Fidelity Connects

Dividend Investing: Looking Ahead to 2023

Ramona Persaud, Portfolio Manager

Pamela Ritchie, Host

Announcer: Hello and welcome to FidelityConnects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

There are still a lot of question marks around inflation and earning expectations in 2023. Portfolio Manager Ramona Persaud joins us today to provide her insights on dividend investing and what she sees in store as we enter the new year.

For Canadian investors, Ramona manages Fidelity U.S. Dividend Fund and also sub-manages several mandates including Global Dividend Fund, as well as private pools.

With host Pamela Ritchie today, Ramona reflects on markets in 2022, looks at valuation in 2023, and shares which sectors and regions are currently appealing for dividend investing, among other topics.

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Pamela Ritchie: The question of valuation walking into 2023. What do investors really after a year like this perhaps need to be thinking about on the valuation front?

[00:01:41]

Ramona Persaud: Wow. That is going straight for it. I like it. The simple answer is that valuation is not obvious. The market really wants to be optimistic about, obviously, the good news of inflation subsiding. A simplistic way to look at valuation right now is let's take the S&P 500, a broad market with a lot of global businesses in there. On an earnings number that has a lot of negative revision risk. it is still a high-teens multiple of that number. I'm a conservative investor. I do really well in drawdowns. That's where the strength of the strategy is downside protection.

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Pamela Ritchie: Do you have recent numbers on that because we're coming up to the end of the year, on sort of the cap share?

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Ramona Persaud: Exactly. I'll tell you the numbers but I do really well. I tend to be more conservative, so I'm not going to be that optimistic unless valuation is obvious is where I'm going with that. So, yes, the numbers are, for tenure which is about ten years or so on this global strategy, the down capture is 81%. So, if the market goes down 1, we're only going down .8 or so and the up-capture tenure is 99%. That's a pretty widespread. So the market goes up 1, we go up .99, for instance. That's what we're trying to drive the strategy. And, typically, that's the most recent, typically, it's probably mid-90s and around 80 or low 80s. What we're really trying to do is have a very wide spread between those two outcomes as driven by the down. We want a great sort of down-capture profile which protects the downside which actually mitigates a lot of the risk which is what gets you a risk-adjusted return or information ratio around .6 for this strategy over time, so your alpha per unit of tracking error.

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What I'm trying to say is I'm not going to be really bullish on valuation the way maybe an average market participant might be today, rightfully, because I'm that kind of investor, I'm a downside protection investor, so at a high teens multiple of a number that needs to go down, which means that the multiple's actually higher than high teens, it's not obvious. That's my simple answer to valuation. There's actually an even more nuanced answer, if you'd like it.

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Pamela Ritchie: Well, as you will tell us, it's a different market. You just wonder sort of where that risk bell, perhaps, is now for investors after a very interesting, tough year in some areas. Does that bell ring louder, do you think? Maybe you don't know, I don't know.

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Ramona Persaud: You're right, you're right to acknowledge that it has been a very hard year for investors overall. Downside protection strategies have done much better. It's been a downside protection type of year. After a very long period of those strategies doing poorly, a very long period of more up-capture investors doing extremely well, and so the shift, when the market shifts from an up-capture type of market, a market that rewards the investor that has something over one in their up-capture profile and shifts to rewarding that downside protection investor, that is so painful and that's what we've seen. To me, one of the ways that you can assess the risk of that kind of shift is valuation so you, rightfully, start out with that kind of metric, that framework in this discussion.

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Valuation is risk and, perhaps, you know, there are different ways to look at it. You can look at valuation dispersions, figure out how much fear there is in the market. There's not a lot today, not a lot of fear in the market in an aggregated sense. There are different types of fear but if you aggregate it all together not a whole lot of fear. That worries me at a high-teens multiple of a number that needs to go down. If you were looking back on this year, there were points at which the stuff that has been really working for a decade just got very, very expensive no matter how you measured it and so you could have seen that as risk if you're willing to view valuation as risk. That's why someone who invests the way I do, or certainly I look for value as a gauge of where the risk is and where it isn't.

