Fidelity Connects

U.S. Equity Outlook and Fund Positioning

Steve MacMillan, Portfolio Manager

Glen Davidson, Host

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

Today, we hear from Portfolio Manager Steve MacMillan. For Canadian investors, Steve manages Fidelity Small Cap America Fund, American Equity Fund, and co-manages Fidelity CanAm Opportunities Class alongside Mark Schmehl.

Steve and Glen Davidson, Regional Vice President of Sales in Ontario sit down to discuss Steve's current outlook and positioning. Currently, he says small-cap industrial companies with a focus on professional services are attractive, whereas the utility sector is not appealing because it lacks protection that most investors are looking for.

In addition to his portfolio positioning, Steve also discusses the impacts of inflation and quantitative tightening, and why businesses he invests in may excel in the later stages of the business cycle. He adds that having niche businesses in his portfolio that dominate the markets and generate a lot of cash flow that can compound in US dollars is appealing to his fund.

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Glen Davidson: I think we should set the scene for Small Cap America, if you could talk about the positioning of the portfolio today.

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Steve MacMillan: The portfolio doesn't change greatly over time because it's relatively longer-term focused so turnover is relatively low, but I would say the biggest changes in the portfolio would be a focus away, actually, from some of the more defensive areas in the market like utilities and more of a focus on what's going to do well coming out of the recession; some of the more cyclical, some of the more interesting businesses that I think can do well through a cycle, but that I think are very attractively priced right now.

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Glen Davidson: You talked about coming out of a cycle; talked about coming out of a recession. Talk about your thoughts on the markets as we stand today.

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Steve MacMillan: Sometimes we often think "when do you want to buy stocks?" You want to buy stocks coming out of a recession when you're going into an expansion. When do you want to sell stocks? You want to sell stocks when we're in a recession. In reality, the market is a forecasting tool. The decline we've seen in the market right now is the market's way of telling us we're going to be going into a recession. As we get closer to that recession, the opportunity to actually own stocks gets closer and closer. I think, unlike past market cycles, I think the market has very ruthlessly priced in this current recession. I think from a market standpoint there's a lot of areas that have really taken a lot of the risk/reward; the risk side of it off the table and I think there's more of a positive reward opportunity to invest in a lot of companies. I do think there's a bit of a difference from large-cap versus small-cap. I think the small caps priced in that recession much faster. If you look back over the last year and a half, the small-cap index -the Russell 2000- actually peaked a long time ago. It actually peaked back in February of 2021 whereas the S&P really only peaked at the very end of last year.

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Glen Davidson: Small caps took an unfair level of abuse, if you will, through the market that we've seen. Why is it that? Is that a lot of psychology, too?

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Steve MacMillan: I think if you look back through history there's been periods of time where the market has really unduly favoured mega-cap stocks. The previous time that really comes to mind for me would be the late '90s and the dot-com bubble. People often associate that time in the market with the NASDAQ and dot-coms that didn't make money going to crazy valuations with the NASDAQ going from 1,000 to 5,000 back to 1,000. But if you actually look under the hood, companies like GE were trading at 35 times earnings. Walmart was 35 times earnings. A lot of businesses that were on the larger-cap side, whether that be Procter and Gamble, etc., went to very high valuations whereas smaller-cap stocks like the Russell 2000 went to very low relative P/Es, relative price-to-books. Then what we saw are those subsequent three years while the broader market was falling, you actually had small-cap stocks outperforming and actually rising.

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I think when you look today, you can make a case where I think some of the larger-cap stocks have been given too much of a benefit on the valuation and the small-caps have been beaten down too much. If you look at things like relative P/E, relative price-to-book, this is the lowest valuations we've seen the Russell 2000 index, the small-cap stocks since that time period 20+ years ago.

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Glen Davidson: Talk about the division between quality because within that small-cap categorization there are great companies and there aren't great companies. I think back to the '90s, there were companies that were just shells. They didn't obviously recover, but those that had quality behind them did recover. How do you look for quality within the portfolio that you build?

