Fidelity Connects

Introducing Fidelity Global Small Cap Opportunities Fund

Chris Maludzinski, Portfolio Manager

Connor Gordon, Portfolio Manager

Dave Bushnell, 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.

Today's uncertain marketplace has highlighted the importance of investing in high-quality names, characterized by sound balance sheet structures that enable companies to weather more challenging environments.

Although some investors correlate high-quality names with large-cap companies, that isn't necessarily true. The small-cap space consists of several high-quality businesses with tremendous growth potential. In September, Fidelity launched Global Small Cap Opportunities Fund, which aims to uncover value by identifying high-quality companies that are mispriced.

Joining today's show to discuss the investment strategy behind Fidelity Global Small Cap Opportunities Fund and how investors could benefit from investing in this space are the fund's co-Portfolio Managers Connor Gordon and Chris Maludzinski. Connor and Chris join today's host Dave Bushnell, SVP Advisor Distribution.

A few key highlights include Connor and Chris noting that volatility creates dislocation, dislocation creates mispricing, which is what sets the stage for future returns. And that there is no area of the market that is more dislocated right now than global small caps. Also that over the last 10 years of experience looking at small caps, they have made a focus list of businesses they are confident in to follow closely which includes 400 stocks in North America, 150 in Europe and 50 in Asia-Pacific.

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[00:02:20]

Dave Bushnell: Let's get into the start of today's program. We're here to talk about a very exciting new mandate here at Fidelity, our new Global Small Cap Opportunities Fund, run by Connor Gordon and Chris Maludzinski. Welcome to both of you.

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Chris Maludzinski: Thanks, Dave.

[00:02:36]

Dave Bushnell: Now, we're very excited to have this mandate. We launch new products at Fidelity for lots of different reasons and this one is actually a little bit unique that both of these individuals have run this mandate for our Canadian institutional clients for just shy of three years but people like myself and many of us on sales have been bugging it all over our Head of Product and Marketing, Kelly Creelman, to say, when can we bring this product to retail for our advisor partners? We are thrilled to now have this mandate available.

Gentlemen, before I get into a line of questions, I think I speak for everybody tuning in today that there is one question that we would all have for the both of you and that is lots of turmoil in the market, lots going on. Why would I want to add small cap, global small caps, to my portfolio today? Chris, can I maybe go to you to give us your answer on that?

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Chris Maludzinski: I think it's a very exciting time to be deploying capital into the asset class. When volatility is high, prospective returns are high and when volatility is low, prospective returns are low in the asset class. Candidly, going back to early 2021 post the vaccine rally, we were really struggling to find returns. Double-digit returns were a stretch looking across the universe. Fast forward 18 months later, stocks are down and IRR is up. Looking across the landscape, we're finding a lot of good ideas with 20 to 100% upside for patient investors looking out a couple of years. We're finding it to be an extremely exciting time to be deploying capital today.

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Dave Bushnell: Connor, can we go to you for any additional comments on that?

[00:04:12]

Connor Gordon: Yeah, for sure. I think, like most people, Dave, my brokerage statements don't like volatility but when we manage the fund, volatility is amazing. Volatility creates dislocation; dislocation creates mispricing. Mispricing is what sets the stage for future returns.

I think there is no area of the market that is more dislocated right now than global small caps. As Chris mentioned there, I think we are seeing companies at stock prices that we could only have dreamed of three or four years ago. I think the key is for Chris and I to differentiate which stocks are down because they have structural problems, as you mentioned, to the external environment and which ones are situations where the baby is being thrown out with the bathwater. That's what gets us energized to wake up in the morning and put money to work for clients.

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Dave Bushnell: Perfect. Now, let me step back now with both of you. Now that we have that question out of the way, both of you are 10+ Fidelity year vets. Chris, can I go back to you? Can you maybe walk us through just very quickly how long you've been at Fidelity and perhaps a little bit about your career so far?

[00:05:14]

Chris Maludzinski: Yeah, sure. I'm actually in my 15th year at Fidelity and started off summer 2008 covering metals and mining right before the GFC and then rotated on to consumer discretionary, media and telecom, and did that for a few years. Three years after that did financials, real estate, and insurance from 2015 to 2019 before launching the Global Small Cap Pilot for the institutional channel.

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Dave Bushnell: Thanks, Chris. Connor, can we go to you?

