Darren mentions how September is conference season and he's been busy with conferences and CEO meetings.

Among other topics today, Darren reflects on commodities including copper and fertilizer, also currencies, railroads, what he's learned from managing during past periods of market volatility, and more.

This podcast was recorded on September 7, 2022.

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Pamela Ritchie: Darren, great to see you. How are you?

[00:02:00]

Darren Lekkerkerker: Hey, I'm doing great. Thanks, Pamela. It's nice to see you as well.

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Pamela Ritchie: Nice to see you. Glad to have you back, joining us here to kick off September. We have to begin a little bit with we kind of know the direction of monetary policy. I mean, we've seen another action here today but for North America, it's not so much an easy story but we certainly don't have too many complications in where things are going and certainly what direction. The rest of the world is much more complicated, actually, on the monetary policy side of things. How does that make investing in North America better, worse, clearer? I don't know how you'd put it.

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Darren Lekkerkerker: Pamela, I'm really lucky because I'm focused on investing in North America in my fund. Why do I say that? Well, look, I think North America has a lot of natural advantages. It's food and energy independent for the most part. It has great neighbours, although different people have different political views, there's a very, very low chance of a violent conflict here. And then three, I also think it's a great source of innovation. We've got some of the best universities, some of the best tech companies in North America. Also on the resource side, we've got some of the biggest, most scalable resource companies in oil and fertilizers, grain and mining. It's been a really great place to look for companies to invest in.

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Pamela Ritchie: It's sort of amazing. It's a very interesting time, too, and it does feel like September. I was noticing yesterday and even today, kids are back at school. It feels like things are getting serious again and you are wearing actually a very nice looking tie. How come?

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Darren Lekkerkerker: Hey, thank you very much. September, my kids went back to school today, but September for the buy side is conference season. I started this morning with a banks conference. I've already met with the CEOs of two major Canadian banks and I've got an afternoon of that to look forward to. So, it's been really interesting, some really good learnings already this morning. I think tomorrow is insurance day, Friday is real estate, next week is the Consumer and Energy Conference and so on and so forth. I really look forward to that, getting a lot of updates on companies I own, making sure that they should be in the portfolio and trying to see if I can find some new companies in there to add to improve the portfolio.

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Pamela Ritchie: It's a whole new season of in-person meetings. It's really interesting and kind of exciting. You spoke to a couple of CEOs, I just picked up on that, of banks. What did they say? Let's start with financials.

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Darren Lekkerkerker: I like what you said about in-person meetings and I totally agree with that. I remember when I did my Fidelity training actually – I've been at the company 18 years now – but when I started this Fidelity training and we had former FBI agents train us in conducting these meetings. I really do believe that by being in-person in the room with someone else you can learn a little more about a company and a CEO. I think that the CEOs that I met with this morning were relatively sanguine on the economy. I think they rightly pointed out that if we are entering a slowdown, we're doing so from a period of strength where you have extremely low unemployment and you have the consumer in a really good place where they have a really good balance sheet, where they've accumulated some wealth during the pandemic.

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I think, having said that, I think they are a little nervous. They do see that the economy, although still positive, is slowing a little bit. I think credit right now... one CEO, as a quote, it's as clean as a whistle, so I think credit's really good. I also think as an investor it does mean that the banks are over earning because I think eventually credit will normalize to more normal levels. When it tends to normalize, it tends to sometimes move past the normal level. That means that earnings would go lower. I think for me, I've been looking at the banks. I think they're good long-term companies in Canada;

they're an oligopoly; they earn outsize ROE. But I've been looking at them as a source of funds and I think I would get more interested either when banks were at a cheaper valuation, when they went closer to one times book value or we do see credit normalize and we see the earnings estimates become easier to achieve.

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Pamela Ritchie: I'm curious sort of from the overall ... because that you mentioned they were looking obviously at sort of the macro picture which banks are obviously going to be very sensitive to ultimately. We do have the rising rate side of the story but do you have a bit of a macro view? To many, it's pretty dire out there.

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Darren Lekkerkerker: Everyone's universally bearish, right? Sentiment's bad, the market's down, the P/E is improved from 20 times to 17 times. There's reasons for that. I think that the economy is slowing, meanwhile, the central banks around the world are raising rates into a slowing economy. We've got a conflict in Europe, and you've got a zero-COVID policy which is hurting growth in China and in Asia. Those are known.

I think from here we're going to grind along. It's hard to see a major rally but I do think that earnings have been much more resilient than investors thought in the second quarter. I do think the economy's been a little more resilient. I do think that, as I mentioned, the multiples are not cheap at 17 times but they're definitely cheaper and more attractive than they were and there are select opportunities. For me, I think it's somewhat neutral and my focus is much more on bottom-up stock selection and owning the right companies.