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Steve MacMillan: I think broadly in the market right now there's an unwinding of the low-quality trade. If you were to look back to 2020 through probably mid-to-late 2021, the qualities of a stock that were outperforming over that time period were things like the higher risk, the better; the less earnings they made, the better, the less cash flow they had, the worst balance sheet. All these things were associated with stocks that were going up, the more risk you took the more money you made. A lot of that has been deflating and I still think there's more of that bubble to burst. I don't think we're at the stage where you need to go in and buy a lot of these growth companies that are down a very large amount, 50, 60, 80%, because they were up so much.

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Whereas if you dig deeper in the market, though, there's actually a remarkable number of companies that generate a lot of cash flow that are high-quality businesses, that have been that proverbial baby thrown out with the bathwater. What I'm looking for right now is the businesses that I think are secular growers, that from the top of an economy to the next top of the economy are growing; from the bottom of the economy to the next bottom they're growing, but the market is pricing in as being purely cyclical. I'm finding opportunities to invest in companies now that I think the market is pricing in a recession and a recession that will stay, whereas I think these businesses are secular growth businesses and it's an opportunity to buy them at a really attractive price.

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Glen Davidson: And they're going to lead us out of the recession.

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Steve MacMillan: Yeah, I believe what's going to happen is that we're going to reach a stage when it becomes obvious that companies have cut earnings, that those earning cuts are actually in the stock prices, that we're in a recession and the market starts to think about how we're coming out of recession that a lot of these stocks start to work. I think the investing experience, though, that investors have had in a number of different markets over the last really 15 years or so, may not be the best analogy. We've had a number of very sharp V-bottoms. Think about what happened in COVID; think about what happened in 2000, early 2019. I think that this could be more of a slower recovery. The reason is we don't have the Fed to bail us out. We don't have loose monetary policy that's going to come back because of the risk of inflation. I think this will be more of a longer, slower grinding recovery both economically and in the market. I think what helps you outperform and compound is companies trading at lower valuations and high cash flows, which reminds me a lot of when I took the fund over 10+ years ago.

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Glen Davidson: For the sake of our viewers clients, we should also establish a small-cap in the United States versus a small-cap in Canada because the name makes people nervous sometimes. There's a big difference and if you could just give us a comparison.

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Steve MacMillan: When people say small caps in Canada, they picture a couple of guys in Calgary with a map on a table. I think that's very different. Market caps on the venture exchange are tens of millions, maybe hundreds of millions. A small cap, the average market cap of my portfolio, is probably in the $6 or $7 billion range. There's probably only about maybe 50 companies in Canada that have a market cap bigger than that. The companies I'm investing in would really be considered mid- to large-cap in a lot of Canadian portfolios.

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Glen Davidson: Thank you. Question's just come in on currency. U.S. dollars relative to Canadian, does that factor into your decisions at all?

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Steve MacMillan: I never try to call the currency. The way I actually look at it is if we think about what's happened over the last 6 to 12 months, this has been a great example of why it's good to have the U.S. dollar currency exposure. In periods of stress in the economy, periods of stress in the market… generally, when asset prices are falling the one asset that is often rising is the U.S. dollar. So, if you're invested in U.S. dollar risk assets like the last year, you've lost money on your stocks but they're priced in U.S. dollars. So, in Canadian dollars, it's actually mitigated your loss. The flip side of that is when we come out of it into a stronger economy you're making money on your stocks, which is great, but you may be giving back a little bit of it on your currency, so it actually reduces your amount of volatility. I think having U.S. dollar exposure in any portfolio, I think is really key from a risk allocation perspective.

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Glen Davidson: Of course, we have a number of options to deal with currency. If you're interested, do talk to your sales team. Another question that's just come in is a great one -I'm sure everybody's wondering about- is what sectors are you finding most attractive right now in this environment?