[00:05:43]

Connor Gordon: Same thing. I've been at Fidelity for 15 years. I started as an intern back in the day. Started on the Canadian team here rotating on tech, health care, and industrials, and then I spent six years as a generalist analyst, kind of looking at everything under the sun for small caps in the U.S. but also globally, working directly for a number of the portfolio managers here with a focus on consumer tech, business services, and industrials. Basically everything outside of commodities and banks.

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Dave Bushnell: As I mentioned, your mandate on the institutional side is actually just one month shy of three-years-old. Chris, can I go back to you? You've now been running this fund for three years. What have you learned about this mandate, about the space and about how you've created such wonderful performance?

[00:06:29]

Chris Maludzinski: I guess just going back to kind of our process. The Global Small Cap Opportunities Fund is a global, go anywhere best ideas fund. We're looking for companies that are great businesses, high quality in nature, simple, predictable, generate cash, and have top tier management team.

The global universe is over 6,000 stocks and we distill this down to the highest quality companies that either have the ability to grow at above-market rates for extended periods of time or mispriced with a catalyst to unlock that value. I think the unique nature of this product is we're putting together two managers with a combined 21 years of experience as covering analysts before launching the pilot, which is extremely unique because there was no sector overlap during our analyst tenure. This gives the fund the ability to cast a wide net and really have a high level of conviction given our prior experience.

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Dave Bushnell: Connor, over to you.

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Connor Gordon: We launched this fund in November, or our institutional fund in November of '19. In that time period, it feels like we've seen multiple market regimes or market cycles, into COVID, out of COVID, into this new inflationary environment. I think the one thing that we keep coming back to is consistency, trying to drive consistent performance for clients regardless of the market, the market cycle or the market regime. I think one of the ways in which we do that is staying down the middle. We often get asked, "Are you growth? Are you value?" We're kind of neither. We are kind of core style agnostic investors. We do that by focusing on profitable, predictable, growing businesses and we kind of avoid that style bent that many investors have.

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I think if you want consistent performance, you have to avoid digging yourself big performance holes. I think growth investors we've seen since maybe the end of November '21, or even maybe going back to February of '21, have dug themselves big holes by buying unprofitable, speculative businesses, didn't generate cash flow. Prior to that, I think deep value investors may have dug themselves a hole over a very long period of time buying cheap stocks but maybe not focusing quite as much on the business quality. What we try to do is stay down the middle, profitable, predictable, growing businesses, and then we wait for them to be mispriced. That's when we act and start putting money to work.

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Dave Bushnell: Thanks for that. Maybe Conner we'll stay with you and then we'll go over to Chris. When so many Canadians hear the word small cap, the first thing that comes into your mind is, well, very, very risky and it's two people in a garage banging out a new idea, maybe with a million bucks in the bank kind of thing to fund this. Can you talk about what is a small-cap security in your product?

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Connor Gordon: In our product right now the average market cap, it changes, but right now it's roughly between 5 and $6 billion U.S. market cap. Just to put that in context, that would put you in the TSX 60. When we talk about small caps in a global context, for a lot of Canadian investors that might be a large cap or at least a mid cap. I think one of the misconceptions is, as you said, Dave, we're not buying speculative oil and gas mining companies or a tech project with a couple of guys in a garage. These are big proven businesses but ones that typically sell globally and we think have a lot of runway still left in front of them for them to become multibillion dollar market caps, not just single digit billion-dollar market caps.

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Chris Maludzinski: Just to add to that, I think it's an extremely attractive asset. Some of the attributes that make it attractive, historically it comes with faster revenue growth. It's also underfollowed. I think the average S&P company has 20 covering analysts looking at it and –correct me if I'm wrong Connor – but the average in our index is roughly 5. It's very hard for large companies to grow at above-market rates for an extended period of time just given the law of large numbers. The index has over 6,000 stocks in it, we distill that into a concentrated portfolio, 40, 80 really high-quality names.

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Dave Bushnell: Chris, I'd like to stay with you. I'd like you to, yes, discuss your process but we talk a lot here at Fidelity about the power of Fidelity, about the fact that we have offices all over the world. We have boots on ground all over the world. Can you talk about, as two small-cap managers living in Canada, how do you leverage the Fidelity ecosystem and perhaps you can incorporate that into your process? How does a stock find its way onto your radar? Who are you interacting with and what in the end makes you say, yes, I'm going to buy this security? Chris, can I stick with you for that question?