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If I can just share an anecdote, last week I was actually on vacation. I was with my family, we were at a family cottage north of Toronto, and I reread one of Peter Lynch's books, *Beating the Street*. In there, he talked about throughout every year of his career there was always reasons to be really bearish. He talked about being on the Barron's Roundtable and how people were always really bearish and there was always a reason every year to be out. It's kind of funny because I thought about my own ... and, by the way, for those that don't know, Peter Lynch managed the Fidelity Magellan Fund. He was a great manager, but he also managed it during one of the huge bull markets. His point was it really paid to be invested in the market and to own the right stocks because it's very, very difficult to time the macro.

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I thought about my own career. I was promoted, this is my 14th year as a diversified portfolio manager at Fidelity, and I was promoted in January of 2009, right in the huge storm of the global financial crisis. There's many reasons not to own stocks. Twenty-ten and 2011 you had a lot of focus on the Southern European debt crisis. I think also in 2011 S&P downgraded the U.S.'s bond rating. In 2013, you had the taper tantrum, so on and so forth. During that period from 2009 to now, it's been a fantastic time to own stocks and it's been a fantastic time to own the best stocks. That's really been my focus is on bottom-up stock selection. Although I do follow the macro. I do have macro opinions, but I try not to let it be the driver of the portfolio.

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Pamela Ritchie: I'm really interested in your style of investing. You've spoken about it before, sort of looking at things through a quality lens. I think we've referenced your background before owning companies in your previous job. Discuss the idea of quality and what quality has meant actually through the last sort of several months, sticking to your guns there.

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Darren Lekkerkerker: Yeah, I think it's been really topical, and I think it's been beneficial for performance. I think that high-quality companies, I think in the first quarter I think they underperformed, or they came down as the valuation compressed. But I think since then we've seen a rally and more recently in high-quality companies. Why is that? I think their earnings are much more resilient to either inflation or recession. They have pricing power. They're able to raise prices and they're able to get positive earnings and more stable earnings.

What are some of the things I look for? Number one, is this a high-quality business? Does it have an economic moat which is a competitive advantage? Is it widening? Hopefully, you want it to widen over time. Does it have a high and rising ROE? Is management focused on increasing shareholder value? And is the valuation attractive?

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I think it's not just important to think about those things, you also have to compare it to consensus, what do other people expect earnings to be. We want to own the ones where we think that earnings power is materially higher than the consensus. That's how you make money and that's what we do. One of the things I've been able to do over the past few months is when we do have these periodic market sell-offs like we're in one right now, is to look and find, hey, what are the quality companies that have been sold off here and where can I add to the portfolio to improve it?

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Pamela Ritchie: Great. We've talked about different areas, different sectors, the transportation discussion, the rails really, which crisscross all of North America, just like pipeline companies do. You like the rails, I think.

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Darren Lekkerkerker: I've been a long-time owner of the Canadian rails. I do like Class 1 North American rails and I do prefer Canadian rails in particular. Why is that? One, it's an oligopoly-type business, right? It's hard to compete with a rail and as a result they're able to get pricing. All the North American rails have gotten very good pricing over the past 10 years and particularly this year. The Canadian rails have actually done a really great job of also getting volume growth as well, so you kind of win both ways in terms of revenue. Why is that? I think the U.S. rails have had thermal coal be a big part of the volume which has gone away, although this year it's kind of increased a little bit. I think in Canada, going forward there's several sort of good areas of growth. One is grain. I think we had a really poor grain harvest last year and so there's less grain to move. This year, it's looking a little better. Grain is roughly, I think, at least on the rails, could be around 20% of the volume. So it's material.

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Two would be autos. Everyone knows about how autos have been hard to come by because there haven't been enough produced. I think autos should recover and be a source of strength. Also, intermodal, and I think in particular that's benefited the Canadian Pacific Rail. They acquired a railway with east coast port access and they've taken some share from the U.S. ports as there's been some gridlock in the U.S. The third way that that all the rails have won has been margins. They've been able to increase their margins over time. I really like the rails, in particular the Canadian rails, and I've owned them for a long time.

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Pamela Ritchie: That's really interesting. There's something to do with Canadian rails being different. I guess they have just longer routes. Is that it as well?

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Darren Lekkerkerker: You're absolutely right. They have a longer length of haul and on their intermodal business it makes it harder for trucks to compete with them. Canadian rails and, in general, North American Class-1 rails have done very well over the past one, three, five, ten years. I think the outlook is still bright for rails. As I said, they're good businesses. I think for the CP Rail, I think that they are going to get competitive approval for a merger that will result in a lot of synergies and faster earnings growth. It's a very well-managed company. I think you've got new management at the CN Rail. I don't want to get too granular here but I like the rails and I've owned them.