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Steve MacMillan: I'm going to start by the flip side of that question; what am I not finding attractive? One area that I've been divesting fairly aggressively is the utilities sector. It might be a little counterintuitive because you would think going into a recession you want the stability of utilities and their earnings and that's what the stocks were providing for a good part of 2022. But now we've reached the stage with interest rates rising so aggressively, as an equity investor you have the option between being invested in the dividend paying equity -who will have growth in that dividend- or you can invest in the fixed income, or the bonds, of the same company. In the past the decision was really easy. If you wanted to invest in a utility bond, you might only make 2% and you could actually invest in the equity with a 2.5% dividend yield, and it would grow. Now, though, the math has flipped a bit. The dividend yield might be 3% but you can now invest at 5.5 - 6% for the fixed income.

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I think it's not as attractive. I think the risk is that the multiples in that space are going to continue to contract so the dividend yields come up. I don't think they offer the defense that most investors are looking for from them. What I do think is more interesting is if I look at some of the small-cap industrial businesses, more in the professional services than opposed to any metal-bending type of typical classical industrial companies. And, similarly, on the cyclical businesses I think some of the secular growth consumer companies I think can do quite well if you buy them at the right price, given how much they're beaten up. One of the areas that I'm focusing on the industrial side is companies that are levered to wage inflation; that actually benefit from wage inflation. That would be companies like ASGN or Kforce, that I own in my portfolio, that do IT staffing. My thesis is that the businesses from a headcount standpoint are going to be more resilient than the market expects. When I talk to people like the president of J.P. Morgan, they'll tell you that their spend on IT is critical to their strategy. It's not as easy as cutting back because there's the recession; they have to be investing because they have to be competitive. These companies will benefit from wage inflation, and they'll benefit from the need to increase IT spend over time.

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Glen Davidson: You typically run a very low turnover portfolio -portfolios- but it sounds like this year you've been making some changes because of interest in some areas and disinterest in others, so there's been some change.

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Steve MacMillan: A lot of the changes have been ... I always say to my analysts "make sure that you're acting and you're not reacting". A lot of these things have been put in place over the last 1 to 2 years. The changes on the utility side have been more recent. The changes in getting into cyclicals have been happening more on a kind of a gradual basis over the last year or so and the pace is accelerating as the opportunity is accelerating.

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Glen Davidson: You've got a tech component in Small Cap America that's around 16% now. Tell us about that.

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Steve MacMillan: I think when people think about small-cap technology companies they might often think about software businesses, maybe semiconductor stocks. I'm much more focused on businesses that are more in the business services, IT services side. More people-based businesses, long-term contracts, companies that can have a recurring nature to their business so you don't have really the product risk and the technological risk that goes along with it.

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Glen Davidson: Another question just came in from our viewers, don't forget to hit that button on the Q&A link, which is the biggest risks in the small-cap space right now.

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Steve MacMillan: I think the biggest risk to the small-cap space is the same risk that is happening in the broader global, all asset classes really, both debt and equity. That's really inflation and interest rates and their impact on the economy. I think the best-case scenario right now is that we go into a mild recession. That cools off consumer demand, brings down wage inflation and we have a decrease of inflation without a remarkable increase in unemployment. That would be your classic soft landing that isn't very often achieved but is the goal. The more worst-case scenario is that inflation remains persistent and that the Federal Reserve has to stay at a higher rate and, even as inflation is easing, it's not easing to the rate that's required and so, unemployment is rising but the Fed can't come to our rescue with lower interest rates, quantitative easing.

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I think in that scenario you have a continuation of compressing multiples and declining earnings. I mentioned earlier that I didn't think we were going to have a V-bottom in the market. The reason is a lot of what's happening right now is a compression in the multiples in the market because interest rates are rising; because there are now alternatives to equities in the fixed income market, so I think that, regardless of what happens with earnings, I don't think we're going to get the same valuation expansion that we've maybe had in past cycles.

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Glen Davidson: How extreme do things need to get to take the consumer to a different level and really slow down the spending that we've been seeing?

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Steve MacMillan: We've already seen it at the lowest quintile of income demographics in the United States. The reason is that lowest-income demographic spends everything they make because they don't have the ability to save because their income is so low. If you have $100 -that is your entire income- when the cost of food goes up, when the cost of fuel goes up; your only choice is to take it out of some other part of your spending. You've already seen a weakening in that consumer. The problem with the broader inflation in the economy is as you go higher up, the higher end consumer is better able to deal with that inflation and they're able to take it out of their savings without impacting consumption. Consumer savings has broadly been quite strong because of the amount of fiscal stimulus that's been in the economy over the last couple of years.