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Chris Maludzinski: Yeah, there's definitely a lot to unpack there. Our historical experience gives us kind of a huge database of companies we've followed over a long period of time that we put on a watch list and we track. They're not necessarily in the fund right now but they're on a watch list and if something changes or the price changes, for example, then that's something that we may revisit to look at, to deploy capital into. Going back to your question on the resources, Fidelity has a ton of resources, several hundred analysts scouring the globe. Given the nature of the pandemic, it's actually made it very easy to connect with them virtually. If there is something I want to look into in Australia or over in Europe, you can just shoot your colleagues a message and have a face-to-face kind of virtual meeting and really get up the curve on that security.

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I think a lot of people on this call probably know that we have a global note database. All of our historical research is published into this database. All prior analysts have published their research into this and it makes our job a lot easier because we can go into this database and really have all the historical research spanning decades and get up to speed in a very short amount of time. There's over 6,000 companies in the index. There's a lot of rocks to turn over and a database like this really makes our job a lot easier.

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Dave Bushnell: Connor, would you add anything to that?

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Connor Gordon: Yeah, Dave, as Chris said, there's roughly 6,400 companies in the global investment universe. If you put some light guardrails around that, call it $1 billion in market cap and a couple of million dollars a day in daily liquidity, it kind of gets you down to 2,500. You take some of the sectors that we don't play in, energy, materials, banks, utilities, biotech, you get down to roughly 1,500. Over time, just through experience, 10 years looking at small caps, we have that whittled down to, I would say, about a focused list of 400 stocks in North America, maybe 150 in Europe, and 50 in APAC that we know pretty well, we're confident in the quality of the business and then we follow these companies. We follow them, Chris and I, but we also then leverage more than 100 analysts around the globe reading the notes daily, trying to identify change.

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I think that's a key point that we have. We have this list of companies that we believe are high quality and then we wait for something to change, we wait for a mispricing to emerge and that's when we act. I can give you an example. A company that we had followed for a long time was a Belgian holding company. They own a big auto glass company globally. All of the sudden one day there was a note that came through and they had sold part of the company to a private equity business. That would be an example of something that triggers a change, that says, hey, we need to re-evaluate the fundamental outlook for this business. So then leveraging the network that we have at Fidelity, I dial up three analysts: our European autos analyst, our Canadian autos analyst who covered a similar business, Boyd Services here in Canada, and I speak to our U.S. analyst. Triangulating that across the globe, different geographies kind of to triangulate what is this business, who are the competitors, what is the outlook for this business in all three geographies in which they operate? That's kind of how you can zero in and really get down into the nitty-gritty details of fundamental analysis and do the valuation work to kind of come to a value for the business and then decide, is this mispriced or not? Is this going to generate excess returns for our portfolio?

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Dave Bushnell: Thank you for that. Connor, let's stay with you. Can we drill down a little bit deeper into the current portfolio, just where are you finding opportunities today? What you just said, lots of stocks you're looking at in America, a decent amount in Europe, a little bit in Canada. How would the portfolio shake out right now from a geographic basis?

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Connor Gordon: We can talk in rough terms, I think historically since launch on the institutional side we have been overweight North America at the expense of Europe, APAC and emerging markets. Obviously, that's been a good decision given the turmoil that many of those markets have seen. I'd say that's flipping. Given the dislocation, particularly in Europe, we are spending a lot of time looking at these European companies in the U.K., in continental Europe. I think that comes back to dislocation. The volatility that has been created from the war on the Ukraine, gas prices in Europe shooting through the roof. Six years later, we're still talking about Brexit. The dislocation there is what creates mispricing.

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One of the key things we want to get across to everyone on this call is we're not buying the European market or the Asian market as a whole. We're very opportunistic across sector, across geography, trying to come up with a handful of ideas. I think we've mentioned we kind of hold roughly 50 core positions across the world. We only need a handful of ideas that are really going to generate returns. I'd say we go kind of toward…moth to a flame. When there's big dislocations we definitely get interested, we roll up our sleeves and that's kind of where we're drawn to right now. European stocks where you have some of these big dislocations happening.

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Dave Bushnell: Thanks Connor. Chris, let's go back to you. We're getting some questions on things like oil, gold. Are these things that would find their way into your portfolio?

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Chris Maludzinski: Generally not. You're going back to, I guess, a prior comment on what we look for, high quality in nature, simple, predictable, and cash generative. When you throw commodity prices into the fold, they're not that predictable. I covered gold for three years and it's notoriously difficult to have high conviction on a commodity price deck. That's generally areas that we shy away from. If we do go in there, it's definitely on the higher quality side of things, maybe a royalty business or a business that sells into E&P companies, for example, like a servicer or a dealer, for example. Generally, no, and we're underweight. If you look at the track record over the last three years, if oil and gas prices are spiking or if commodity prices are going through the roof, the fund will generally have a tougher period in that kind of a macro environment just given the kind of high-quality nature of the fund.