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Pamela Ritchie: Let's take a look at the macro piece, which you've been pointing to in many of your discussions there. If we just sort of go to, for instance, what the Fed said last week, every other central bank around the world too, but there

were some very hawkish statements, shall we say. The Fed's certainly talking again down the market in some way. How do you look at this? Peak inflation is past us, where do you look at the inflation story, where do you look at the rate story? Give us the macro view from your perspective.

[00:06:54]

Ramona Persaud: I'm going to go back to your last question to answer this question. I also think things that are hard to predict is also risk. The way that valuation is risk, in my framework anyway and it's totally legit that other types of successful investors invest differently and view risk differently, that's how I view risk. Another form of risk is stuff you can't predict and the "stuff" of the post GFC era, the biggest factor is interest rates. It's been a one-way direction down sort of you could argue in this entire globalization era for lots of legitimate reasons and you can argue that it accelerated, the slope steepened going down post GFC. That's risk in the sense that it's unclear that you could predict the down necessarily, you could predict the steepening of the slope and definitely hard to predict that that slope changing or even inflecting.

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Now I'm talking about second derivative and that's where we are today, that's what's caused this shift in what's being valued and what's being devalued. What I mean by that is all of a sudden an interest rate picture that is changing in a profound way on the back of inflation – inflation being the catalyst – that's hugely risky. What I'm trying to say is stuff that you can't predict is really risky and so in my mind you kind of have to wait for valuation to sort of lead you and guide you.

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This is a way to answer your macro. What worries me about the macro is that it still is based on highly ... macro, sort of definitionally is unpredictable. We've got a lot of unpredictable variables. One of the reasons that I'm not as optimistic as the market remains is that these factors that are driving the market, I view it as geometric risk, so risk that multiplies not risk that adds. That's because the level of unpredictability is higher than average. I can't quantify that. I suppose we could sit down and try but I don't think I need to quantify it.

Let's think about it. You've got war, sort of nuclear blackmail in Europe, energy security issues. You can't really predict what kind of winter you're going to get, right? Then you put that on top of energy security issues and sort of what appears to be, to a Western observer an irrational player, and I caveat it that way on purpose because a non-Western observer might see it differently, that's a lot of compounded risk. That's multiplicative risk, not additive risk in my mind. To me, that means that valuation needs to meet a sort of higher bar which is in effect a lower valuation to be interesting. That's how I think about the macro.

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You've got a lot of different types of risk that are hard to predict and when they become hard to predict, they multiply. In a way, I think I said this last time, the human brain, the typical human brain, doesn't really do geometric math especially well. We saw that with the GFC. That worries me about the macro. I didn't even mention all the risk. There's just a lot of risks that I think are multiplicative and I'm not sure we've really had a clearing, a proper clearing of that. What could be a clearing of that? People who have been heavy in NASDAQ stuff would say that we have because of the really profoundly painful derating we've seen there but we haven't had much of any systemic failure that tends to be pretty good clearing. Broad market indices have gone down but at the current valuation it's not clear that they're done going down. These are the things that are on my mind.

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Now, I need to remind you, I am a downside protection investor. This is how I'm going to sound when you've got a high-teens multiple of a number that needs to go down in terms of valuation. I fully recognize I may not be right. We may have seen the bottom already. I tend to be okay even if we've seen the bottom already because even the 99% notwithstanding, I'm more of a downside-capture investor than an upside-capture investor, so I'm okay even if we've seen the bottom already. I don't think we have.

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Pamela Ritchie: Just to sort of ask one more question into that, to some, well, Europe's had actually a pretty impressive quarter when you think about everything that you've mentioned. That said, I think there's still cheapness in other parts of the world. For instance, is that cheap enough considering the risk, that many, many, many risks, geometric risk. Is that cheap enough or is that also somewhat concerning?

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Ramona Persaud: You mean the rest of the world ex Europe?

Pamela Ritchie: Yup.