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I think what we're going to see is that we need to see unemployment start to rise more materially, but the issue right now is there's a labour shortage, and so you have to actually reduce the demand for labour just to come into equilibrium before you can get into an increasing unemployment rate. The hope in that soft landing scenario is by just reducing the excess demand for labour we can have people having lower wage inflation and then lower overall inflation without creating marked amounts of unemployment.

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Glen Davidson: Housing prices have been a comfort for people for years. That's changing. Can you talk about housing? Because that's obviously affecting how people feel about going out and spending.

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Steve MacMillan: One of the biggest differences between the Canadian housing market and the U.S. housing market is the structure of the mortgages. The mortgage market in Canada, as most people here are familiar with, are you either choose a variable rate; you choose typically a 5-year fixed rate or, if you're lucky enough, you don't have a mortgage. In Canada, that's roughly a third, a third, a third. A third of people float, a third of people are fixed and a third don't have a mortgage. In the U.S. that math is a little bit different. The typical mortgage in the U.S. is actually a 30-year mortgage. You have a mortgage that doesn't renew for 30 years unless you move. What's happened is that over the last 2 to 10 years peoples' mortgage rates have been going down and down and down. With that 30-year mortgage you can actually refinance at a lower rate if rates go down. But if rates go up, you don't have to take the higher rate. It's called convexity, it's an option that's built into them. As rates were falling, that was great. Most people have a mortgage in the U.S. that might be in the 2 or 3% range, whereas right now if you wanted to get a mortgage today, it would be 7.2%.

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What happens is you think "I've got a two-bedroom house, I'd really like a three-bedroom house but right now I have a 2 1/2% mortgage and I would have to give up that 2 1/2% mortgage and replace it with a 7 1/4 mortgage". The decision becomes "well, I'm not going to move because the cost of my monthly payment is going to be too much". What you're seeing is the number of houses on the market is going down fairly markedly and it's reducing supply. The people that do want to move have less houses to choose from, so supply and demand is actually relatively in balance. Whereas in Canada, you have enough people that have floating rate mortgages that if they want to move, they're just going to go from one floating rate mortgage -that they're probably not happy with right now- to another floating rate mortgage they're also not happy with. The market seems to be repricing on a much faster basis. I think in Toronto prices are down about 17% from February, whereas in the U.S. you haven't seen that drop in prices as of yet.

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Glen Davidson: Interesting. Let's talk about some of the companies that have been in your portfolios for quite a while. Actually, we have a question about online education, so I want to ask you about Grand Canyon education and a couple of others, but let's start with that.

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Steve MacMillan: With Grand Canyon, the stock has been relatively flat for a period of time that I'm not super happy with. One of the reasons is that one of their big programs that they offer is nursing, and you would think during a pandemic where there's a huge nursing shortage, this should be their sweet spot. One of the nuances is that the hospitals are so busy they don't have time to train new nurses. So, it's a bit of a vicious cycle. The nurses that want to become nurses, the students can't get placements and so we've seen a decline in enrolment. Now, the good news is as the hospitals are learning to kind of deal with the waves, they're creating the capacity for nurses to come back. I think you'll see an acceleration in enrolment and improvement in the multiple of that company. One of the things that was hurting them was that the economy was so strong people didn't feel the need to go back and improve their skills because there's so many jobs to be had. This would be a great example of a countercyclical business that, as the economy gets worse, it's actually better for their business.

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Glen Davidson: Cooper Industries, still in the portfolio as well.

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Steve MacMillan: Cooper is great, steady recurring business; contact lenses. There's about four companies in the world that dominate the contact lens market, very stable and recurring. One thing that they've been hurt from recently is currency. They have a mismatch between where they make their lenses and where they sell them. Tend to make them in U.S. dollars, sell them in pounds, yen, euros. With the wild swings that we've had in currencies, that's put them on the wrong side of margins. I think over time those things recalibrate through pricing, but in the short-term it's hurt margins. The revenue side, from a volume standpoint, I think remains very resilient because people continue to wear contact lenses throughout an economic recession.