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Dave Bushnell: Chris, I'd like to stay with you. A great next question which is, we always talk about Fidelity regardless of the portfolio manager and how many company meetings we do and to your point, all those meetings are categorized and kept so we can reference back to them. What are you hearing today? I know that probably changes by company to company and sector to sector but are there any themes that have come out of your company meetings over, say, the last month or so that have really stood out to you?

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Chris Maludzinski: Yeah, freight rates are down, they're down big. There's a lot of companies, if you look at supply chain disruption over particularly 2021 and early 2022, margins were really squeezed at a lot of high-quality companies, top line going very well, pricing power, things look great but if you look at gross margins, they were under pressure given that. We're starting to see that unwind, especially over the last month. Looking into 2023, everyone's worried about a recession, everyone's worried about nominal GDP growth and corporate revenues, but on the flip side as we see these supply chain headwinds unwind, there's going to be a big margin benefit for a lot of high-quality companies.

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Dave Bushnell: Chris, let me just stay with you for one more quick one. Conviction and cash. If the two of you were very excited, would the cash be very low? Would you raise cash if you were nervous or seeing opportunity? How would you keep those levels?

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Chris Maludzinski: We want to keep as little cash as possible. When clients put money into the fund, they're making that asset allocation call and they expect us to do the work and turn over the rocks. Ideally we'd have zero cash. There's always frictional cash here and there but we want to run, max, 5% cash.

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Dave Bushnell: Connor, I want to go back to you. You mentioned about 50 names is I think what I heard you say. Could you talk about how did the two of you figure out what goes in? Do you work together and come up with your favourite ideas? You both have a set amount of names. How is that 50 broken down between the two of you?

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Connor Gordon: The fund is kind of structured as two independent sub-portfolios. The reason we do that, we like to leverage what we call mutual collaboration, independent decision making. As Chris mentioned, or you highlighted, we have different historical backgrounds and complementary backgrounds. We both are active in consumer. I tend to spend most of my time looking at tech, industrials, business services, in addition to consumer. Chris has a little bit more expertise on the financial side. Historically, that kind of plays very complementary. When we have an idea or one of us sees a new idea and it's in someone else's wheelhouse, we can kind of quickly get up the learning curve.

For example, Chris has covered real estate. I come across a real estate name and say, hey, have you looked at this, have you seen this, does this look interesting to you? Let's work on this idea together and try and come to a conclusion there. I think that's one of the things that we really try to emphasize is that complementary background and creating nice balance in the portfolio so that we never get too far one way as far as sector exposure goes.

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Dave Bushnell: Chris, let me come back to you. I know we always talk at Fidelity that we try and ignore things like the war that's currently going on. We try and really focus on the stocks. But has that become more difficult, especially if you're getting outside of North America. How do you work with someone like him to figure out is there more risk to this stock taking into consideration the tensions over there right now?

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Chris Maludzinski: I would just put that in more of a macro bucket. The way that we think about macro, we plug it into our scenario analysis. How does this company look if commodity prices are high and interest rates are high or commodity prices are low and interest rates are low? We do a scenario analysis and that kind of creates an expected value. We can kind of look at it versus where it's currently trading. That's what I would say. In Europe in particular, Connor walked through a lot of this but when we're scouring the landscape right now, there's a lot of companies that are obviously going through a tougher time at the moment. There's been a lot of gas surcharges out there, consumer sentiment is weak, but stocks and currencies are down a ton. There are some companies that are down 70 to 80%, and these are some higher quality companies, just because capital has left. When capital leaves certain areas, IRRs go up, prospective returns go up. So, it's a very attractive geography for new capital.

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Dave Bushnell: Chris, can I stay with you? We often like to talk at Fidelity in your group, in the portfolio manager group, how it's a very close-knit group of people. You share ideas despite the fact that someone might be growth or someone might be value. Can you perhaps talk about some of the portfolio managers that you worked more closely with in your time as an analyst?