Ramona Persaud: Let's call it developing or Eastern because you could have developed in Eastern as well. There are some parts of the world, like Taiwan is really interesting. A stock like Taiwan Semi, which is the Taiwanese stock and a big stock in that part of the world, has gotten beat up for so many different reasons. It's derated significantly. I've owned that for a very, very long time. It's extremely well-run and they are responding appropriately to the shifting trading frameworks, if you will, production moving to different places because of geopolitical risk, and it's cheap. I think there are pockets of cheapness that are interesting but I don't see it overall.

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If I can go back to valuation, I think this is important and this is the nuance that I was referring to. I tried to keep it at broad market valuation on an inflated number. Let's get into it a little bit. If you look at valuation dispersion, so that's fear on earnings alone, there's a lot of dispersion around fear on earnings. What that tells you is the market, from a dispersion perspective, is trying to anticipate margin pressure because of inflation on earnings. That's 87th percentile on Denise's work, which is super high. That's encouraging, right? That gives me some pause but then when I look at that same metric on free cash flow, the market is craving free cash flow or craving quality. That's only like, I don't know, 50th percentile. That worries me in that the market is still sort of latching on to quality which says there's a measure of fear. What really worries me is that on book value, so on sort of systemic risk, so let's call book value dispersion, book value fear is a measure of fear around systemic risk, it's still in the 50s. I want to see fear on earnings and fear on going concern risk in order to get interested.

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That's why I come back to this idea, have we had enough panic? Not that I'm trying to be negative going into Christmas and all this stuff but that's the kind of investor I am and that's why the down capture is 80 and the up capture is 95 to 100. To me, when your book value dispersion is like 50 to 55th percentile, you really want to be optimistic. So you're not seeing, you, the market, you're not seeing all the places where there are landmines. That's not to say that there will be landmines. I recognize Christmas is in a few days and I don't want to talk about landmines but the way that I invest I have to think about where there could be landmines.

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Pamela Ritchie: Within the overall discussion of companies that fit into the downside-capture way of investing that you approach things, how did the dividends hold up in this kind of earnings, perhaps, overall not coming down in the way that you think might be making it look interesting? Do dividends sort of stay steady in this?

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Ramona Persaud: It depends. The quintessential answer to most questions. I am really worried ... I've, historically, through this entire [audio cuts out] years I've always been cautious of the idea of investing in high dividends for high-dividends sake. That's a little bit sacrilege because of the type of strategy I run but I've been very upfront, transparent about this, which is to say dividends are very sensitive to interest rates. The reason I've had this caution is because I'm not trying to predict interest rates. They are not very predictable even by the people who are supposed to predict them, and for good reason. There's a lot of variables going into them and a lot of competing objectives like employment versus inflation, for instance, where we are today.

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Because dividends have the sensitivity to the interest rate environment, I try to be really careful not living on the edges. The edges would be very low dividend or very high dividend and a lot of strategies that are income strategies will just go for the high dividends irrespective of things like valuation. What I've tried to do is to go for dividends where there is valuation support because that just actually compounds your alpha odds. You add valuation support to anything and your alpha odds go up a lot. What makes me extremely nervous about dividends today is if you take yields on equity versus yields on fixed income and you sort of measure that spread through time and you normalize that spread, meaning you percentile it through time, it was at a decent percentile. That's the way the kind of [audio cuts out] percentile in the last several years a lower-for-longer interest rate environment, so you could be okay taking the risk of investing in higher dividends because actually you're getting your dividends from equity versus fixed income because that spread was wide.

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Today, fixed income has gotten crushed, so the yields are higher, so that percentile today is like in the 40s. It is low. That puts higher income equities at serious ... That's another form of risk, a serious risk. It makes me even more leery of going in the direction of higher dividends because there's better alternatives elsewhere in an asset allocation world, to your point. You're not really asking that question but I actually think that this is a more important point for the people who are investing for income. You have to be careful because people can now go and get a little bit more from fixed income.