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Glen Davidson: Charles River Labs has been in your portfolio for quite a while. Is that a continuing play on health care?

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Steve MacMillan: That's really a focus on development of new drugs. There's been a lot of different improvements in drug development, including things like cell and gene therapy. Charles River Labs is at the centre of that; offering pre-clinical services, helping drugs essentially come to market. They're an outsource service provider for the drug industry.

As you see large numbers of biotech companies investing in new drugs, Charles River is the company that they go to because they don't have the infrastructure to run the trials, to run the pre-clinical work. I think, as long as you believe in science, I think that the company benefits over a long period of time. Right now, what's happening is that the amount of biotech funding has gone down fairly materially because of the fall in the equity markets and the amount of risk taking. My view is that over time good drugs will get funded. I think it'll happen more at the private equity level, the venture capital level, and from large pharma acquiring and investing in a lot of these drugs.

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Glen Davidson: What is a name that we haven't talked about that you're very excited about within your portfolio that you'd like to share with our viewers?

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Steve MacMillan: I always like to talk about consumer stocks because I think that it's easy to relate to and helps people kind of understand the way I'm thinking about it. One of the newer positions in the portfolio that would be relatively small right now, but we'll be building, would be a company called Fox Factory. I think in the shorter term there's going to continue to be volatility. I'm not of the view that we've necessarily hit the bottom on the stock or the market, but I think what's interesting about it is: what they make is shocks for mountain bikes, for off-road vehicles, for ATVs. The market is really pricing it as a COVID winner. More people went out and bought mountain bikes, they've benefited from that; that is very clearly going to come back very hard the other way. Going into COVID, Fox factory was actually growing revenue 15 to 20% a year over probably 10 years.

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One of the big areas of benefit for them is ... probably a lot of you don't know this but Glen loves to drive a Ford Raptor off-road on the weekend; they would make the shocks that go in vehicles like that. Those are increasing in popularity and the demand for them is actually always above their supply before COVID, before the supply shortages, and that remains the case. As that category continues to grow within auto, they're going to benefit from that. As the growth in ATVs happens, going from a typical one-person rider to, they're called side-by-sides, that grows.

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The other big growth driver for Fox Factory that a lot of North Americans may not appreciate is the growth in electronic bikes, e-bikes. People that don't want to pedal their mountain bike up the hill are investing in e-bikes that will help pedal it up for them and, also, using them to commute to work and whatnot. This is a big growth driver, and the great thing is they're quite heavy and they need shocks. The stock has become very attractively-priced. The company has some very aggressive targets for earnings for 2025. If they hit those, the stock should do quite well. I think it's going to be an uncertain next 6 to 12 months, but I'm not looking at that time horizon. I'm looking at it in that kind of 3 to 5+ year secular growth.

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Glen Davidson: Full disclosure, it's a Jeep Wrangler that I have, and I do have Fox shocks and they're very good, so I'm glad to hear that's in your portfolio. I did not know that coming into this conversation. We have to wrap very soon, so your thoughts on where Small Cap America, given the psychology around name and the value connotation as well, where does it fit within a portfolio for our viewers?

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Steve MacMillan: I think if you look back over the last five years, the small-cap space has been a fairly material laggard versus large-cap U.S. equities. I think that the days of just buying five very large-cap stocks and watching them go up are probably behind us. You have stocks like Tesla down today. A lot of the sheen has come off a lot of these mega-cap businesses. I think that small caps are going to shine much more than they have over the last five years. Having an allocation to businesses that are niche companies that dominate their markets, that generate a lot of cash flow, that can compound over a long period of time in U.S. dollars... I think is very attractive. This reminds me a lot of the set-up coming out of the financial crisis when I took the fund over 10+ years ago and I think there's a lot of good days ahead for U.S. small-cap stocks in the Small Cap America Fund.

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Glen Davidson: That's a very compelling conclusion. Thank you very much, Steve MacMillan.

Ending: [27:12]

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