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Chris Maludzinski: Again, 15th year at Fidelity and the interesting thing is there hasn't been a lot of turnover really since I joined. I've been able to work with a number of different portfolio managers through that time period. Mark Schmehl, sat beside him and learned a ton from him — focus on change, cut losses early. If your thesis isn't working out, you know you're wrong and you just admit it and you need to move on. That's something really important that we learned from him. Dan Dupont, for example, the power of conviction, ability to stick with it no matter what the market throws at you. That's something that you can't teach and we learned a lot from him over time. Steve and Pat, focusing on quality and stability and having patience. Hugo, just being contrarian. What we just talked about in Europe, things look bad there but for new money looking out a few years, things can look quite attractive.

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Dave Bushnell: Connor, can I go to you with the same question, please?

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Connor Gordon: One of the rules of investing is know thyself. I think one of the great benefits of the Fidelity platform as an analyst is that you get to find out who you are as an investor. You get to discover your own style. You have pre-existing beliefs when you come in and start, and I think you get to figure out what works but more importantly, what works for you. You get to learn from great mentors, successful portfolio managers. I would echo the same thing. Maybe just highlight four people. Steve MacMillan, I worked for for a long time on the U.S. small-cap side, emphasis on profitability and predictability of businesses. Hugo Lavallée, I think contrarian investing. If you want to beat the market your portfolio needs to look different than the market and you need to be able to, at turning points, look through the uncertainty and take a stand.

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Dan Dupont: I, the emphasis on downside protection. You kind of asked the question earlier about risk in small-caps. When you're dealing with smaller businesses, you really need to be attuned to business risk and really go through the balance sheet and kind of find those risks and really be attuned to those things. In smaller businesses, things can go off the rails faster than they can at Johnson & Johnson, for example. Mark Schmehl, as Chris said, I think ruthless portfolio management. When you are wrong, admit you were wrong and move on. Get out and find the next best idea.

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Dave Bushnell: Chris, can we go back to you? We've got a couple of questions on valuations. How do you view those in your space?

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Chris Maludzinski: It all comes down to valuations. If you want to talk about our process, it's mispricing, so we value every single security in the fund and we try to hit low to mid-teens returns. If you look across it, we're not a value or a growth manager. People like to say growth is high P/E values, low P/E but we can find a lot of good value in traditional growth names.

It's what we talked about earlier, having the ability to look out and if you can compound capital at above market rates for an extended period of time, it's okay paying more than a market multiple for that because a 30 times P/E stock, growing at 30% starts to look very cheap in a short period of time. I guess you can bucket it as GARP. We don't want to pay too much to get that growth which should result in higher-than-average rates of return over time.

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Dave Bushnell: Chris, we're unfortunately getting somewhat close to the top of the hour here. I wanted to ask you, is there a sector or a theme right now that you're particularly excited about in the small-cap space?

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Chris Maludzinski: A point I kind of wanted to get across was where we're finding opportunities. It's interesting, the sell side is very, very slow to update their macro assumptions. FX has moved a lot, interest rates have moved a lot, so this is an area that we really are finding a lot of mispricing because when rates have moved so far in such a short period of time, the numbers are just wrong, the numbers are stale. You can find a company that their earnings power has increased dramatically and the sell side, the market, is very slow to pick that up. That's a very interesting part of the market that we're finding opportunities on.

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Dave Bushnell: Connor, same question.

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Connor Gordon: I think companies historically that have had pricing power but have had a temporary dislocation, what I would say. Prices have shot up faster than they can raise prices in a 3-to-6 month period. I think we're already seeing this. Chris mentioned freight rates rolling over, we're seeing it in other commodities. So really focusing on high-quality companies that have had pricing power where margins have been crushed in the past 12 months but we see a path to normalization if we look out 6, 12 months and the market isn't there yet.

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Dave Bushnell: Chris, as I said, we're now right at the top of the hour. Any final thoughts? Chris we'll go to you. Conner, then we'll come back, any final thoughts you would leave for the audience today?

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Chris Maludzinski: I'm excited. Like I said, 18 months ago we're coming in, turning over rocks, not a lot interesting. Now we're coming in, lots of opportunity, lots of dislocation, great time to be deploying capital.

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Dave Bushnell: Connor, would you add anything to that?

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Connor Gordon: Global, maximize the size of the opportunity set that you have in front of you. Small cap, maximize the inefficiency of the opportunity set. You combine Chris and I, two style-consistent managers, into a concentrated fund and I think we have something that's really set up to deliver consistent returns for clients over time.

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Dave Bushnell: Thank you both. I thought that was a great session. For all of our partners tuning in today, I would encourage you to speak to your sales teams. Obviously, some very compelling reasons, not just to look at small caps but to, obviously, look at this mandate and coming off a wonderful three-year track record in our institutional space.

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Thanks again, see you next time.