Your point about whether dividends will sustain or not depends on cash flows which depends on this scenario. The market really wants a soft landing or a mild recession. If you get that, yes, you'll get dividend sustainability. If you get my scenario, not my necessarily desired scenario but the thing I worry about of geometric risk, risks that multiply, that implies free cash flow pressure which implies dividend pressure.

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Pamela Ritchie: Tell us how...if the soft landing isn't necessarily there for the offing, which is one of the scenarios, and there is pain, how ultimately do you sort of get the growth thesis to grow out of the pain? How does that look for you, ultimately?

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Ramona Persaud: The growth thesis to grow, sorry, I keep coming back to this valuation. The only stuff I can find is here and there, a company trading at 15 times, 14 times, 13 times, there's a problem with the company and I have to be willing to ... and that's been the case for 10+ years. You have to be willing to accept some sort of damage to get a decent valuation, and that's okay. It's a more grinding way to invest but it's also fun because you get to invest in damage when nobody else wants to. You build your stomach. It would be amazing to get a normal company for 15 times earnings, 14, 13 times earnings. That's, to me, [audio cuts out] almost initially. That's how you get a price appreciation because your starting valuation is tolerable.

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To me, where we are today it's just not widespread that you can get those kinds of valuations. I still have to be willing to accept all kinds of different types of damage, which is, okay, I've done that for 10+ years, but I'd really like a market where I can pick up a 20, 25% ROE company where there's not a whole lot of doubt about the cash flow and I pay 13 to 15 times for that. That would be amazing. What would get you there is much higher interest rates.

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Pamela Ritchie: So interesting. What about if interest rates just had to stay high?

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Ramona Persaud: I don't think the market is, not that I don't think, you could mathematically prove this, that's not what the market is anticipating. The market, if you put all the pieces together the market seems to be anticipating a Fed that goes to 5 ... I'm referring to the U.S. Central Bank because a lot of the world pegs off of that. I'm not trying to be nationalistic. I'm sensitive to the audience I'm speaking to you not being a U.S. audience, a lot of the world pegs off of the Fed. The Fed goes to 5, the market seems to be anticipating that that comes off pretty quickly because inflation subsides pretty quickly so then the Fed very quickly eases off of that, which could happen.

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I get nervous when valuations imply sort of one scenario because the risk in that is inflation is stickier than we anticipate here at 17ish times, 18ish times, a high number for the market, that inflation is stickier than we anticipate, that could be very bumpy for a market at this valuation. Again, if it were at 14,15 times, different story. We could absorb a range of trajectories for inflation subsiding. Right now, I'm not sure this valuation can absorb anything but an inflation that subsides quickly.

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Pamela Ritchie: Interesting. And then precipitates cuts at an appropriate time.

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Ramona Persaud: It seems that's what the market is ... you've got to put a lot of pieces together and look at valuation ... it seems that's what we really want to happen. That would be wonderful for economies, forget markets, for jobs and all this stuff. I just worry about how many different risks are out there and how they combine. That's just me being a conservative downside protection person.

[00:22:19]

Pamela Ritchie: Again, what do you think investors might want to be thinking about? There's obviously, I don't know if you would call it regime change. There was a huge change to value investing versus growth. That was one of many stories of this year. There a lot of them. But this discussion of looking at the world through maybe an either/or lens going forward, is it as strong or clear picture to you? What muddies either/or at the moment, in your mind?

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Ramona Persaud: It is a bit reductionist, the value versus growth thing but there's nuance in everything. I'm a very nuancey person in case you guys haven't figured that out by now. I think you could argue that post-GFC and certainly 3 to 4 decades of rates going down have been really helpful to longer duration stuff and definitely post-GFC where the decrease in rates accelerated. Let's call that a rate distortion that really supported long-duration stuff and, frankly, supported so much amazing innovation across the world and definitely in America and the Western world. We can't live without all these apps now and all these services and all this stuff that has been the by-product of distortion in interest rates. I totally give it up that distortion in interest rates has not been the evil, the entire evil, that value people like to make it out to be. We all have benefited tremendously from it in the way we live our lives. Let's just make a note of that.