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Pamela Ritchie: Putting your natural resources hat on a little bit because that's also where you manage in the Natural Resources Fund. We're looking at oil today: $83. I think it's a little bit of a question mark why exactly, but we have seen oil, obviously, further. That's the oil story, there's a broader energy story, obviously, what do you like within natural resources? What do you lean into?

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Darren Lekkerkerker: I think last time we talked a lot about fertilizers, and I still like the fertilizers. I think the story with fertilizers, start with grain prices, corn and soybean prices, corn prices are really high. Why is that? I think it's because inventories globally are really low and it'll take two to three years to replenish those inventories for grain prices to fall to more normalized levels. As a result, farmers are being incentivized to grow as much as they can. A key way they can do that is through fertilizers. There's three types of fertilizers, all focused on nitrogen and on potash. In terms of potash, massive supply restrictions due to sanctions against Belarus and Russia which is a huge part of the global potash supply. Meanwhile, there's strong demand. So, you have really high prices which is generating a lot of cash flow for these companies. Nitrogen is produced from natural gas. Europe historically has been an exporter but because of very, very high European natural gas prices due to the ... it actually started before the conflict but it's been exacerbated by the conflict in Europe, has resulted in some shutdowns of nitrogen capacity and it's producing really high nitrogen prices. I think these companies are advantaged in their production. They're producing a lot of cash flow.

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One of the big differences between this commodity cycle and the last cycle, in the 2000s – I was actually a resource analyst in Boston for Fidelity at the time – was that the companies back then were taking the cash flow and they were investing it in sort of very expensive, long-dated, risky operationally and politically and financial return risky projects and they were doing big M&A, whereas today a lot of, most of the companies, what they're doing is they're increasing the dividend or increasing the share buyback. They're giving it back to investors which I think is really positive for shareholder returns. So still positive on the fertilizers.

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More broadly, taking a step back in resources, I think some of the key things are what happens to economic demand in the short term, and I think that's what some folks are concerned about and that's probably why oil has come down a little bit, as you mentioned in your question. I think the key things on a medium-term basis are there's massive supply shocks. There's geopolitical issues in Europe. And I think medium term, you have an energy transition as we transition from fossil fuels towards renewable energy which really, really benefits some metals like copper but also steel, aluminum and then more smaller metals like lithium. I think it also could restrict demand but also supply on the energy side.

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Pamela Ritchie: It's fascinating. Copper has had a rough go maybe, as you say, for all those same reasons on sort of the demand, worries about demand anyway but it seems to be a huge part of the energy transition story, ultimately. If I were to say which part of the energy transition do you find interesting, would it come down to sort of the commodity side of things?

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Darren Lekkerkerker: Yes, it would. I can see a huge benefit there. You mentioned copper. Copper is a small part of the portfolio and, in the short term, I worry a little bit about demand in China. I do think that it looks better one year from now than it does today. I think next month President Xi will start his third term which is unprecedented. I think the market expects more economic stimulus to be announced for the Chinese economy, which would be beneficial. I think also market forecasters have predicted an end to the zero-Covid policy in China next year which has been holding back growth. I think it looks more positive. It also benefits from the energy transition. There's a few mines coming on this year and next year in copper but beyond that it's hard to see the next large mines and it's hard to see people investing also due to geopolitical concerns, not only in Europe but also in countries like Chile where it produces 20, 25% of the world's copper. I think what it means is you should have demand exceeding supply in a few years which I would expect to result in higher prices.

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Pamela Ritchie: I just wanted to go to some other parts of the portfolio, areas that you find of interest that are not necessarily in any way commodity-driven, more services side of things. What's of interest within that quality or GARP description?

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Darren Lekkerkerker: Within high quality ... I just want to remind the viewers what my mandates are. Fidelity North American Equity Fund, the equity portion of Canadian Balanced Fund as well as some of the other Canadian funds, and then the Fidelity Global Natural Resource Fund. Within the diversified funds, I do own high-quality companies and some resources because I've been bullish on resources for the past couple of years. On the higher-quality portion of the portfolio, which tends to be the majority of the portfolio for the diversified, we've talked about rails. I would say some of the other areas... We talked about banks within financials but two other areas that I own are insurance brokers as well as alternative investment companies like private equity companies.