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If you're willing to believe that, then you could argue that there is the risk of some regime change into more normalized interest rates which potentially is a function of more sticky inflation, like the Fed really wants 2% but let's say they hang at 4 for a while and it ends up being three and it was sort of maybe zeroish before, 0 to 1. What does that mean for the interest rate picture and what does that mean for longer versus shorter duration? We probably get more balance and I'd like to think we go back to more of a stock-picking type market as opposed to a factor market. It's been a factor market for ... you had to get really good at factors in the last 10+ years. Certainly in developed markets that are highly efficient, the emphasis on factors and therefore portfolio construction, has been huge. In a market that balances out more where both ... some sort of mid duration stuff does really well, maybe that's more of a stock-picking market and that is bullish for, at least relative to the last 10 years. That's pretty positive for more valuation-oriented investing.

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Pamela Ritchie: Are there sectors or regions around the world where there are more opportunities for stronger dividends? Does the story kind of fit together in some way internationally? Dividends, what do you see there?

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Ramona Persaud: Stronger dividends ex U.S.. The U.K. has always been a really nice place to invest because you get a nice balance between capital investment and capital return, which is the essence of the question, capital return in the form of dividend. You get good quality companies that balance growth ... You get basically growth in income type stocks which is nice when you get them at good valuations.

Today in the U.K., there are quite a lot of high-quality companies with really fat dividends because they're cheap. You are getting this cheapness and quality combination. I've spent a lot of time there both literally but also thinking about investing there. When I think about places in the world that are even more interesting, the U.K. is interesting but it's caught up in all this Europe stuff. So, to me, your valuation thresholds just need to be stricter, I think, because you've got sort of compounding risk.

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As I mentioned, Taiwan, there are parts of Asia that have a lot of fear in the markets because of China, because of Chinese approach to geopolitics, Chinese approach to how the country is being run in this sort of more autocratic way, that could be really interesting to the extent we're legitimately coming out of COVID-zero.

One of the positives could be, is it possible that coming out of COVID-zero China, again, similar to 2016, pulls the world out of it. When we were getting the industrial, materials, and energy recession in late 2015, China essentially pulled the world out of it and so it ended up being a very sector-localized recession as opposed to a whole recession because China started spending again. That's one of the bull cases for coming out of COVID-zero. I'm not sure. I tend to believe it when I see it. Again, downside protection investor, not upside capture investor. There are some cheap stuff over there that is interesting to me.

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Pamela Ritchie: Cheap stuff, there's the valuation, that's how we started. That's what you think about all the time and it's sort of how you round out. Interesting just sort of looking out to 2023 as one of the things. Just to wrap it up in a bow, 2023 valuation risk, what do we need to [audio cuts out].

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Ramona Persaud: To me, it's not obvious. Maybe I'll wrap it up by talking about time with Joel because that's influenced me a lot in the 10, 20 years at Fidelity, 20 years at Fidelity, 10+ years managing diversified money, and then the last 3 to 5 years of just really tricky markets.

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Pamela Ritchie: All in one minute.

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Ramona Persaud: Joel and I went through these big, thick Value Line books. He used to work for Value Line and he keeps Value Line books. We were trying to just think through what's an analogue and we're looking at the late '60s into the '70s with inflation, even as inflation was decelerating as it is today, even the antidotes to that scenario back then were growth and quality. Even those guys derated from 20-something times to 5 to 10 times earnings, and it was a relative gain because the worst stuff derated even worse to 3 times earnings. There's no survivorship bias when you're looking at a book from the '70s or from the '80s or whatever. That was really instructive to me that there's still risk in valuation, there really is, and I'm still at the margin or way beyond the margin like defensive and quality oriented and especially if I could find that, as I mentioned in the U.K., with some valuation support I think taking a 5+ year view, even a 3+ year view, on names like that will get us a lot of alpha and certainly risk-adjusted alpha in that time frame.

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Pamela Ritchie: Ramona Persaud, you are fantastic. We wish you and your family the very best over the holiday season and see you in the new year.

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Ramona Persaud: Thank you. Nice to spend time with you. Bye.

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