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Why insurance brokers? I think this is a phenomenal business. It's capital light, right? It's the broker; it's not the actual insurance company that writes the policy, so there is no big capital requirement. They've had very nice organic growth lately. As insurance premiums have been rising so have their brokerage fees and they've been able to have some operating leverage and increase margins as well. There's been really attractive capital deployment areas; they're not that cyclical either. So, it's been a nice area of performance for the fund and also alternative investments. I think this is a high-return area. I think it's going to attract inflows. This year it's down a little bit but I think that has to do with rising discount rates and interest rates. I think that'll be an attractive area in the future.

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Some of the other areas are software. I think software stocks primarily are down this year but I think it's attractive and it's an area that we're really focused on. We're looking at companies that are down and why are they down. Do they have a great business? Do they have a great product? Do they have unit economics? I think that software is really important. In an inflationary world software is deflationary, it increases productivity. The digital transformation of the world is not going to stop, it's going to keep going. I think that where I'm investing is not in the very high-growth, very high-valuation area but more in the sort of medium growth, high margin, very profitable, lots of free cash flow area. I'm very interested there and continuing to add on sell-offs.

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Pamela Ritchie: One question we'll often come across and it's such a day for currencies. Oh, my goodness, today. How do you manage currency as part of the process within the North American Equity Class Fund?

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Darren Lekkerkerker: I haven't hedged it. My view is I like the exposure to the U.S. dollar when I own it just because it tends to be a less cyclical currency, so it kind of reduces that cyclicality of the portfolio. I think the U.S. dollar has outperformed the Canadian dollar this year.

One other thing I wanted to talk about was ... two of the things, I'll just slide them in really quick here ... on your high-quality companies, two other areas that I find attractive are waste management companies which really have very stable and resilient earnings, as well as information services companies which are kind of like software companies but it's a little different. They have really high margins, great opportunities to deploy capital for buying other competitors.

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Pamela Ritchie: Got it. Okay, fantastic. A couple other questions. The overall story of the health of the consumer, this is in Canada with the rate backdrop and then I'll just also add this in, you can hit maybe consumers and then this. This is Europe and energy, the discussion of more LNG leaving our country, heading to Europe. What do you hear around that conversation, if anything?

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Darren Lekkerkerker: I'll answer the second one first because it's a quick answer. I think it's hard to increase it because we need more pipelines and countries are not really permitting for pipelines. So it's difficult to help out. I think we have lots of natural gas but we lack the pipelines.

On the first question, I think within the consumer I've been a little cautious on the consumer just with rising rate. It hurts demand a little bit. I think we've seen some weakness, more so in the lower end consumer, more so in the U.S. and Canada. Canada's had the delayed opening, so we are still seeing strains. I've got big positions in the Dollar Stores which have been attractive investments. I think there's a lot of attractive, idiosyncratic things going on. I think when they raise prices it helps add more revenues, it's also margin positive. Again, it's a high-quality business that can really increase earnings just through raising the prices, adding new stores, and increasing margins over time.

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Pamela Ritchie: Does it feel like sort of an exciting time at this time? As we sort of started out saying, there's a lot of things to be dire about but at the same time there's a lot of getting back to things that makes you wonder if all companies aren't going through a little bit of an evolution right now.

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Darren Lekkerkerker: Yeah, it's really important in the investing business to just keep a kind of moderate, sort of steady temperament and not get too sort of emotional with the highs and lows of the market. That's what I try to do myself. I'm just really trying to focus and find good companies. I think when we see market sell-offs, I'm looking at those companies that are selling off and so two of the areas that I am looking for where companies are down a lot and are already pricing in a negative scenario are consumer discretionary as well as technology which I think are two attractive long-term areas. There are definitely some higher-quality companies on sale in both those areas.

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Pamela Ritchie: It's fascinating. Anything else that you want to talk a little bit about? One of the things I was going to ask is just sort of if you can bring us back to the positioning, just give us a snapshot of the positioning of the fund.

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Darren Lekkerkerker: Just very broadly, North American Equity Fund, it's mostly in high-quality companies and resources within high-quality companies. Some of the larger areas are software, industrial companies, within industrials it's rails, information services and waste management companies. There's some aerospace companies in there which benefit from a resumption of airline travel. Within resources, I would say would be fertilizers and energy. I think that's a good sort of broad...

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Pamela Ritchie: Snapshot picture. So, you're going back to the conference this afternoon.

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Darren Lekkerkerker: I didn't mention health care. There's some health care, life sciences in schools and insurance within health care.

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Pamela Ritchie: Okay. Well, say hi to all the bank CEOs for us.

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Darren Lekkerkerker: Thank you so much, Pamela. Thank you for everyone that listened. I really appreciate it. For those of you that are invested in the fund, I really appreciate it. I am working really hard to manage the portfolios the best I can. Thank you very much.

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Pamela Ritchie: Great. Darren Lekkerkerker, thank you for joining us.

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